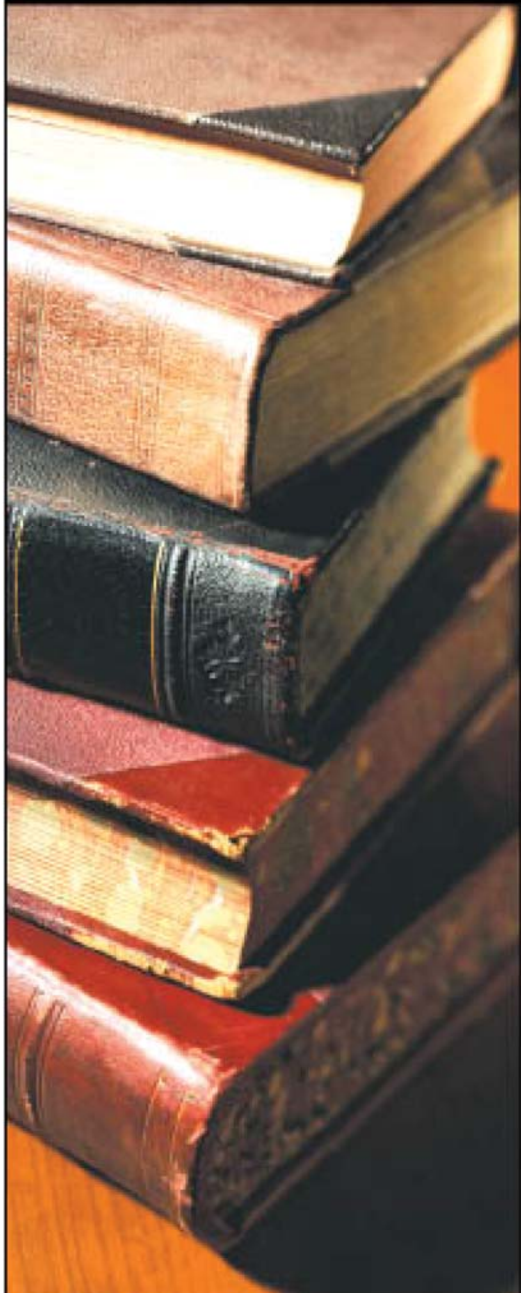
Professional Education Services, LP



Quality education offered by PES...

Individual Income Tax

Course #5300M/QAS5300M

Course Material

Professional Education Services, LP

The Professional's Choice for CPE. sm

4208 Douglas Blvd. • Suite 50 • Granite Bay, CA 95746

To Order: 1-800-998-5024 • Customer Service: 1-800-990-2731 • Fax: 916-791-4099

www.mypescpe.com • www.pescpe.com • www.pesqascpe.com • www.eacpe.com

Individual Income Tax (Course #5300M/QAS5300M)
Table of Contents

Table of Contents (cont.)

Table of Contents (cont.)

Table of Contents (cont.)

Table of Contents (cont.)

Table of Contents (cont.)

Table of Contents (cont.)

Table of Contents (cont.)

Introduction

This course is a general overview of federal income tax laws for individuals filing 2011 tax returns. It begins with the rules for filing a tax return. It explains who must file a return, which tax form to use, when the return is due, and other general information. It will help you identify which filing status you qualify for, whether you can claim any dependents, and whether the income you are receiving is taxable. The course goes on to explain the standard deduction, the kinds of expenses you may be able to deduct, and the various kinds of credits you may be able to take to reduce your tax.

Throughout the course are examples showing how the tax law applies in typical situations. Sample forms and schedules show you how to report certain items on your return. Also, throughout the course are flowcharts and tables that present tax information in an easy-to-understand manner.

We start with a section on important tax changes.

Summary of Important Tax Changes

I. Temporary Extension of Tax Relief

Two major legislative acts enacting tax cuts for individuals expired at the end of 2010: the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA); and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). The following items were signed into law on December 17, 2010, as part of the Tax Relief Act of 2010, extending many provisions from the EGTRRA and JGTRRA for an additional two years, through 2012. The Tax Relief Act of 2010 (2010 Act) also extended a number of provisions enacted as part of EGTRRA that were modified in the American Recovery and Reinvestment Act.

Tax Rates

Tax rates on ordinary income are extended to 2011 and 2012; 10%, 15%, 25%, 28%, 33%, and 35%. The 0% and 15% rates on long-term capital gains and qualified dividends also are extended through 2012.

Temporarily repeal the Personal Exemption Phase-out. Personal exemptions allow a certain amount per person to be exempt from tax. Due to the Personal Exemption Phase-out (“PEP”), the exemptions are phased out for taxpayers with AGI above a certain level. The EGTRRA repealed PEP for 2010. The 2010 Act extends the repeal of PEP for an additional two years, through 2012.

Temporarily repeal the itemized deduction limitation. Generally, taxpayers itemize deductions if the total deductions are more than the standard deduction amount. Since 1991, the amount of itemized deductions that a taxpayer may claim has been reduced, to the extent the taxpayer’s AGI is above a certain amount. This limitation is generally known as the “Pease limitation.” The EGTRRA repealed the Pease limitation on itemized deductions for 2010. The 2010 Act extends the repeal of the Pease limitation for an additional two years, though 2012.

Capital Gains and Dividends

Temporarily extend the capital gains and dividend rates. Under current law, the capital gains and dividend rates for taxpayers below the 25% bracket is equal to zero percent. For those in the 25% bracket and above, the capital gains and dividend rates are currently 15%. These rates are extended through 2012.

Child Tax Credit

Temporarily extend the modified child tax credit. Generally, taxpayers with income below certain threshold amounts may claim the child tax credit to reduce federal income tax for each qualifying child under the age of 17. The EGTRRA increased the credit from $500 to $1,000. The EGTRRA also expanded refundability. The amount that may be claimed as a refund was 15% of earnings above $10,000. The American Recovery and Reinvestment Act of 2009 provided that earnings above $3,000 would count towards refundability for 2009 and 2010. The 2010 Act extends the current child tax credit for an additional two years, through 2012.

Marriage Penalty Relief

Temporarily extend marriage penalty relief. The 2010 Act extends the marriage penalty relief for the standard deduction, the 15 percent bracket, and the EITC for an additional two years, through 2012.

Incentives for Families and Children

Temporarily extend the expanded dependent care credit. The dependent care credit allows a taxpayer a credit for an applicable percentage of child care expenses for children under 13 and disabled dependents. The EGTRRA increased the amount of eligible expenses from $2,400 for one child and $4,800 for two or more children to $3,000 and $6,000, respectively. The EGTRRA also increased the applicable percentage from 30 percent to 35 percent. The 2010 Act extends the changes to the dependent care credit made by the EGTRRA for an additional two years, through 2012.

Temporarily extend the increased adoption tax credit and the adoption assistance programs exclusion. Taxpayers that adopt children can receive a tax credit for qualified adoption expenses. A taxpayer may also exclude from income adoption expenses paid by an employer. The EGTRRA increased the credit from $5,000 ($6,000 for a special needs child) to $10,000, and provided a $10,000 income exclusion for employer-assistance programs. The Patient Protection and Affordable Care Act of 2010 extended these benefits to 2011 and made the credit refundable. The 2010 Act extends for an additional year, through 2012, the increased adoption credit amount and the exclusion for employer-assistance programs as enacted in the EGTRRA.

Temporarily extend the credit for employer expenses for child care assistance. The EGTRRA provided employers with a credit of up to $150,000 for acquiring, constructing, rehabilitating, or expanding property which is used for a child care facility. The 2010 Act extends this provision for an additional two years, through 2012.

Earned Income Tax Credit (EITC)

Temporarily extend third-child EITC. Under current law, working families with two or more children currently qualify for an earned income tax credit equal to 40% of the family's first $12,570 of earned income. The American Recovery and Reinvestment Act increased the earned income tax credit to 45% of the family's first $12,570 of earned income for families with three or more children and increased the beginning point of the phase-out range for all married couples filing a joint return (regardless of the number of children). The 2010 Act extends for an additional two years, through 2012, the American Recovery and Reinvestment Act provisions that increased the credit for families with three or more children and increased the phase-out range for all married couples filing a joint return.

Education Incentives

Temporarily extend expanded Coverdell Accounts. Coverdell Education Savings Accounts are tax-exempt savings accounts used to pay the higher education expenses of a designated beneficiary. The EGTRRA increased the annual contribution amount from $500 to $2,000 and expanded the definition of education expenses to include elementary and secondary school expenses. The 2010 Act extends the changes to Coverdell accounts for an additional two years, through 2012.

Temporarily extend the expanded exclusion for employer-provided educational assistance. An employee may exclude from gross income up to $5,250 for income and employment tax purposes per year of employer-provided education assistance. Prior to 2001, this incentive was temporary and only applied to undergraduate courses. The EGTRRA expanded this provision to graduate education and extended the provision for undergraduate and graduate education to the end of 2010. The 2010 Act extends the changes of this provision for an additional two years, through 2012.

Temporarily extend the expanded student loan interest deduction. Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses up to $2,500. Prior to 2001, this benefit was only allowed for 60 months and phased-out for taxpayers with income between $40,000 and $55,000 ($60,000 and $75,000 for joint filers). The EGTRRA eliminated the 60 month rule and increased the income phase-out to $55,000 to $70,000 ($110,000 and $140,000 for joint filers). The 2010 Act extends the changes to this provision for an additional two years, through 2012.

Temporarily extend the exclusion from income of amounts received under certain scholarship programs. Scholarships for qualified tuition and related expenses are excludible from income. Qualified tuition reductions for certain education provided to employees are also excluded. Generally, this exclusion does not apply to qualified scholarships or tuition reductions that represent payment for teaching, research, or other services. The National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program provide education awards to participants on the condition that the participants perform certain services. The EGTRRA allowed the scholarship exclusion to apply to these programs. The 2010 Act extends the changes to this provision for an additional two years, through 2012.

Temporarily extend the American Opportunity Tax Credit. Created under the American Recovery and Reinvestment Act, the American Opportunity Tax Credit is available for up to $2,500 of the cost of tuition and related expenses paid during the taxable year. Under this tax credit, taxpayers receive a tax credit based on 100% of the first $2,000 of tuition and related expenses (including course materials) paid during the taxable year and 25% of the next $2,000 of tuition and related expenses paid during the taxable year. Forty percent of the credit is refundable. This tax credit is subject to a phase-out for taxpayers with adjusted gross income in excess of $80,000 ($160,000 for married couples filing jointly). The 2010 Act extends the American Opportunity Tax Credit for an additional two years, through 2012.

II. Temporary Individual Alternative Minimum Tax (AMT) Relief

Increases the exemption amounts for 2011 to $48,450 (individuals) and $74,450 (married filing jointly). Also allows nonrefundable personal credits against the AMT.

III. Temporary Estate Tax Relief

Temporary estate, gift and generation skipping transfer tax relief. The EGTRRA phased-out the estate and generation-skipping transfer taxes so that they were fully repealed in 2010, and lowered the gift tax rate to 35 percent and increased the gift tax exemption to $1 million for 2010. The 2010 Act sets the exemption at $5 million per person and $10 million per couple and a top tax rate of 35 percent for the estate, gift, and generation skipping transfer taxes for two years, through 2012. The exemption amount is indexed beginning in 2012.

IV. Temporary Extension of Investment Incentives

Extension of bonus depreciation. Under current law, businesses are allowed to recover the cost of capital expenditures over time according to a depreciation schedule. Congress allowed businesses, beginning January 1, 2008 through December 31, 2009, to take an additional depreciation deduction allowance equal to 50 percent of the cost of the depreciable property placed in service in those years. Under the Small Business Jobs Act of 2010, this temporary increase in the depreciation deduction allowance was extended through December 31, 2010. The Tax Relief Act of 2010 extends and temporarily increases this bonus depreciation provision for investments in new business equipment. For investments placed in service after September 8, 2010 and through December 31, 2011, the Act provides for 100 percent bonus depreciation. For investments placed in service after December 31, 2011 and through December 31, 2012, the Act provides for 50 percent bonus depreciation. The 2010 Act also allows taxpayers to elect to accelerate some AMT credits in lieu of bonus depreciation for taxable years 2011 and 2012.

Temporarily extend increase in the maximum amount and phase-out threshold under section 179. Under current law, a taxpayer with a sufficiently small amount of annual investment may elect to deduct the cost of certain property placed in service for the year rather than depreciate those costs over time. The 2003 tax cuts temporarily increased the maximum dollar amount that may be deducted from $25,000 to $100,000. The tax cuts also increased the phase-out amount from $200,000 to $400,000. In 2007, tax cuts temporarily increased these thresholds to $125,000 and $500,000 respectively, indexed for inflation. These amounts have been further increased and extended several times on a temporary basis, including most recently as part of the Small Business Jobs Act which increased the thresholds to $500,000 and $2,000,000 for the taxable years beginning in 2010 and 2011. The 2010 Act extends the 2007 maximum amount and phase-out thresholds for taxable years beginning in 2012, at $125,000 and $500,000 respectively, indexed for inflation, and is effective for taxable years beginning after December 31, 2011.

V. <u>Temporary Employee Payroll Tax Cut</u>

Temporary reduction in employee-paid payroll taxes. Under current law, employees pay a 6.2 percent social security tax on all wages earned up to $106,800 (in 2011) and self-employed individuals pay a 12.4 percent social security self-employment tax on all their self-employment income up to the same threshold. The 2010 Act provides a payroll/self-employment tax holiday during 2011 of two percentage points. This means employees will pay only 4.2 percent on wages and self-employed individuals will pay only 10.4 percent on self-employment income up to the threshold.

VI. <u>Temporary Extension of Certain Expiring Provisions</u>

<u>Energy</u>

Biodiesel and renewable diesel. The 2010 Act extends through 2011 the $1.00 per gallon production tax credit for biodiesel, as well as the small agri-biodiesel producer credit of 10 cents per gallon. The Act also extends through 2011 the $1.00 per gallon production tax credit for diesel fuel created from biomass.

Refined Coal. The 2010 Act extends through 2011 the placed-in-service deadline for qualifying refined coal facilities.

Energy-efficient new homes credit. The 2010 Act extends through 2011 the credit for manufacturers of energy-efficient residential homes.

Alternative fuels credit. The 2010 Act extends through 2011 the $0.50 per gallon alternative fuel tax credit. The Act does not extend this credit to any liquid fuel derived from a pulp or paper manufacturing process (i.e., black liquor).

Special rule for sales of electric transmission property. The 2010 Act extends through 2011 the present law deferral of gain on sales of transmission property by vertically integrated electric utilities to FERC-approved independent transmission companies.

Special rule for marginal wells. The 2010 Act extends through 2011 the suspension on the taxable income limit for purposes of depleting a marginal oil or gas well.

Section 1603. The 2010 Act extends for one year the start-of-construction deadline for the cash grant in lieu of tax credit program, established in Section 1603 of the American Recovery and Reinvestment Act.

Ethanol. The 2010 Act extends through 2011 the per-gallon tax credits and outlay payments for ethanol. The Act also extends through 2011 the existing 14.27 cents per liter (54 cents per gallon) tariff on imported ethanol and the related 5.99 cents per liter (22.67 cents per gallon) tariff on ethyl tertiary-butyl ether (ETBE).

Energy-efficient appliances. The 2010 Act extends through 2011 and modifies standards for the Section 45M credit for US-based manufacture of energy-efficient clothes washers, dishwashers and refrigerators.

Energy-efficient existing homes. The 2010 Act extends through 2011 the credit under Section 25C of the Code for energy-efficient improvements to existing homes, reinstating the credit as it existed before passage of the American Recovery and Reinvestment Act. Standards for property eligible under 25C are updated to reflect improvements in energy efficiency.

Alternative vehicle refueling property. The 2010 Act extends through 2011 the 30% investment tax credit for alternative vehicle refueling property.

<u>Individual Tax Relief</u>

Above-the-line deduction for certain expenses of elementary and secondary school teachers. The 2010 Act extends for two years (through 2011) the $250 above-the-line tax deduction for teachers and other school professionals for expenses paid or incurred for books, supplies (other than non-athletic supplies for courses of instruction in health or physical education), computer equipment (including related software and service), other equipment, and supplementary materials used by the educator in the classroom.

Deduction of state and local general sales taxes. The 2010 Act extends for two years (through 2011) the election to take an itemized deduction for state and local general sales taxes in lieu of the itemized deduction permitted for state and local income taxes.

Extension of provision encouraging contributions of capital gain real property for conservation purposes. The 2010 Act extends for two years (through 2011) the increased contribution limits and carryforward period for contributions of appreciated real property (including partial interests in real property) for conservation purposes.

Above-the-line deduction for qualified tuition and related expenses. The 2010 Act extends for two years (through 2011) the above-the-line tax deduction for qualified education expenses.

Extension of tax-free distributions from individual retirement plans for charitable purposes. The 2010 Act extends for two years (through 2011) the provision that permits tax-free distributions to charity from an Individual Retirement Account (IRA) of up to $100,000 per taxpayer, per taxable year. The Act also allowed individuals to make charitable transfers during January of 2011 and treat them as if made during 2010.

Parity for mass transit benefits. The 2010 Act extends through 2011 the increase in the monthly exclusion for employer-provided transit and vanpool benefits to that of the exclusion for employer-provided parking benefits.

Refund and tax credit disregard for means tested programs. Current law ensures that the refundable components of the EITC and the Child Tax Credit do not make households ineligible for means-tested benefit programs and includes provisions stating that these tax credits do not count as income in determining eligibility (and benefit levels) in means-tested benefit programs, and also do not count as assets for specified periods of time. Without them, the receipt of a tax credit would put a substantial number of families over the income limits for these programs in the month that the tax refund is received. The 2010 Act disregards all refundable tax credits and refunds as income for means tested programs. The Act is effective for amounts received after December 31, 2009 and does not apply to amounts received after December 31, 2012.

Form 8949

Form 8949 is a new form for reporting 2011 sales (and other dispositions) of capital assets that is attached to Schedule D. After entering short-term transactions in Part I of Form 8949 and long-term transactions in Part II, the total sales price and basis amounts are transferred to Schedule D where net gain or loss is figured.

If you acquired stock in 2011 and sold it before the end of the year, the broker must report your cost basis for the securities in Box 3 of Form 1099-B. In Parts I and II of Form 8949, you must enter a code to indicate whether your basis for sold securities was reported to you by your broker in Box 3 of Form 1099-B.

SE Tax Deduction

In 2011, the tax rate for the employee share of social security is 4.2%, 2% less than for 2010, making the maximum 2011 employee social security liability $4,485.60, 4.2% of the first $106,800 of wages.

For 2011, the self-employment tax of 13.3% consists of the following two rates: 10.4% for social security (4.2% employee share and 6.2% employer share) and 2.9% for Medicare. After multiplying the net earnings by .9235, the combined 13.3% rate applies to a taxable earnings base of $106,800 or less; the 2.9% rate applies to all taxable earnings exceeding $106,800.

In prior years, 50% of the self-employment tax was the amount of the above-the-line deduction that could be claimed on Form 1040 (Line 27), but for 2011, because of the 2% reduction in the self-employment tax rate, a special computation applies, and the deduction is larger.

Standard Deduction

The standard deduction is $11,600 for married persons filing jointly or qualifying widow(er)s, $8,500 for heads of households, or $5,800 for single taxpayers or married filing separately. The additional standard deduction for being 65 or older or blind is $1,450 if single or head of household ($2,900 if 65 and blind). If married filing jointly, the additional standard deduction is $1,150 if one spouse is 65 or older or blind, $2,300 if both spouses are at least 65 (or one is 65 and blind).

IRA and Roth IRA Contribution Phaseout

For 2011, the contribution limit for traditional IRAs and Roth IRAs remains at $5,000, or $6,000 for those age 50 or older.

The deduction limit for 2011 contributions to a traditional IRA is phased out for active plan participants with modified AGI (MAGI) of over $56,000 and under $66,000 for a single person or head of household, or over $90,000 and under $110,000 for married persons filing jointly. The phaseout range is MAGI over $169,000 and under $179,000 for a spouse who is not an active plan participant and files jointly with a spouse who is an active plan participant.

The 2011 Roth IRA contribution limit is phased out for a single person or head of household with MAGI over $107,000 and under $122,000, and for married persons filing jointly with MAGI over $169,000 and under $179,000.

Revised Home Energy Credit

For 2011, the credit for energy efficient home energy improvements such as storm windows, insulation, furnaces, and water heaters is reduced to 10%, with an overall limit of $500 that is reduced by prior-year credits, plus specific property limits such as $200 for exterior windows and $150 for a furnace.

Qualified Tuition Plan Distributions

For purposes of figuring if a distribution from a qualified tuition plan (Section 529 plan) is tax free, the cost of a computer, software, and Internet access that will be used while the student is enrolled is considered a qualified expense.

Saver Credit

The adjusted gross income brackets for the 10%, 20%, and 50% credits are increased for 2011. The AGI limit for claiming a 2011 saver's credit is $28,250 for single taxpayers, $42,375 for heads of households, and $56,500 for married persons filing jointly.

Solar Energy Credit

A 30% credit is available for solar energy property, equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for) a structure, or to provide solar process heat (but not for heating a swimming pool). The previous limit for homeowners has been repealed. The 30% credit is available only for periods ending before 2017. After 2016, the credit will be 10%.

Small Business Healthcare Tax Credit

Small employers meeting certain requirements based on the size and wages of their workforce will be entitled to a tax credit for providing health insurance. The amount of the credit is based on the year.

Time Period	Amount of Credit
2010	35%
2011	35%
2012	35%
2013	35%
2014 and beyond	50%

Standard Mileage Rates

The standard mileage rate for the cost of operating your car is 51 cents a mile for all business miles driven from January 1, 2011 through June 30, 2011, and 55.5 cents from July 1, 2011 through December 31, 2011.

The standard mileage rate allowed for use of your car for medical reasons is 19 cents a mile for the first six months of 2011, and 23.5 cents for the last six months of 2011.

The standard mileage rate allowed for use of your car for moving expenses is 19 cents a mile for the first six months of 2011, and 23.5 cents for the last six months of 2011.

The rate for charitable volunteers is 14 cents per mile.

Health Coverage Exclusion Extended to Children Under Age 27

The exclusions for employer-paid health coverage and employer reimbursements of medical expenses apply to an employee's children who are under age 27 at the end of the year, regardless of whether they can be claimed as dependents by the employee.

Refundable Credit for Prior Year AMT

The refundable portion of the credit for prior-year AMT will apply through 2012. The phaseout threshold will be adjusted annually.

AMT Exemption

The AMT exemption for 2011 is $74,450 for married persons filing jointly and qualifying widow(er)s, $48,450 for single persons and heads of households, and $37,225 for married persons filing separately.

Gift Tax Annual Exclusion

The annual exclusion is $13,000 for gifts made in 2011.

Domestic Production Activities Deduction

The deductible percentage is 9% in 2011.

Additional Child Tax Credit

The child tax credit is refundable for 2011 to the extent of 15% of earned income in excess of $3,000.

Foreign Earned Income Exclusion

The maximum foreign earned income exclusion for 2011 is $92,900.

Bonus Depreciation

Bonus first-year depreciation at a 100% rate is allowed for qualified property purchased new and placed in service in 2011. If bonus depreciation is not available, first-year expensing is allowed for qualifying property up to a limit of $500,000, of which up to $250,000 may be applied to the combined cost of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. If the total cost of qualifying property placed in service during 2011 is over $2 million, the 500,000 expensing limit is reduced dollar for dollar by the cost of qualifying property exceeding $2 million.

Vehicle Depreciation Limits

The maximum depreciation deduction (including expensing) for a car placed in service in 2011 is $11,060 if bonus depreciation applies; otherwise it is $3,060. For a light truck or van, the maximum deduction is $11,260 with ($8,000) bonus depreciation, or $3,260 without the special allowance.

Key 2012 Adjustments

- Personal exemptions increase from $3,700 to $3,800.
- Annual gift exclusion remains at $13,000.
- Estate and gift tax lifetime exclusions for decedents dying during 2012 goes up from $5 million to $5.12 million.
- The elective deferral limit for employees who participate in 401(k), 403(b), or 457(b) plans increase from $16,500 to $17,000. The catch-up contribution remains at $5,500 for those age 50 and over.
- The social security base wage for 2012 will be $110,100, up from $106,800 in 2011.

INTRODUCTION – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The FICA and self-employment tax base is $106,800 for 2011.

   a) true
   b) false

2. The standard mileage rate for the cost of operating your car for medical reasons increased to 51 cents per mile for the first six months of 2011.

   a) true
   b) false

INTRODUCTION – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** These wages and self-employment earnings are subject to the 4.2% (10.4% for self-employed) social security tax.

   B: False is incorrect. This base is the same as 2010.

2. A: True is incorrect. The standard mileage rate allowed for the use of your car for medical reasons is 19 cents a mile for the first six months of 2011.

   B: False is correct. The standard mileage rate for business use of your car for the first six months of 2011 is 51 cents per mile, but the standard mileage rate for medical reasons is 19 cents per mile during this time period.

PART ONE. THE INCOME TAX RETURN

The four chapters in this part provide basic information on the tax system. They take you through the first steps of filling out a tax return -- such as deciding what your filing status is, how many exemptions you can take, and what form to file. They also discuss recordkeeping requirements, IRS e-file (electronic filing), certain penalties, and the two methods used to pay tax during the year: withholding and estimated tax.

Chapter 1: Filing Information

I. Important Changes

Who must file. Generally, the amount of income you can receive before you must file a return has been increased. See *Table 1-1, Table 1-2,* and *Table 1-3* for the specific amounts.

II. Important Reminders

For federal tax purposes, only a man and woman in legal union as husband and wife are considered married.

Installment agreement. If you cannot pay the full amount due with your return, you may ask to make monthly installment payments. See *Installment Agreement,* later, under *Amount You Owe.*

Automatic 6-month extension. Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, provides for an automatic 6-month extension. When you file Form 4868, you will get an automatic extension to file for 6 months.

Service in combat zone. You are allowed extra time to take care of your tax matters if you are a member of the Armed Forces who served in a combat zone, or if you served in the combat zone in support of the Armed Forces. See *Individuals Serving in Combat Zone,* later, under *When Do I Have To File.*

Adoption taxpayer identification number. If a child has been placed in your home for purposes of legal adoption and you will not be able to get a social security number for the child in time to file your return, you may be able to get an adoption taxpayer identification number (ATIN). For more information, see *Social Security Number,* later.

Taxpayer identification number for aliens. If you or your dependent is a nonresident or resident alien who does not have and is not eligible to get a social security number, file **Form W-7** with the IRS to apply for an Individual Taxpayer Identification Number (ITIN). For more information, see *Social Security Number,* later.

III. Introduction

This chapter discusses:

- Whether you have to file a return,
- Which form to use,
- How to file electronically,
- When, how, and where to file your return,
- What happens if you pay too little or too much tax,
- What records you should keep and how long you should keep them, and
- How you can change a return you have already filed.

IV. Do I Have To File a Return?

You must file a federal income tax return if you are a citizen or resident of the United States or a resident of Puerto Rico and you meet the filing requirements for any of the following categories that apply to you.

1) Individuals in general. (There are special rules for surviving spouses, executors, administrators, legal representatives, U.S. citizens living outside the United States, residents of Puerto Rico, and individuals with income from U.S. possessions.)
2) Dependents.
3) Child under age 19 or full-time students.
4) Self-employed persons.
5) Aliens.

The filing requirements for each category are explained in this chapter.

The filing requirements apply even if you do not owe tax.

Tip. *Even if you do not have to file a return, it may be to your advantage to do so. See Who Should File, later.*

One return. File only ***one*** federal income tax return for the year regardless of how many jobs you had, how many Forms W-2 you received, or how many states you lived in during the year.

INDIVIDUALS – IN GENERAL

If you are a U.S. citizen or resident, whether you must file a return depends on three factors:

1) Your gross income,
2) Your filing status, and
3) Your age.

To find out whether you must file, see *Table 1-1, Table 1-2,* and *Table 1-3.* Even if no table shows that you must file, you may need to file to get money back. (See *Who Should File,* later.)

Gross income. This includes all income you receive in the form of money, goods, property, and services that is not exempt from tax. It also includes income from sources outside the United States (even if you may exclude all or part of it).

Include part of your social security benefits if:

1) You were married, filing a separate return, and you lived with your spouse at any time during 2011; or

2) Half of your social security benefits plus your other gross income is more than $25,000 ($32,000 if married filing jointly).

If either (1) or (2) applies, see the instructions for Form 1040 or 1040A, or Publication 915, Social Security and Equivalent Railroad Retirement Benefits, to figure the social security benefits you must include in gross income.

Common types of income are discussed in the chapters in *Part Two* of this course.

Community income. If you are married and your permanent home is in a community property state, half of any income described by state law as community income may be considered yours. This affects your federal taxes, including whether you must file if you do not file a joint return with your spouse.

Self-employed individuals. If you are self-employed, your gross income includes the amount on line 7 of Schedule C (Form 1040), Profit or Loss From Business; line 1 of Schedule C-EZ (Form 1040), Net Profit From Business; and line 11 of Schedule F (Form 1040), Profit or Loss From Farming. See Self-Employed Persons, later, for more information about your filing requirements.

Filing status. Your filing status depends on whether you are single or married and on your family situation. Your filing status is determined on the last day of your tax year, which is December 31 for most taxpayers. See chapter 2 for an explanation of each filing status.

Age. If you are 65 or older at the end of the year, you generally can have a higher amount of gross income than other taxpayers before you must file. See *Table 1-1.* You are considered 65 on the day before your 65th birthday. For example, if your 65th birthday was on January 1, 2012, you are considered 65 for 2011.

Table 1-1. 2011 Filing Requirements for Most Taxpayers

IF your filing status is…	AND at the end of 2011 you were…*	THEN file a return if your gross income was at least…**
single	under 65	$9,500
	65 or older	$10,950
married filing jointly***	under 65 (both spouses)	$19,000
	65 or older (one spouse)	$20,150
	65 or older (both spouses)	$21,300
married filing separately	any age	$3,700
head of household	under 65	$12,200
	65 or older	$13,650
qualifying widow(er) with dependent child	under 65	$15,300
	65 or older	$16,450

* If you were born on January 1, 1947, you are considered to be age 65 at the end of 2011.

** Gross income means all income you received in the form of money, goods, property, and services that is not exempt from tax, including any income from sources outside the United States (even if you may exclude part or all of it). Do not include social security benefits unless (a) you are married filing a separate return and you lived with your spouse at any time during 2011, or (b) one-half of your social security benefits plus your other gross income is more than $25,000 ($32,000 if married filing jointly).

*** If you did not live with your spouse at the end of 2011 (or on the date your spouse died) and your gross income was at least $3,700, you must file a return regardless of your age.

Surviving Spouses, Executors, Administrators, and Legal Representatives

You must file a final return for a decedent (a person who died) if both of the following are true.

- You are the surviving spouse, executor, administrator, or legal representative.
- The decedent met the filing requirements at the date of death.

U.S. Citizens Living Outside the United States

If you are a U.S. citizen living outside the United States, you must file a return if you meet the filing requirements.

Residents of Puerto Rico

Generally, if you are a U.S. citizen and a resident of Puerto Rico, you must file a U.S. income tax return if you meet the filing requirements. This is in addition to any legal requirement you may have to file an income tax return for Puerto Rico.

If you are a resident of Puerto Rico for the entire year, gross income does not include income from sources within Puerto Rico, except for amounts received as an employee of the United States or a U.S. agency. If you receive income from Puerto Rican sources that is not subject to U.S. tax, you must reduce your standard deduction. As a result, the amount of income you must have before you are required to file a U.S. income tax return is lower than the applicable amount in *Table 1-1* or *Table 1-2.*

Individuals with Income from U.S. Possessions

If you had income from Guam, the Commonwealth of the Northern Mariana Islands, American Samoa, or the Virgin Islands, special rules may apply when determining whether you must file a U.S. federal income tax return. In addition, you may have to file a return with the individual island government.

DEPENDENTS

If you are a dependent (one who meets the dependency tests in chapter 3), see *Table 1-2* to find whether you must file a return. You also must file if your situation is described in *Table 1-3.*

Responsibility of parent. Generally, a child is responsible for filing his or her own tax return and for paying any tax on the return. But if a dependent child who must file an income tax return cannot file it for any reason, such as age, a parent, guardian, or other legally responsible person must file it for the child. If the child cannot sign the return, the parent or guardian must sign the child's name followed by the words "By (signature), parent (or guardian) for minor child."

Child's earnings. Amounts a child earns by performing services are his or her gross income. This is true even if under local law the child's parents have the right to the earnings and may actually have received them. If the child does not pay the tax due on this income, the parent is liable for the tax.

Table 1-2. **2011 Filing Requirements for Dependents**
See chapter 3 to find out if someone else can claim you as a dependent.

If your parents (or someone else) can claim you as a dependent, and any of the situations below apply to you, you must file a return. (See Table 1-3 for other situations when you must file.)

In this table, earned income includes salaries, wages, tips, and professional fees. It also includes taxable scholarship and fellowship grants. (See *Scholarships and fellowships* in chapter 12.) Unearned income includes investment-type income such as taxable interest, ordinary dividends, and capital gain distributions. It also includes unemployment compensation, taxable social security benefits, pensions, annuities, and distributions of unearned income from a trust. Gross income is the total of your earned and unearned income.

Single dependents – Were you either age 65 or older or blind?

☐ No. You must file a return if any of the following apply.

- Your unearned income was more than $950.
- Your earned income was more than $5,800.
- Your gross income was more than the larger of:
  - $950, or
  - Your earned income (up to $5,500) plus $300.

☐ Yes. You must file a return if any of the following apply.

- Your unearned income was more than $2,400 ($3,850 if 65 or older and blind).
- Your earned income was more than $7,250 ($8,700 if 65 or older and blind).
- Your gross income was more than the larger of:
  - $2,400 ($3,850 if 65 or older and blind), or
  - Your earned income (up to $5,500) plus $1,750 ($3,200 if 65 or older and blind).

Married dependents – Were you either age 65 or older or blind?

☐ No. You must file a return if any of the following apply.

- Your unearned income was more than $950.
- Your earned income was more than $5,800.
- Your gross income was at least $5 and your spouse files a separate return and itemizes deductions.
- Your gross income was more than the larger of:
  - $950, or
  - Your earned income (up to $5,500) plus $300.

☐ Yes. You must file a return if any of the following apply.

- Your unearned income was more than $2,100 ($3,250 if 65 or older and blind).
- Your earned income was more than $6,950 ($8,100 if 65 or older and blind).
- Your gross income was at least $5 and your spouse files a separate return and itemizes deductions.
- Your gross income was more than the larger of:
  - $2,100 ($3,250 if 65 or older and blind), or
  - Your earned income (up to $5,500) plus $1,450 ($2,600 if 65 or older and blind).

CERTAIN CHILDREN UNDER AGE 19 OR FULL-TIME STUDENTS

If a child's only income is interest and dividends (including capital gain distributions and Alaska Permanent Fund dividends), the child was under age 19 at the end of 2011 or was a full-time student under age 24 at the end of 2011, and certain other conditions are met, a parent can elect to include the child's income on the parent's return. If this election is made, the child does not have to file a return. See *Parent's Election to Report Child's Interest and Dividends* in chapter 31.

SELF-EMPLOYED PERSONS

You are self-employed if you:

- Carry on a trade or business as a sole proprietor,
- Are an independent contractor,
- Are a member of a partnership, or
- Are in business for yourself in any other way.

Self-employment can include work in addition to your regular full-time business activities. It also includes certain part-time work that you do at home or in addition to your regular job.

You must file a return if your gross income is at least as much as the filing requirement amount for your filing status and age (shown in *Table 1-1*). Also, you must file Form 1040 and **Schedule SE** (Form 1040), *Self-Employment Tax,* if:

1) Your net earnings from self-employment (excluding church employee income) were $400 or more.
2) You had church employee income of $108.28 or more.

Use Schedule SE (Form 1040) to figure your self-employment tax. Self-employment tax is comparable to the social security and Medicare tax withheld from an employee's wages.

Foreign governments or international organizations. If you are a U.S. citizen who works in the United States for an international organization, a foreign government, or a wholly owned instrumentality of a foreign government, and your employer is not required to withhold social security and Medicare taxes from your wages, you must include your earnings from services performed in the United States when figuring your net earnings from self-employment.

Ministers. You must include income from services you performed as a minister when figuring your net earnings from self-employment, unless you have an exemption from self-employment tax. This also applies to Christian Science practitioners and members of a religious order who have not taken a vow of poverty.

ALIENS

Your status as an alien – resident, nonresident, or dual-status – determines whether and how you must file an income tax return.

Resident alien. If you are a resident alien for the entire year, you must file a tax return following the same rules that apply to U.S. citizens.

Nonresident alien. If you are a nonresident alien, the rules and tax forms that apply to you are different from those that apply to U.S. citizens and resident aliens.

Dual-status taxpayer. If you were a resident alien for part of the tax year and a nonresident alien for the rest of the year, you are a dual-status taxpayer. Different rules apply for each part of the year.

WHO SHOULD FILE

Even if you do not have to file, you should file a federal income tax return to get money back if any of the following conditions apply.

1) You had federal income tax withheld from your pay.
2) You qualify for the earned income credit. See chapter 36 for more information.
3) You qualify for the additional child tax credit. See chapter 34 for more information.
4) You qualify for the health coverage tax credit. See chapter 37 for more information.
5) You qualify for the refundable credit for prior year minimum tax. See chapter 37 for more information.
6) You qualify for the refundable American opportunity credit. See chapter 35 for more information.

Table 1-3. Other Situations When You Must File a 2011 Return

If any of the four conditions listed below apply, you must file a return, even if your income is less than the amount shown in Table 1-1 or Table 1-2.

1. You owe any special taxes, such as:

- Social security or Medicare tax on tips you did not report to your employer. (See chapter 6.)
- Social security or Medicare tax on wages you received from an employer who did not withhold these taxes.
- Uncollected social security, Medicare, or railroad retirement tax on tips you reported to your employer. (See chapter 6.)
- Uncollected social security, Medicare, or railroad retirement tax on your group-term life insurance. This amount should be shown in box 12 of your Form W-2.
- Alternative minimum tax. (See chapter 30.)
- Additional tax on a qualified retirement plan, including an individual retirement arrangement (IRA). (See chapter 17.)
- Additional tax on an Archer MSA or health savings account.
- Additional tax on a Coverdell ESA or qualified tuition program.
- Recapture of an investment credit or a low-income housing credit. (See the instructions for Form 4255, Recapture of Investment Credit, or Form 8611, Recapture of Low-Income Housing Credit.)
- Recapture tax on the disposition of a home purchased with a federally-subsidized mortgage. (See chapter 15.)
- Recapture of the qualified electric vehicle credit. (See chapter 37.)
- Recapture of an education credit. (See chapter 35.)
- Recapture of the Indian employment credit. (See the instructions for Form 8845, Indian Employment Credit.)
- Recapture of the new markets credit. (See Form 8874, New Markets Credit.)
- Recapture of alternative motor vehicle credit.
- Household employment taxes

2. You received any advance earned income credit (EIC) payments from your employer. This amount should be shown in box 9 of your Form W-2. (See chapter 36.)
3. You had net earnings from self-employment of at least $400. (See *Self-Employed Persons* earlier in this chapter.)
4. You had wages of $108.28 or more from a church or qualified church-controlled organization that is exempt from employer social security and Medicare taxes.

V. Which Form Should I Use?

You must use one of three forms to file your return: Form 1040EZ, Form 1040A, or Form 1040.

FORM 1040EZ

You can use Form 1040EZ if all of the following apply.

1) Your filing status is single or married filing jointly. If you were a nonresident alien at any time in 2011, your filing status must be married filing jointly.
2) You (and your spouse if married filing a joint return) were under age 65 and not blind at the end of 2011. If you were born on January 1, 1947, you are considered to be age 65 at the end of 2011.
3) You do not claim any dependents.
4) Your taxable income is less than $100,000.
5) Your income is ***only*** from wages, salaries, tips, unemployment compensation, Alaska Permanent Fund dividends, taxable scholarship and fellowship grants, and taxable interest of $1,500 or less.
6) You did not receive any advance earned income credit (EIC) payments.
7) You do not claim any adjustments to income, such as a deduction for IRA contributions or student loan interest.
8) You do not claim any credits other than the earned income credit or the making work pay credit.
9) You do not owe any household employment taxes on wages you paid to a household employee.
10) You are not claiming the additional standard deduction for real estate taxes, taxes on the purchase of a new motor vehicle, or disaster losses.

You must meet all of these requirements to use Form 1040EZ. If you do not, you must use Form 1040A or Form 1040.

Figuring tax. On Form 1040EZ, you can only use the tax table to figure your tax. You cannot use Form 1040EZ to report any other tax.

FORM 1040A

You can use Form 1040A if all of the following apply.

1) Your income is ***only*** from wages, salaries, tips, IRA distributions, pensions and annuities, taxable social security and railroad retirement benefits, taxable scholarship and fellowship grants, interest, ordinary dividends (including Alaska Permanent Fund dividends), capital gain distributions, and unemployment compensation.
2) Your taxable income is less than $100,000.
3) Your adjustments to income are for only the following items.
   a) Educator expenses.
   b) IRA deduction.
   c) Student loan interest deduction.
   d) Tuition and fees deduction.
4) You do not itemize your deductions.

5) Your taxes are from only the following items.
    a) Tax Table.
    b) Alternative minimum tax. (See chapter 30.)
    c) Advance earned income credit (EIC) payments, if you received any. (See chapter 36.)
    d) Recapture of an education credit. (See chapter 35.)
    e) Form 8615, *Tax for Children Who Have Investment Income of More Than $1,900.*
    f) Qualified Dividends and Capital Gain Tax Worksheet.
6) You claim only the following credits.
    a) The credit for child and dependent care expenses. (See chapter 32.)
    b) The credit for the elderly or the disabled. (See chapter 33.)
    c) The child tax credit. (See chapter 34.)
    d) The additional child tax credit. (See chapter 34.)
    e) The education credits, including the refundable American opportunity credit. (See chapter 35.)
    f) The retirement savings contributions credit. (See chapter 37.)
    g) The earned income credit. (See chapter 36.)
7) You did not have an alternative minimum tax adjustment on stock you acquired from the exercise of an incentive stock option.

You must meet all of the above requirements to use Form 1040A. If you do not, you must use Form 1040.

If you meet the above requirements, you can use Form 1040A even if you received employer-provided dependent care benefits, or claim the additional standard deduction for real estate taxes paid or for taxes on the purchase of a new motor vehicle.

FORM 1040

If you cannot use Form 1040EZ or Form 1040A, you must use Form 1040. You can use Form 1040 to report all types of income, deductions, and credits.

You may have received Form 1040A or Form 1040EZ in the mail because of the return you filed last year. If your situation has changed this year, it may be to your advantage to file Form 1040 instead. You may pay less tax by filing Form 1040 because you can take itemized deductions and some adjustments to income and credits you cannot take on Form 1040A or Form 1040EZ.

You must use Form 1040 if any of the following apply.

1) Your taxable income is $100,000 or more.
2) You itemize your deductions.
3) You had income that cannot be reported on Form 1040EZ or Form 1040A, including tax-exempt interest from private activity bonds issued after August 7, 1986.
4) You claim any adjustments to gross income other than the adjustments listed earlier under *Form 1040A*.
5) Your Form W-2, box 12, shows uncollected employee tax (social security and Medicare tax) on tips (see chapter 6) or group-term life insurance (see chapter 5).
6) You received $20 or more in tips in any one month and did not report all of them to your employer. (See chapter 6.)

7) You were a bona fide resident of Puerto Rico and exclude income from sources in Puerto Rico.
8) You claim any credits other than the credits listed earlier under *Form 1040A*.
9) You owe the excise tax on insider stock compensation from an expatriated corporation.
10) Your Form W-2 shows an amount in box 12 with a code z.
11) You had a qualified health savings account funding distribution from your IRA.
12) You are an employee and your employer did not withhold social security and Medicare tax.
13) You have to file other forms with your return to report certain exclusions, taxes, or transactions.
14) You are a debtor in a bankruptcy case filed after October 16, 2005.
15) You have a net disaster loss attributable to a federally declared disaster, even if you are claiming the standard deduction.

VI. Does My Return Have to Be on Paper?

IRS *E-FILE*

Per the IRS, using *e-file* does not affect your chances of an IRS examination of your return.

Table 1-4. Benefits of IRS *e-file*

- Free File allows qualified taxpayers to prepare and *e-file* their own tax returns for free.
- Free File is available in English and Spanish.
- Free File is available online 24 hours a day, 7 days a week.
- Get your refund faster than paper filers do, in as little as 10 days with Direct Deposit.
- Sign electronically with a secure self-selected PIN number and file a completely paperless return.
- Receive an e-mailed proof of receipt within 48 hours after the IRS receives your return.
- If you owe, you can *e-file* and authorize an electronic funds withdrawal or pay by credit card. You can also file a return early and pay the amount you owe later.
- Save time by preparing and e-filing federal and state returns together.
- IRS computers quickly and automatically check for errors or other missing information.
- Help the environment, use less paper, and save taxpayer money – it costs less to process an e-filed return than a paper return.

Electronic signatures. Paperless filing is easier than you think and it's available to most taxpayers who file electronically – including those first-time filers who were 16 or older at the end of 2011. If you file electronically using tax preparation software or a tax professional, you may be able to participate in the Self-Select PIN (personal identification number) program. If you are married filing jointly, you and your spouse will each need to create a PIN and enter these PINs as your electronic signatures.

State returns. In most states, you can file an electronic state return simultaneously with your federal return. For more information, check with your local IRS office, state tax agency, tax professional, or the IRS web site at **www.irs.gov/efile**.

Refunds. You can have a refund check mailed to you, or you can have your refund deposited directly to your checking or savings account, or split among two or three accounts.

With *e-file,* your refund will be issued faster than if you filed on paper.

See *How to Pay,* later, for information on how to pay the balance due.

VII. When Do I Have to File?

Table 1-5. When To File Your 2011 Return
For U.S. citizens and residents who file returns on a calendar year.

	For Most Taxpayers	For Certain Taxpayers Outside the U.S.
No extension requested	April 17, 2012	June 15, 2012
Automatic extension Form 4868 filed, or credit card payment made	October 15, 2012	October 15, 2012

Filing on time. Your paper return is filed on time if it is mailed in an envelope that is properly addressed and postmarked by the due date. The envelope must have enough postage. If you send your return by registered mail, the date of the registration is the postmark date. The registration is evidence that the return was delivered. If you send a return by certified mail and have your receipt postmarked by a postal employee, the date on the receipt is the postmark date. The postmarked certified mail receipt is evidence that the return was delivered.

Private delivery services. If you use a private delivery service designated by the IRS to send your return, the postmark date generally is the date the private delivery service records in its database or marks on the mailing label. The private delivery service can tell you how to get written proof of this date.

The following are designated private delivery services.

- DHL Express (DHL): Same Day Service.
- Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2Day, FedEx International Priority, and FedEx International First.
- United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M, UPS Worldwide Express Plus, and UPS Worldwide Express.

Caution. *Private delivery services cannot deliver items to P.O. boxes. You must use the U.S. Postal Service to mail any item to an IRS P.O. box address.*

Electronically filed returns. If you use IRS *e-file,* your return is considered filed on time if the authorized electronic return transmitter postmarks the transmission by the due date. An authorized electronic return transmitter is a participant in the IRS *e-file* program that transmits electronic tax return information directly to the IRS.

The electronic postmark is a record of when the authorized electronic return transmitter received the transmission of your electronically filed return on its host system. The date and time in your time zone controls whether your electronically filed return is timely.

Filing late. If you do not file your return by the due date, you may have to pay a failure-to-file penalty and interest. For more information, see *Penalties,* later. Also see *Interest* under *Amount You Owe.*

If you were due a refund but you did not file a return, you generally must file within 3 years from the date the return was originally due to get that refund.

Nonresident alien. If you are a nonresident alien and earn wages subject to U.S. income tax withholding that are in excess of the amount of one personal exemption, your 2011 U.S. income tax return (Form 1040NR or Form 1040NR-EZ) is due by:

- April 17, 2012, if you use a calendar year, or
- The 15th day of the 4th month after the end of your fiscal year if you use a fiscal year.

If you do not earn wages subject to U.S. income tax withholding, your return is due by:

- June 15, 2012, if you use a calendar year, or
- The 15th day of the 6th month after the end of your fiscal year, if you use a fiscal year.

Filing for a decedent. If you must file a final income tax return for a taxpayer who died during the year (a decedent), the return is due by the 15th day of the 4th month after the end of the decedent's normal tax year. In most cases, for a 2011 return, this will be April 17, 2012.

EXTENSIONS OF TIME TO FILE

You may be able to get an extension of time to file your return. Special rules apply if you were:

- Outside the United States, or
- Serving in a combat zone.

Automatic extension

If you cannot file your 2011 return by the due date, you may be able to get an automatic 6-month extension of time to file.

Example. If your return is due on April 17, 2012, you will have until October 15, 2012, to file.

Caution. *If you do not pay the tax due by the regular due date (generally, April 15), you will owe interest. You may also be charged penalties, discussed later.*

How to get the automatic extension. You can get the automatic extension by:

1) Using IRS *e-file* (electronic filing), or
2) Filing a paper form.

***E-file* options.** There are two ways you can use *e-file* to get an extension of time to file.

Complete **Form 4868**, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return,* to use as a worksheet. If you think you may owe tax when you file your return, use *Part II* of the form to estimate your balance due. If you *e-file* Form 4868 to the IRS, do not also send a paper Form 4868.

***E-file* using your personal computer.** You can file Form 4868 electronically. You will need to provide certain information from your tax return for 2010.

***E-file* and pay by credit card.** You can get an extension by paying part or all of your estimate of tax due by using a credit card. You can do this by phone or over the Internet. You do not file Form 4868. See *Payment by credit card,* under *How to Pay,* later in this chapter.

Filing a paper Form 4868. You can get an extension of time to file by filing a paper Form 4868. Mail it to the address shown in the form instructions.

If you want to make a payment with the form, make your check or money order payable to the "United States Treasury." Write your social security number, daytime phone number, and "2011 Form 4868" on your check or money order.

When to file. You must request the automatic extension by the due date for your return. You can file your return any time before the 6-month extension period ends.

When you file your return. Enter any payment you made related to the extension of time to file on line 68, Form 1040. If you file Form 1040EZ or Form 1040A, include that payment in your total payments on line 10 of Form 1040EZ or line 44 of Form 1040A. Also enter "Form 4868" and the amount paid in the space to the left of line 10 or line 44.

Individuals Outside the United States

You are allowed an automatic 2-month extension (until June 15, 2012, if you use the calendar year) to file your 2011 return and pay any federal income tax due if:

1) You are a U.S. citizen or resident, and
2) On the due date of your return:
    a) You are living outside of the United States and Puerto Rico, and your main place of business or post of duty is outside the United States and Puerto Rico, ***or***
    b) You are in military or naval service on duty outside the United States and Puerto Rico.

However, if you pay the tax due after the due date (generally, April 15), interest will be charged from that date until the date the tax is paid.

Married taxpayers. If you file a joint return, only one spouse has to qualify for this automatic extension. If you and your spouse file separate returns, this automatic extension applies only to the spouse who qualifies.

How to get the extension. To use this special automatic extension, you must attach a statement to your return explaining what situation qualified you for the extension. (See the situations listed under (2), earlier.)

Extensions beyond 2 months. If you cannot file your return within the automatic 2-month extension period, you may be able to get an additional 4-month extension, for a total of 6 months. Generally, you must file a paper Form 4868 by the end of the automatic extension period (usually June 15) to get this additional 4-month extension. Check the box on line 8 of Form 4868.

This additional 4-month extension of time to file is ***not*** an extension of time to pay. You can use a credit or debit card to pay your estimate of tax due. See *How To Pay*, later in this chapter.

No further extension. An extension of more than 6 months will generally not be granted. However, if you are outside the United States and meet certain tests, you may be granted a longer extension.

Individuals Serving in Combat Zone

The deadline for filing your tax return, paying any tax you may owe, and filing a claim for refund is automatically extended if you serve in a combat zone. This applies to members of the Armed Forces, as well as Red Cross personnel, accredited correspondents, and civilians under the direction of the Armed Forces in support of the Armed Forces.

Combat zone. For purposes of the automatic extension, the term "combat zone" includes the following areas.

1) The Persian Gulf Area, since January 17, 1991.
2) The qualified hazardous duty area of the Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, and the Ionian Sea north of the 39th parallel, effective March 24, 1999.
3) Afghanistan, effective September 19, 2001.

Extension period. The deadline for filing your return, paying any tax due, and filing a claim for refund is extended for at least 180 days after the later of:

1) The last day you are in a combat zone (or the last day the area qualifies as a combat zone), or
2) The last day of any continuous qualified hospitalization for injury from service in the combat zone.

In addition to the 180 days, your deadline is also extended by the number of days you had left to take action with the IRS when you entered the combat zone. For example, you have 3 1/2 months (January 1 - April 15) to file your tax return. Any days left in this period when you entered the combat zone (or the entire 3 1/2 months if you entered it before the beginning of the year) are added to the 180 days.

VIII. <u>How Do I Prepare My Return?</u>

Substitute tax forms. You cannot use your own version of a tax form unless it meets the requirements explained in Publication 1167, *General Rules and Specifications for Substitute Forms and Schedules.*

Form W-2. If you are an employee, you should receive Form W-2 from your employer. You will need the information from this form before you prepare your return. See *Form W-2* under *Credit for Withholding and Estimated Tax* in chapter 4.

If you do not receive Form W-2 by February 1, 2012, contact your employer. If you still do not get the form by February 15, the IRS can help you by requesting the form from your employer. When you request IRS help, be prepared to provide the following.

- Your name, address (including zip code), and phone number.
- Your social security number.
- Your dates of employment.
- Your employer's name, address (including zip code), and phone number.

Form 1099. If you received certain types of income, you may receive a Form 1099. For example, if you received taxable interest of $10 or more, the payer generally must give you a Form 1099. If you have not received it by Feburary 1, 2012, contact the payer. If you still do not get the form by February 15, call the IRS for help.

<u>WHEN DO I REPORT MY INCOME AND EXPENSES?</u>

You must figure your taxable income on the basis of a tax year. A "tax year" is an annual accounting period used for keeping records and reporting income and expenses. You must account for your income and expenses in a way that clearly shows your taxable income. The way you do this is called an accounting method. This section explains which accounting periods and methods you can use.

Accounting Periods

Most individual tax returns cover a ***calendar year*** – the 12 months from January 1 through December 31. If you do not use a calendar year, your accounting period is a ***fiscal year.*** A regular fiscal year is a 12-month period that ends on the last day of any month except December. A 52-53 week fiscal year varies from 52 to 53 weeks and always ends on the same day of the week.

You choose your accounting period (tax year) when you file your first income tax return. It cannot be longer than 12 months.

Accounting Methods

Your accounting method is the way you account for your income and expenses. Most taxpayers use either the cash method or an accrual method. You choose a method when you file your first income tax return. If you want to change your accounting method after that, you generally must get IRS approval.

Cash method. If you use this method, report all items of income in the year in which you actually or constructively receive them. Deduct all expenses in the year you actually pay them. This is the method most individual taxpayers use.

Constructive receipt. You constructively receive income when it is credited to your account or set apart in any way that makes it available to you. You do not need to have physical possession of it. For example, interest credited to your bank account on December 31, 2011, is taxable income to you in 2011 if you could have withdrawn it in 2011 (even if the amount is not entered in your passbook or withdrawn until 2012).

Garnisheed wages. If your employer uses your wages to pay your debts, or if your wages are attached or garnisheed, the full amount is constructively received by you. You must include these wages in income for the year you would have received them.

Debts paid for you. If another person cancels or pays your debts (but not as a gift or loan), you have constructively received the amount and generally must include it in your gross income for the year. See *Canceled Debts* in chapter 12 for more information.

Payment to third party. If a third party is paid income from property you own, you have constructively received the income. It is the same as if you had actually received the income and paid it to the third party.

Payment to an agent. Income an agent receives for you is income you constructively received in the year the agent receives it. If you indicate in a contract that your income is to be paid to another person, you must include the amount in your gross income when the other person receives it.

Check received or available. A valid check you received or that was made available to you before the end of the tax year is constructively received by you in that year, even if you do not cash the check or deposit it in your account until the next year.

No constructive receipt. There may be facts to show that you did not constructively receive income.

Example. Alice Johnson, a teacher, agreed to her school board's condition that, in her absence, she would receive only the difference between her regular salary and the salary of a substitute teacher hired by the school board. Therefore, Alice did not constructively receive the amount by which her salary was reduced to pay the substitute teacher.

Accrual method. If you use an accrual method, you generally report income when you earn it, rather than when you receive it. You generally deduct your expenses when you incur them, rather than when you pay them.

Income paid in advance. An advance payment of income is generally included in gross income in the year you receive it. Your method of accounting does not matter as long as the income is available to you. An advance payment may include rent or interest you receive in advance and pay for services you will perform later.

A limited deferral until the next tax year may be allowed for certain advance payments.

SOCIAL SECURITY NUMBER

You must enter your social security number (SSN) in the space provided on your return. Be sure the SSN on your return is the same as the SSN on your social security card. If you are married, enter the SSNs for both you and your spouse, whether you file jointly or separately.

If you are filing a joint return, write the SSNs in the same order as the names. Please use this same order in submitting other forms and documents to the IRS.

Name change. If you changed your name because of marriage, divorce, etc., immediately notify your Social Security Administration (SSA) office so the name on your tax return is the same as the one the SSA has on its records. This may prevent delays in issuing your refund and safeguard your future social security benefits.

Dependent's social security number. You must provide the SSN of each dependent you claim, regardless of the dependent's age. This requirement applies to ***all dependents*** (not just your children) claimed on your tax return.

Exception. If your child was born and died in 2011 and you do not have an SSN for the child, you may attach a copy of the child's birth certificate instead. If you do, enter "DIED" in column 2 of line 6c. (Form 1040 or 1040A).

No social security number. File **Form SS-5** with your local SSA office to get an SSN for yourself or your dependent. It usually takes about 2 weeks to get an SSN. If you or your dependent is not eligible for an SSN, see *Individual taxpayer identification number,* later.

If you are a U.S. citizen or resident alien, you must show proof of age, identity, and citizenship with your Form SS-5. If you are 12 or older and you have never been assigned an SSN, you must appear in person with this proof at an SSA office.

Form SS-5 is available at any SSA office. If you have any questions about which documents you can use as proof of age, identity, or citizenship, contact your SSA office.

If your dependent does not have an SSN by the time your return is due, you may want to ask for an extension of time to file, as explained earlier under *When Do I Have To File.*

If you do not provide a required SSN or if you provide an incorrect SSN, your tax may be increased and any refund may be reduced.

Adoption taxpayer identification number (ATIN). If you are in the process of adopting a child who is a U.S. citizen or resident and cannot get an SSN for the child until the adoption is final, you can apply for an ATIN to use instead of an SSN.

File **Form W-7A** with the IRS to get an ATIN if all of the following are true.

- You have a child living with you who was placed in your home for legal adoption.
- You cannot get the child’s existing SSN even though you have made a reasonable attempt to get it from the birth parents, the placement agency, and other persons.
- You cannot get an SSN for the child from the SSA because, for example, the adoption is not final.
- You are eligible to claim the child as a dependent on your tax return.

After the adoption is final, you must apply for an SSN for the child. You cannot continue using the ATIN. See Form W-7A for more information.

Nonresident alien spouse. If your spouse is a nonresident alien, your spouse must have either an SSN or an ITIN if:

- You file a joint return,
- You file a separate return and claim an exemption for your spouse, or
- Your spouse is filing a separate return.

If your spouse is not eligible for an SSN, see the next discussion.

Individual taxpayer identification number (ITIN). The IRS will issue you an ITIN if you are a nonresident or resident alien and you do not have and are not eligible to get an SSN. To apply for an ITIN, file **Form W-7** with the IRS. It usually takes about 6 weeks to get an ITIN. Enter this number on your tax return wherever your SSN is requested.

Caution. *An ITIN is for tax use only. It does not entitle you or your dependent to social security benefits or change the employment or immigration status of either of you under U.S. law.*

Penalty for not providing social security number. If you do not include your SSN or the SSN of your spouse or dependent as required, you may have to pay a penalty. See the discussion on *Penalties,* later, for more information.

SSN on correspondence. If you write to the IRS about your tax account, be sure to include your SSN (and the name and SSN of your spouse, if you filed a joint return) in your correspondence. Because your SSN is used to identify your account, this helps the IRS respond to your correspondence promptly.

ATTACHMENTS

Depending on the form you file and the items reported on your return, you may have to complete additional schedules and forms and attach them to your return.

Tip. *You may be able to file a paperless return using IRS e-file. There's nothing to sign, attach, or mail, not even your Forms W-2.*

Form W-2. Form W-2 is a statement from your employer of wages and other compensation paid to you and taxes withheld from your pay. You should have a Form W-2 from each employer. Be sure to attach a copy of Form W-2 in the place indicated on the front page of your return. Attach it only to the front page of your return, not to any attachments. For more information, see *Form W-2* in chapter 4.

If you received a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., showing federal income tax withheld, attach a copy of that form in the place indicated on the front page of your return.

Form 1040EZ. There are no additional schedules to file with Form 1040EZ.

Form 1040A. Attach the additional schedules and forms that you had to complete behind the Form 1040A in order by number. If you are filing Schedule EIC, put it last. Do not attach items unless required to do so.

Form 1040. Attach any forms and schedules behind Form 1040 in order of the "Attachment Sequence Number" shown in the upper right corner of the form or schedule. Then arrange all other statements or attachments in the same order as the forms and schedules they relate to and attach them last. Do not attach items unless required to do so.

THIRD PARTY DESIGNEE

You can authorize the IRS to discuss your return with a friend, family member, or any other person you choose. If you check the "Yes" box in the third party designee area of your 2011 tax return and provide the information required, you are authorizing:

1) The IRS to call the designee to answer any questions that arise during the processing of your return, and
2) The designee to:
   a) Give information that is missing from your return to the IRS,
   b) Call the IRS for information about the processing of your return or the status of your refund or payments,
   c) Receive copies of notices or transcripts related to your return, upon request, and
   d) Respond to certain IRS notices about math errors, offsets (see *Refunds*, later), and return preparation.

The authorization will automatically end no later than the due date (without any extensions) for filing your 2012 tax return. This is April 15, 2013, for most people. See your form instructions for more information.

SIGNATURES

When someone can sign for you. You can appoint an agent to sign your return if you are:

1) Unable to sign the return because of disease or injury,
2) Absent from the United States for a continuous period of at least 60 days before the due date for filing your return, or
3) Given permission to do so by the IRS office in your area.

Power of attorney. A return signed by an agent in any of these cases must have a power of attorney (POA) attached that authorizes the agent to sign for you. You can use a POA that states that the agent is granted authority to sign the return, or you can use **Form 2848**, *Power of Attorney and Declaration of Representative.* Part I of Form 2848 must state that the agent is granted authority to sign the return.

Unable to sign. If the taxpayer is mentally incompetent and cannot sign the return, it must be signed by a court-appointed representative who can act for the taxpayer.

If the taxpayer is mentally competent but physically unable to sign the return or POA, a valid "signature" is defined under state law. It can be anything that clearly indicates the taxpayer's intent to sign. For example, the taxpayer's "X" with the signatures of two witnesses might be considered a valid signature under a state's law.

Spouse unable to sign. If your spouse is unable to sign for any reason, see *Signing a joint return* in chapter 2.

Child's return. If a child has to file a tax return but cannot sign the return, the child's parent, guardian, or another legally responsible person must sign the child's name, followed by the words "By (signature), parent (or guardian) for minor child."

REFUNDS

When you complete your return, you will determine if you paid more income tax than you owed. If so, you can get a refund of the amount you overpaid or, if you file Form 1040 or Form 1040A, you can choose to apply all or part of the overpayment to your next year's (2012) estimated tax. You cannot have your overpayment applied to your 2012 estimated tax if you file Form 1040EZ.

Caution. *If you choose to have a 2011 overpayment applied to your 2012 estimated tax, you cannot change your mind and have any of it refunded to you after the due date of your 2011 return.*

Follow the form instructions to complete the entries to claim your refund and/or to apply your overpayment to your 2012 estimated tax.

Direct Deposit. Instead of getting a paper check, you may be able to have your refund deposited directly into your account at a bank or other financial institution. Follow the form instructions to request Direct Deposit.

If the Direct Deposit cannot be done, the IRS will send a check instead.

Joint return and injured spouse. When a joint return is filed and only one spouse owes a past-due amount, the other spouse can be considered an ***injured spouse.*** An injured spouse should file Form 8379, *Injured Spouse Allocation*, if both of the following apply and the spouse wants a refund of his or her share of the overpayment shown on the joint return.

1) You are not legally obligated to pay the past-due amount.
2) You made and reported tax payments (such as federal income tax withheld from your wages or estimated tax payments), or claimed a refundable tax credit (such as the earned income credit or additional child tax credit).

AMOUNT YOU OWE

When you complete your return, you will determine if you have paid the full amount of tax that you owe. If you owe additional tax, you should pay it with your return.

If the IRS figures your tax for you, you will receive a bill for any tax that is due. You should pay this bill within 30 days (or by the due date of your return, if later).

How to Pay

Enclose your payment with your return, but do not attach it to the form. If you filed Form 1040 or 1040A, complete **Form 1040-V,** *Payment Voucher,* and enclose it with your payment and return. Form 1040-V will help to process your payment more accurately and efficiently. Follow the instructions that come with the form.

Payment not honored. If your check or money order is not honored by your bank (or other financial institution) and the IRS does not receive the funds, you still owe the tax. In addition, you may be subject to a dishonored check penalty.

Payment by credit or debit card. To pay by credit or debit card, call toll-free or visit the website of one of the service providers.

A convenience fee will be charged by the service provider. This fee is deductible as a miscellaneous itemized deduction subject to the 2% of AGI limit on your 2012 income tax return. Fees may vary among the providers. You will be told what the fee is during the transaction and you will have the option to either continue or cancel the transaction. You can also find out what the fee will be by calling the provider's toll-free automated customer service number or visiting the provider's website.

Caution. *Do not add the convenience fee to your tax payment.*

Interest

Interest is charged on tax you do not pay by the due date of your return. Interest is charged even if you get an extension of time for filing.

Interest on penalties. Interest is charged on the failure-to-file penalty, the accuracy-related penalty, and the fraud penalty from the due date of the return (including extensions) to the date of payment. Interest on other penalties starts on the date of notice and demand, but is not charged on penalties paid within 21 calendar days from the date of the notice (or within 10 business days if the notice is for $100,000 or more).

Interest due to IRS error or delay. All or part of any interest you were charged can be forgiven if the interest is due to an unreasonable error or delay by an officer or employee of the IRS in performing a ministerial or managerial act.

A ministerial act is a procedural or mechanical act that occurs during the processing of your case. A managerial act includes personnel transfers and extended personnel training. A decision concerning the proper application of federal tax law is not a ministerial or managerial act.

The interest can be forgiven only if you are not responsible in any important way for the error or delay and the IRS has notified you in writing of the deficiency or payment.

Interest and certain penalties may also be suspended for a limited period if you filed your return by the due date (including extensions) and the IRS does not provide you with a notice specifically stating your liability and the basis for it before the close of the 36-month period beginning on the later of:

- The date the return is filed, or
- The due date of the return without regard to extensions.

Installment Agreement

If you cannot pay the full amount due with your return, you can ask to make monthly installment payments. However, you will be charged interest and may be charged a late payment penalty on the tax not paid by the date your return is due, even if your request to pay in installments is granted. If your request is granted, you must also pay a fee. To limit the interest and penalty charges, pay as much of the tax as possible with your return. But before requesting an installment agreement, you should consider other less costly alternatives, such as a bank loan.

To ask for an installment agreement, use **Form 9465,** *Installment Agreement Request.* You should receive a response to your request within 30 days. But if you file your return after March 31, it may take longer for a reply.

Guaranteed availability of installment agreement. The IRS must agree to accept the payment of your tax liability in installments if, as of the date you offer to enter into the agreement:

1) Your total taxes (not counting interest, penalties, additions to the tax, or additional amounts) do not exceed $10,000,
2) In the last 5 years, you (and your spouse if the liability relates to a joint return) have not:
   a) Failed to file any required income tax return,
   b) Failed to pay any tax shown on any such return, or
   c) Entered into an installment agreement for the payment of any income tax,
3) You show you cannot pay your income tax in full when due,
4) The tax will be paid in full in 3 years or less, and
5) You agree to comply with the tax laws while your agreement is in effect.

Foreign address. If your address is outside the United States or its possessions or territories, enter the information on the line for "City, town or post office, state, and ZIP code" in the following order:

1) City,
2) Province or state, and
3) Name of foreign country. (***Do not*** abbreviate the name of the country.)

Follow the country's practice for entering the postal code.

IX. <u>Where Do I File?</u>

After you complete your return, you must send it to the IRS. You can mail it or you may be able to file it electronically.

Mailing your return. If an addressed envelope came with your tax forms package, you should mail your return in that envelope.

If you do not have an addressed envelope or if you moved during the year, mail your return to the Internal Revenue Service Center for the area where you now live. A list of Service Center addresses is shown in your tax forms package.

X. <u>What Records Should I Keep?</u>

Records. You must keep records so that you can prepare a complete and accurate income tax return. The law does not require any special form of records. However, you should keep all receipts, canceled checks or other proof of payment, and any other records to support any deductions or credits you claim.

If you file a claim for refund, you must be able to prove by your records that you have overpaid your tax.

How long to keep records. You must keep your records for as long as they are important for the federal tax law.

Keep records that support an item of income or a deduction appearing on a return until the period of limitations for the return runs out. (A period of limitations is the period of time after which no legal action can be brought.) For assessment of tax you owe, this generally is 3 years from the date you filed the return. For filing a claim for credit or refund, this generally is 3 years from the date you filed the original return, or 2 years from the date you paid the tax, whichever is later. Returns filed before the due date are treated as filed on the due date.

If you did not report income that you should have reported on your return, and it is more than 25% of the income shown on the return, the period of limitations does not run out until 6 years after you filed the return. If a return is false or fraudulent with intent to evade tax, or if no return is filed, an action can generally be brought at any time.

You may need to keep records relating to the basis of property longer than the period of limitations. Keep those records as long as they are important in figuring the basis of the original or replacement property. Generally, this means for as long as you own the property and, after you dispose of it, for the period of limitations that applies to you. See chapter 13 for information on basis.

Note. If you receive a Form W-2, keep Copy C until you begin receiving social security benefits. This will help protect those benefits, just in case there is a question about your work record or earnings in a particular year. Review the information shown on your annual (for workers over age 25) Social Security Statement.

If you need a copy of a prior year tax return, you can get it from the IRS. Use **Form 4506**, *Request for Copy or Transcript of Tax Form*. There is a charge for a copy of a return, which you must pay with Form 4506. It may take up to 60 days to process your request.

<u>INTEREST ON REFUNDS</u>

If you are due a refund, you may get interest on it. The interest rates are adjusted quarterly.

If the refund is made within 45 days after the due date of your return, no interest will be paid. If you file your return after the due date (including extensions), no interest will be paid if the refund is made within 45 days after the date you filed. If the refund is not made within this 45-day period, interest will be paid from the due date of the return or from the date you filed, whichever is later.

Accepting a refund check does not change your right to claim an additional refund and interest. File your claim within the period of time that applies. See *Amended Returns and Claims for*

Refund, later. If you do not accept a refund check, no more interest will be paid on the overpayment included in the check.

XI. <u>What If I Made a Mistake?</u>

AMENDED RETURNS AND CLAIMS FOR REFUND

You should correct your return if, after you have filed it, you find that:

1) You did not report some income,
2) You claimed deductions or credits you should not have claimed,
3) You did not claim deductions or credits you could have claimed, or
4) You should have claimed a different filing status. (You cannot change your filing status from married filing jointly to married filing separately after the due date of the original return. However, an executor may be able to make this change for a deceased spouse.)

Form 1040X. Use Form 1040X, *Amended U.S. Individual Income Tax Return,* to correct the return you have already filed. An amended tax return cannot be filed electronically under the *e-file* system.

Completing Form 1040X. On Form 1040X, write your income, deductions, and credits as you originally reported them on your return, the changes you are making, and the corrected amounts. Then figure the tax on the corrected amount of taxable income and the amount you owe or your refund.

If you owe tax, pay the full amount with Form 1040X. The tax owed will not be subtracted from any amount you had credited to your estimated tax.

If you cannot pay the full amount due with your return, you can ask to make monthly installment payments. See *Installment Agreement,* earlier.

If you overpaid tax, you can have all or part of the overpayment refunded to you, or you can apply all or part of it to your estimated tax. If you choose to get a refund, it will be sent separately from any refund shown on your original return.

Filing Form 1040X. After you finish your Form 1040X, check it to be sure that it is complete. Do not forget to show the year of your original return and explain all changes you made. Be sure to attach any forms or schedules needed to explain your changes. Mail your Form 1040X to the Internal Revenue Service Center serving the area where you now live (as shown in the instructions to the form).

File a separate form for each tax year involved.

Time for filing a claim for refund. Generally, you must file your claim for a credit or refund within 3 years after the date you filed your original return or within 2 years after the date you paid the tax, whichever is later. Returns filed before the due date (without regard to extensions) are considered filed on the due date (even if the due date was a Saturday, Sunday, or legal holiday). These time periods are suspended while you are financially disabled, discussed later.

If the last day for claiming a credit or refund is a Saturday, Sunday, or legal holiday, you can file the claim on the next business day.

If you do not file a claim within this period, you may not be entitled to a credit or a refund.

Limit on amount of refund. If you file your claim within 3 years after the date you filed your return, the credit or refund cannot be more than the part of the tax paid within the 3-year period (plus any extension of time for filing your return) immediately before you filed the claim. This time period is suspended while you are financially disabled, discussed later.

Tax paid. Payments made before the due date (without regard to extensions) of the original return are considered paid on the due date. Examples include federal income tax withheld from wages and estimated income tax.

Example 1. You made estimated tax payments of $500 and got an automatic extension of time to October 15, 2009, to file your 2008 income tax return. When you filed your return on that date, you paid an additional $200 tax. On October 15, 2012, you filed an amended return and claimed a refund of $700. Because you filed your claim within 3 years after you filed your original return, you can get a refund of up to $700, the tax paid within the 3 years plus the 6-month extension period immediately before you filed the claim.

Example 2. The situation is the same as in *Example 1,* except you filed your return on October 30, 2009, 2 weeks after the extension period ended. You paid an additional $200 on that date. On October 29, 2012, you filed an amended return and claimed a refund of $700. Although you filed your claim within 3 years from the date you filed your original return, the refund was limited to $200, the tax paid within the 3 years plus the 6-month extension period immediately before you filed the claim. The estimated tax of $500 paid before that period cannot be refunded or credited.

If you file a claim more than 3 years after you file your return, the credit or refund cannot be more than the tax you paid within the 2 years immediately before you file the claim.

Example. You filed your 2008 tax return on April 17, 2009. You paid taxes of $500. On November 5, 2010, after an examination of your 2008 return, you had to pay an additional tax of $200. On May 12, 2012, you file a claim for a refund of $300. However, because you filed your claim more than 3 years after you filed your return, your refund will be limited to the $200 you paid during the 2 years immediately before you filed your claim.

Financially disabled. The time periods are suspended for the period in which you are financially disabled. You are financially disabled if you are unable to manage your financial affairs because of a medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months. However, you are not treated as financially disabled during any period your spouse or any other person is authorized to act on your behalf in financial matters.

To claim that you are financially disabled, you must send in the following written statements with your claim for refund.

1) A statement from your qualified physician that includes:
   a) The name and a description of your physical or mental impairment,
   b) The physician's medical opinion that the impairment prevented you from managing your financial affairs,
   c) The physician's medical opinion that the impairment was or can be expected to result in death, or that its duration has lasted, or can be expected to last, at least 12 months,
   d) The specific time period (to the best of the physician's knowledge), and
   e) The following certification signed by the physician: "I hereby certify that, to the best of my knowledge and belief, the above representations are true, correct, and complete."
2) A statement made by the person signing the claim for credit or refund that no person, including your spouse, was authorized to act on your behalf in financial matters during the period of disability (or the exact dates that a person was authorized to act for you).

Exceptions for special types of refunds. If you file a claim for one of the items listed below, the dates and limits discussed earlier may not apply. These items, and where to get more information, are as follows.

- A bad debt. (See *Nonbusiness Bad Debts* in chapter 14.)
- A worthless security. (See *Worthless securities* in chapter 14.)
- Foreign tax paid or accrued. (See Publication 514, *Foreign Tax Credit for Individuals*.)
- Net operating loss carryback. (See Publication 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.)
- Carryback of certain business tax credits. (See Form 3800, *General Business Credit*.)
- A claim based on an agreement with the IRS extending the period for assessment of tax.

Reduced refund. Your refund may be reduced by an additional tax liability that has been assessed against you.

Also, your refund may be reduced by amounts you owe for past-due child support, debts to another federal agency, or for state income tax.

Effect on state tax liability. If your return is changed for any reason, it may affect your state income tax liability. This includes changes made as a result of an examination of your return by the IRS. Contact your state tax agency for more information.

PENALTIES

The law provides penalties for failure to file returns or pay taxes as required.

Civil Penalties

If you do not file your return and pay your tax by the due date, you may have to pay a penalty. You may also have to pay a penalty if you substantially understate your tax, file a frivolous return, or fail to supply your social security number. If you provide fraudulent information on your return, you may have to pay a civil fraud penalty.

Filing late. If you do not file your return by the due date (including extensions), you may have to pay a ***failure-to-file*** penalty. The penalty is based on the tax not paid by the due date (without regard to extensions). The penalty is usually 5% for each month or part of a month that a return is late, but not more than 25%.

Fraud. If your failure to file is due to fraud, the penalty is 15% for each month or part of a month that your return is late, up to a maximum of 75%.

Return over 60 days late. If you file your return more than 60 days after the due date or extended due date, the minimum penalty is the smaller of $135 or 100% of the unpaid tax.

Exception. You will not have to pay the penalty if you show that you failed to file on time because of reasonable cause and not because of willful neglect.

Paying tax late. You will have to pay a ***failure-to-pay*** penalty of ½ of 1% (.50%) of your unpaid taxes for each month, or part of a month, after the due date that the tax is not paid. This penalty does not apply during the automatic 6-month extension of time to file period, if you paid at least 90% of your actual tax liability on or before the due date of your return and pay the balance when you file the return.

The monthly rate of the failure-to-pay penalty is half the usual rate (.25% instead of .50%) if an installment agreement is in effect for that month. You must have filed your return by the due date (including extensions) to qualify for this reduced penalty.

If a notice of intent to levy is issued, the rate will increase to 1% at the start of the first month beginning at least 10 days after the day that the notice is issued. If a notice and demand for immediate payment is issued, the rate will increase to 1% at the start of the first month beginning after the day that the notice and demand is issued.

This penalty cannot be more than 25% of your unpaid tax. You will not have to pay the penalty if you can show that you had a good reason for not paying your tax on time.

Combined penalties. If both the failure-to-file penalty and the failure-to-pay penalty (discussed earlier) apply in any month, the 5% (or 15%) failure-to-file penalty is reduced by the failure-to-pay penalty. However, if you file your return more than 60 days after the due date or extended due date, the minimum penalty is the smaller of $135 or 100% of the unpaid tax.

Accuracy-related penalty. You may have to pay an accuracy-related penalty if you underpay your tax because:

1) You show "negligence" or "disregard" of the rules or regulations, or
2) You substantially understate your income tax.

The penalty is equal to 20% of the underpayment. The penalty will not be figured on any part of an underpayment on which the fraud penalty (discussed later) is charged.

Negligence or disregard. The term "negligence" includes a failure to make a reasonable attempt to comply with the tax law or to exercise ordinary and reasonable care in preparing a return. Negligence also includes failure to keep adequate books and records. You will not have to pay a negligence penalty if you have a reasonable basis for a position you took.

The term "disregard" includes any careless, reckless, or intentional disregard.

Adequate disclosure. You can avoid the penalty for disregard of rules or regulations if you adequately disclose on your return a position that has at least a reasonable basis. See *Disclosure statement,* later.

Substantial understatement of income tax. You understate your tax if the tax shown on your return is less than the correct tax. The understatement is substantial if it is more than the larger of 10% of the correct tax or $5,000. However, the amount of the understatement is reduced to the extent the understatement is due to:

1) Substantial authority, or
2) Adequate disclosure and a reasonable basis.

Substantial authority. Whether there is or was substantial authority for the tax treatment of an item depends on the facts and circumstances. Consideration will be given to court opinions, Treasury regulations, revenue rulings, revenue procedures, and notices and announcements issued by the IRS and published in the *Internal Revenue Bulletin* that involve the same or similar circumstances as yours.

Disclosure statement. To adequately disclose the relevant facts about your tax treatment of an item, use **Form 8275,** *Disclosure Statement.* You must also have a reasonable basis for treating the item the way you did.

In cases of substantial understatement only, items that meet the requirements of Revenue Procedure 2006-48 (or later update) are considered adequately disclosed on your return without filing Form 8275.

Use **Form 8275-R,** *Regulation Disclosure Statement,* to disclose items or positions contrary to regulations.

Reasonable cause. You will not have to pay a penalty if you show a good reason (reasonable cause) for the way you treated an item. You must also show that you acted in good faith.

Frivolous tax submission. You may have to pay a penalty of $5,000 if you file a frivolous tax return or other frivolous submissions. A frivolous return is one that does not include enough information to figure the correct tax or that contains information clearly showing that the tax you reported is substantially incorrect.

You will have to pay the penalty if you filed this kind of return because of a frivolous position on your part or a desire to delay or interfere with the administration of federal income tax laws. This includes altering or striking out the preprinted language above the space provided for your signature.

This penalty is added to any other penalty provided by law.

Fraud. If there is any underpayment of tax on your return due to fraud, a penalty of 75% of the underpayment due to fraud will be added to your tax.

Joint return. The fraud penalty on a joint return does not apply to a spouse unless some part of the underpayment is due to the fraud of that spouse.

Failure to supply social security number. If you do not include your social security number (SSN) or the SSN of another person where required on a return, statement, or other document, you will be subject to a penalty of $50 for ***each*** failure. You will also be subject to a penalty of $50 if you do not give your SSN to another person when it is required on a return, statement, or other document.

For example, if you have a bank account that earns interest, you must give your SSN to the bank. The number must be shown on the Form 1099-INT or other statement the bank sends you. If you do not give the bank your SSN, you will be subject to the $50 penalty. (You also may be subject to "backup" withholding of income tax. See chapter 4.)

You will not have to pay the penalty if you are able to show that the failure was due to reasonable cause and not willful neglect.

Criminal Penalties

You may be subject to criminal prosecution (brought to trial) for actions such as:

1) Tax evasion,
2) Willful failure to file a return, supply information, or pay any tax due,
3) Fraud and false statements, or
4) Preparing and filing a fraudulent return.

CHAPTER 1 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. For U.S. citizens, which of the following is <u>not</u> a determining factor as to whether you must file a U.S. income tax return:

   a) your gross income
   b) your filing status
   c) your age
   d) the source of your income

2. Return filing requirements may vary for aliens residing in the U.S. Which of the following must follow the same requirements as a long-time U.S. citizen:

   a) illegal aliens
   b) resident aliens
   c) nonresident aliens
   d) dual-status aliens

3. Even if you do not have to file a return, you should file a federal income tax return to get money back if you had income tax withheld from your pay.

   a) true
   b) false

4. The chance of getting audited by the IRS does not differ if you file using e-file rather than filing a paper return.

   a) true
   b) false

5. If you file for an automatic 6-month extension prior to the due date of your return, you do not have to pay any tax due until the extension is due.

   a) true
   b) false

6. Which of the following is <u>not</u> a valid individual taxpayer tax year:

   a) calendar year
   b) regular fiscal year
   c) 52-53 week fiscal year
   d) tax year longer than 12 months

7. An advance payment of income is generally included in gross income in the year it is received.

   a) true
   b) false

8. You can authorize another person to sign your tax return for you, along with attaching a power of attorney (POA), when any of the following situations apply <u>except</u>:

   a) you are unable to sign the return due to disease or injury
   b) you are absent from the U.S. for a period of at least 60 days before the filing due date of your return
   c) you are not present in your home state on the tax return due date
   d) given permission to do so by the IRS

9. Exactly how long should a taxpayer retain documents supporting a return's claim for credit or refund to remain in compliance with federal tax law:

   a) keep your records for two years after filing your return
   b) until the period of limitations for the return runs out
   c) generally 3 years from the filing date of the original tax return
   d) it is 6 years in all cases

10. If you do not file your return by the due date (including extensions), you may have to pay a failure-to-file penalty.

   a) true
   b) false

CHAPTER 1 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Gross income is one of the three factors determining a taxpayer's return filing requirements.

   B: Incorrect. Your filing status, such as being married or single, is a factor in determining your return filing requirements.

   C: Incorrect. Older taxpayers generally may have a higher amount of gross income than other taxpayers before they must file a return. Therefore, age does affect a taxpayer's filing requirements.

   D: Correct. The source of income is not a factor in determining whether an individual must file a tax return.

2. A: Incorrect. This status is not addressed in the material.

   B: Correct. If you are a resident alien for the entire year, you must file a tax return following the same rules that apply to U.S. citizens.

   C: Incorrect. Rules and forms for nonresident aliens are different than for U.S. citizens.

   D: Incorrect. Dual-status taxpayers follow two sets of rules (resident and nonresident alien) during the year.

3. **A: True is correct.** You should also file a return if you qualify for the earned income credit or if you qualify for the additional child tax credit.

   B: False is incorrect. Even if you are not required to file a return, sometimes there are amounts that will be refunded if you do file.

4. **A: True is correct.** Using e-file does not reduce or increase the chances of an IRS examination.

   B: False is incorrect. Per the IRS, using e-file does not affect your chances of an IRS examination of your return.

5. A: True is incorrect. Even if you file for an extension, if you do not pay the tax due by the regular due date, you will owe interest. You may also be charged penalties.

   B: False is correct. The automatic extension extends the time to file, but not the time to pay the tax due.

6. A: Incorrect. A calendar year is a valid tax year and is the most common.

   B: Incorrect. A regular fiscal year is a valid tax year for taxpayers.

   C: Incorrect. A fiscal year containing 52-53 weeks is a valid tax year; it will always end on the same day of the week each year.

   D: Correct. A valid tax year can never be longer than 12 months.

7. **A: True is correct.** Your method of accounting does not matter as long as the income is available to you.

   B: False is incorrect. An advance payment of income includes rent or interest you receive in advance and pay for services you will perform later.

8. A: Incorrect. Disease or injury is a valid reason to appoint an agent to sign your return.

   B: Incorrect. Being out of the U.S. for a period of at least 60 days is a valid reason to appoint an agent to sign your return.

   C: Correct. A person traveling out of their home state on the tax return due date is not a valid reason to ask another person to sign your return.

   D: Incorrect. A person's tax return can be signed by another person who has been given permission to do so by a local IRS office.

9. A: Incorrect. This period reflects the time period after paying tax, but not the time period after filing the tax return.

   B: Incorrect. This reflects a possible objective of the taxpayer, but does not provide the specific time period requested.

   C: Correct. This provides a specific time period and briefly explains when the period begins.

   D: Incorrect. This time period applies to unreported income in excess of 25% of the amount shown on the return and for taxpayers where the return does not involve fraud or the intent to evade taxes.

10. **A: True is correct.** The penalty is based on the tax not paid by the due date (without regard to extensions.)

    B: False is incorrect. If the failure to file is due to fraud, the penalty is 15% for each month or part of a month that your return is late, up to a maximum of 75%.

Chapter 2: Filing Status

I. <u>Introduction</u>

This chapter helps you determine which filing status to use. There are five filing statuses:

- Single,
- Married Filing Jointly,
- Married Filing Separately,
- Head of Household, and
- Qualifying Widow(er) With Dependent Child.

Tip. *If more than one filing status applies to you, choose the one that will give you the lowest tax.*

You must determine your filing status before you can determine your filing requirements (chapter 1), standard deduction (chapter 20), and correct tax (chapter 30). You also use your filing status in determining whether you are eligible to claim certain deductions and credits.

II. <u>Marital Status</u>

In general, your filing status depends on whether you are considered unmarried or married. A marriage means only a legal union between a man and a woman as husband and wife.

Caution. Under federal law, same sex marriages are not recognized for tax purposes even though they may be valid for state purposes, e.g., Massachusetts. If you are married in such a state, you may have to file using a different status for federal and state tax purposes.

Unmarried persons. You are considered unmarried for the whole year if, on the last day of your tax year, you are unmarried or legally separated from your spouse under a divorce or a separate maintenance decree. State law governs whether you are married or legally separated under a divorce or separate maintenance decree.

Divorced persons. If you are divorced under a final decree by the last day of the year, you are considered unmarried for the whole year.

Divorce and remarriage. If you obtain a divorce in one year for the sole purpose of filing tax returns as unmarried individuals, and at the time of divorce you intended to and did remarry each other in the next tax year, you and your spouse must file as married individuals.

Annulled marriages. If you obtain a court decree of annulment, which holds that no valid marriage ever existed, you are considered unmarried even if you filed joint returns for earlier years. You must file amended returns (Form 1040X, *Amended U.S. Individual Income Tax Return*) claiming single or head of household status for all tax years affected by the annulment that are not closed by the statute of limitations for filing a tax return. The statute of limitations generally does not expire until 3 years after your original return was filed.

Head of household or qualifying widow(er) with dependent child. If you are considered unmarried, you may be able to file as a head of household or as a qualifying widow(er) with a dependent child. See *Head of Household* and *Qualifying Widow(er) With Dependent Child* to see if you qualify.

Married persons. If you are considered married for the whole year, you and your spouse can file a joint return, or you can file separate returns.

Considered married. You are considered married for the whole year if on the last day of your tax year you and your spouse meet any one of the following tests.

1) You are married and living together as husband and wife.
2) You are living together in a ***common law marriage*** that is recognized in the state where you now live or in the state where the common law marriage began.
3) You are married and living apart, but not legally separated under a decree of divorce or separate maintenance.
4) You are separated under an interlocutory (not final) decree of divorce. For purposes of filing a joint return, you are not considered divorced.

Spouse died. If your spouse died during the year, you are considered married for the whole year for filing status purposes. If you did not remarry before the end of the tax year, you can file a joint return for yourself and your deceased spouse. For the next 2 years, you may be entitled to the special benefits described later under *Qualifying Widow(er) With Dependent Child.* If you remarried before the end of the tax year, you can file a joint return with your new spouse. Your deceased spouse's filing status is married filing separately for that year.

Married persons living apart. If you live apart from your spouse and meet certain tests, you may be ***considered unmarried.*** If this applies to you, you can file as head of household even though you are not divorced or legally separated. If you qualify to file as head of household instead of as married filing separately, your standard deduction will be higher. Also, your tax may be lower, and you may be able to claim the earned income credit. See *Head of Household,* later.

III. Single

Your filing status is ***single*** if, on the last day of the year, you are unmarried or legally separated from your spouse under a divorce or separate maintenance decree, and you do not qualify for another filing status. To determine your marital status on the last day of the year, see *Marital Status,* earlier.

Your filing status may be single if you were widowed before January 1, 2011, and did not remarry in 2011. However, you might be able to use another filing status that will give you a lower tax. See *Head of Household* and *Qualifying Widow(er) With Dependent Child* to see if you qualify.

How to file. You can file Form 1040EZ (if you have no dependents, are under 65 and not blind, and meet other requirements), Form 1040A, or Form 1040. If you file Form 1040A or Form 1040, show your filing status as single by checking the box on line 1. Use the *Single* column of the Tax Table or Section A of the Tax Computation Worksheet to figure your tax.

IV. Married Filing Jointly

You can choose ***married filing jointly*** as your filing status if you are married and both you and your spouse agree to file a joint return. On a joint return, you report your combined income and deduct your combined allowable expenses. You can file a joint return even if one of you had no income or deductions.

If you and your spouse decide to file a joint return, your tax may be lower than your combined tax for the other filing statuses. Also, your standard deduction (if you do not itemize deductions) may be higher, and you may qualify for tax benefits that do not apply to other filing statuses.

How to file. If you file as married filing jointly, you can use Form 1040 or Form 1040A. If you have no dependents, are under 65 and not blind, and meet other requirements, you can file Form 1040EZ. If you file Form 1040 or Form 1040A, show this filing status by checking the box on line 2. Use the *Married filing jointly* column of the Tax Table or Section B of the Tax Computation Worksheet to figure your tax.

Spouse died during the year. If your spouse died during the year, you are considered married for the whole year and can choose married filing jointly as your filing status. See *Spouse died,* earlier, for more information.

Divorced persons. If you are divorced under a final decree by the last day of the year, you are considered unmarried for the whole year and you cannot choose married filing jointly as your filing status.

FILING A JOINT RETURN

Both you and your spouse must include all of your income, exemptions, and deductions on your joint return.

Joint responsibility. Both of you may be held responsible, jointly and individually, for the tax and any interest or penalty due on your joint return. One spouse may be held responsible for all the tax due even if all the income was earned by the other spouse.

Divorced taxpayer. You may be held jointly and individually responsible for any tax, interest, and penalties due on a joint return filed before your divorce. This responsibility may apply even if your divorce decree states that your former spouse will be responsible for any amounts due on previously filed joint returns.

Relief from joint liability. In some cases, one spouse may be relieved of joint liability for tax, interest, and penalties on a joint return for items of the other spouse that were incorrectly reported on the joint return. You can ask for relief no matter how small the liability. There are three types of relief available.

1) Innocent spouse relief.
2) Separation of liability, which applies to joint filers who are divorced, widowed, legally separated, or have not lived together for the 12 months ending the date election of this relief is filed.
3) Equitable relief.

You must file Form 8857, *Request for Innocent Spouse Relief,* to request any of these kinds of relief.

Signing a joint return. For a return to be considered a joint return, both husband and wife must generally sign the return. If your spouse died before signing the return, the executor or administrator must sign the return for your spouse. If neither you nor anyone else has yet been appointed as executor or administrator, you can sign the return for your spouse and enter “filing as surviving spouse” in the area where you sign the return.

Spouse away from home. If your spouse is away from home, you should prepare the return, sign it, and send it to your spouse to sign so that it can be filed on time.

Signing as guardian of spouse. If you are the guardian of your spouse who is mentally incompetent, you can sign the return for your spouse as guardian.

Spouse in combat zone. If your spouse is unable to sign the return because he or she is serving in a combat zone (such as the Persian Gulf Area, Yugoslavia, or Afghanistan), or a qualified hazardous duty area (Bosnia and Herzegovina, Croatia, and Macedonia), and you do not have a power of attorney or other statement, you can sign for your spouse. Attach a signed statement to your return that explains that your spouse is serving in a combat zone.

Nonresident alien or dual-status alien. A joint return generally cannot be filed if either spouse is a nonresident alien at any time during the tax year. However, if one spouse was a nonresident alien or dual-status alien who was married to a U.S. citizen or resident at the end of the year, the spouses can choose to file a joint return. If you do file a joint return, you and your spouse are both treated as U.S. residents for the entire tax year.

V. Married Filing Separately

You can choose ***married filing separately*** as your filing status if you are married. This method may benefit you if you want to be responsible only for your own tax or if this method results in less tax than a joint return. If you and your spouse do not agree to file a joint return, you may have to use this filing status, unless you qualify for head of household status.

If you live apart from your spouse and meet certain tests, you may be ***considered unmarried*** and may be able to file as head of household. This can apply to you even if you are not divorced or legally separated. If you qualify to file as head of household, instead of as married filing separately, your tax may be lower, you may be able to claim the earned income credit and certain other credits, and your standard deduction will be higher. The head of household filing status allows you to choose the standard deduction even if your spouse chooses to itemize deductions. See *Head of Household,* later, for more information.

Tip. *Unless you are required to file separately, you should figure your tax both ways (on a joint return and on separate returns). This way you can make sure you are using the method that results in the lowest combined tax. However, you will generally pay more combined tax on separate returns than you would on a joint return because the tax rate is higher for married persons filing separately.*

How to file. If you file a separate return, you generally report only your own income, exemptions, credits, and deductions. You can claim an exemption for your spouse if your spouse had no gross income and was not a dependent of another person. However, if your spouse had any gross income, or was the dependent of someone else, you cannot claim an exemption for him or her on your separate return.

If you file as married filing separately, you can use Form 1040A or Form 1040. Select this filing status by checking the box on line 3 of either form. You must also write your spouse's social security number and full name in the spaces provided. Use the *Married filing separately* column of the Tax Table or Section C of the Tax Computation Worksheet.

SPECIAL RULES

If you choose married filing separately as your filing status, the following special rules apply. Because of these special rules, you will usually pay more tax on a separate return than if you used another filing status that you qualify for.

1) Your tax rate generally will be higher than on a joint return.
2) Your exemption amount for figuring the alternative minimum tax will be half that allowed to a joint return filer.
3) You cannot take the credit for child and dependent care expenses in most cases, and the amount that you can exclude from income under an employer's dependent care assistance program is limited to $2,500 (instead of $5,000 if you filed a joint return). For more information about these expenses, the credit, and the exclusion, see chapter 32.
4) You cannot take the earned income credit.
5) You cannot take the exclusion or credit for adoption expenses in most cases.
6) You cannot take the education credits (the American opportunity credit and lifetime learning credit), the deduction for student loan interest, or the tuition and fees deduction.
7) You cannot exclude any interest income from qualified U.S. savings bonds that you used for higher education expenses.
8) If you lived with your spouse at any time during the tax year:
    a) You cannot claim the credit for the elderly or the disabled.
    b) You will have to include in income more (up to 85%) of your social security benefits or equivalent railroad retirement benefits you received, and
    c) You cannot roll over amounts from an eligible retirement plan (other than a Roth IRA or designated Roth account) into a Roth IRA.
9) The following deductions and credits are reduced at income levels that are half those for a joint return:
    a) The child tax credit, and
    b) The retirement savings contributions credit,
10) Your capital loss deduction limit is $1,500 (instead of $3,000 if you filed a joint return).
11) If your spouse itemizes deductions, you cannot claim the standard deduction. If you can claim the standard deduction, your basic standard deduction is half the amount allowed on a joint return.

Individual retirement arrangements (IRAs). You may not be able to deduct all or part of your contributions to a traditional IRA if you or your spouse were covered by an employee retirement plan at work during the year. Your deduction is reduced or eliminated if your income is more than a certain amount. This amount is lower for married individuals who file separately and lived together at any time during the year. For more information, see *How Much Can You Deduct* in chapter 17.

Rental activity losses. If you actively participated in a passive rental real estate activity that produced a loss, you generally can deduct the loss from your nonpassive income, up to $25,000. This is called a special allowance. However, married persons filing separate returns who lived together at any time during the year cannot claim this special allowance. Married persons filing separate returns who lived apart at all times during the year are each allowed a $12,500 maximum special allowance for losses from passive real estate activities. See *Limits on Rental Losses* in chapter 9.

Community property states. If you live in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin and file separately, your income may be considered separate income or community income for income tax purposes.

JOINT RETURN AFTER SEPARATE RETURNS

You can change your filing status by filing an amended return using Form 1040X.

If you or your spouse (or both of you) file a separate return, you generally can change to a joint return any time within 3 years from the due date of the separate return or returns. This does not include any extensions. A separate return includes a return filed by you or your spouse claiming married filing separately, single, or head of household filing status.

SEPARATE RETURNS AFTER JOINT RETURN

Once you file a joint return, you cannot choose to file separate returns for that year after the due date of the return.

Exception. A personal representative for a decedent can change from a joint return elected by the surviving spouse to a separate return for the decedent. The personal representative has 1 year from the due date of the return to make the change.

VI. Head of Household

You may be able to file as head of household if you meet all of the following requirements.

1) You are unmarried or "considered unmarried" on the last day of the year. You are "considered unmarried" if you meet the following requirements:

   - You file a separate return.
   - You paid more than half the cost of keeping up your home for the tax year.
   - Your spouse did not live in your home during the last 6 months of the tax year. Your spouse is considered to live in your home even if he or she is temporarily absent due to special circumstances.
   - Your home was the main home of your child, stepchild, or foster child for more than half the year.
   - You must be able to claim an exemption for the child. However, you meet this test if you cannot claim the exemption only because the noncustodial parent can claim the child. The general rules for claiming an exemption for a dependent are explained under *Exemptions for Dependents* in chapter 3.

2) You paid more than half the cost of keeping up a home for the year.

3) A "qualifying person" lived with you in the home for more than half the year (except for temporary absences, such as school). However, if the "qualifying person" is your dependent parent, he or she does not have to live with you. See *Special rule for parent*, later, under *Qualifying Person*.

> ***Tip.*** *If you qualify to file as head of household, your tax rate usually will be lower than the rates for single or married filing separately. You will also receive a higher standard deduction than if you file as single or married filing separately.*

How to file. If you file as head of household, you can use either Form 1040A or Form 1040. Indicate your choice of this filing status by checking the box on line 4 of either form. Use the *Head of a household* column of the Tax Table or *Schedule D* of the Computation Worksheet to figure your tax.

Nonresident alien spouse. You are considered unmarried for head of household purposes if your spouse was a nonresident alien at any time during the year and you do not choose to treat your nonresident spouse as a resident alien. However, your spouse is not a qualifying person for head of household purposes. You must have another qualifying person and meet the other tests to be eligible to file as a head of household.

Earned income credit. Even if you are considered unmarried for head of household purposes because you are married to a nonresident alien, you are still considered married for purposes of the earned income credit (unless you meet the five tests listed earlier). You are not entitled to the credit unless you file a joint return with your spouse and meet other qualifications. See chapter 36 for more information.

Choice to treat spouse as resident. You are considered married if you choose to treat your spouse as a resident alien.

KEEPING UP A HOME

To qualify for head of household status, you must pay more than half of the cost of keeping up a home for the year. You can determine whether you paid more than half of the cost of keeping up a home by using the *Cost of Keeping Up a Home* worksheet, shown below.

Cost of Keeping Up a Home

	Amount You Paid	**Total Cost**
Property taxes	$______	$______
Mortgage interest expense	$______	$______
Rent	$______	$______
Utility charges	$______	$______
Upkeep and repairs	$______	$______
Property insurance	$______	$______
Food consumed on the premises	$______	$______
Other household expenses	$______	$______
Totals	$______	$______
Minus total **amount you paid**		(______)
Amount others paid		$______

If the total amount you paid is more than the amount others paid, you meet the requirement of paying more than half the cost of keeping up the home.

Costs you include. Include in the cost of upkeep expenses such as rent, mortgage interest, real estate taxes, insurance on the home, repairs, utilities, and food eaten in the home.

Costs you do not include. Do not include in the cost of upkeep expenses such as clothing, education, medical treatment, vacations, life insurance, or transportation. Also, do not include the rental value of a home you own or the value of your services or those of a member of your household.

QUALIFYING PERSON

See Table 2-1 to see who is a qualifying person. Any person not described in Table 2-1 is not a qualifying person.

Home of qualifying person. Generally, the qualifying person must live with you for more than half of the year.

Special rule for parent. You may be eligible to file as head of household even if the parent for whom you can claim an exemption does not live with you. You must pay more than half the cost of keeping up a home that was the main home for the ***entire year*** for your father or mother. You are keeping up a main home for your father or mother if you pay more than half the cost of keeping your parent in a rest home or home for the elderly.

Temporary absences. You and your qualifying person are considered to live together even if one or both of you are temporarily absent from your home due to special circumstances such as illness, education, business, vacation, or military service. It must be reasonable to assume that the absent person will return to the household after the temporary absence. You must continue to keep up the home during the absence.

Death or birth. You may be eligible to file as head of household if the individual who qualifies you for this filing status is born or dies during the year. You must have provided more than half of the cost of keeping up a home that was the individual's main home for more than half the year or, if less, the period during which the individual lived.

Example. You are unmarried. Your mother, for whom you can claim an exemption, lived in an apartment by herself. She died on September 2. The cost of the upkeep of her apartment for the year until her death was $6,000. You paid $4,000 and your brother paid $2,000. Your brother made no other payments toward your mother's support. Your mother had no income. Because you paid more than half the cost of keeping up your mother's apartment from January 1 until her death, and you can claim an exemption for her, you can file as a head of household.

Table 2-1. Who Is a Qualifying Person Qualifying You To File as Head of Household?[1]

> ***Caution.*** *See the text of this chapter for the other requirements you must meet to claim head of household filing status.*

IF the person is your…	AND…	THEN that person is…
qualifying child (such as a son, daughter, or grandchild who lived with you more than half the year and meets certain other tests)[2]	he or she is single	a qualifying person, whether or not you can claim an exemption for the person.
	he or she is married and you can claim an exemption for him or her	a qualifying person.
	he or she is married and you cannot claim an exemption for him or her	not a qualifying person.[3]
qualifying relative[4] who is your father or mother	you can claim an exemption for him or her[5]	a qualifying person.[6]
	you cannot claim an exemption for him or her	not a qualifying person.
qualifying relative[4] other than your father or mother (such as a grandparent, brother, or sister who meets certain tests)	he or she lived with you more than half the year, and he or she is related to you in one of the ways listed under *Relatives who do not have to live with you* in chapter 3 and you can claim an exemption for him or her[5]	a qualifying person.
	he or she did not live with you more than half the year	not a qualifying person.
	he or she is not related to you in one of the ways listed under *Relatives who do not have to live with you* in chapter 3 and is your qualifying relative only because he or she lived with you all year as a member of your household	not a qualifying person.
	you cannot claim an exemption for him or her	not a qualifying person.

[1]A person cannot qualify more than one taxpayer to use the head of household filing status for the year.
[2]The term "qualifying child" is defined in chapter 3. **Note.** If you are a noncustodial parent, the term "qualifying child" for head of household filing status does not include a child who is your qualifying child for exemption purposes only because of the rules described under *Children of divorced or separated parents or parents who live apart* under *Qualifying Child* in chapter 3. If you are the custodial parent and those rules apply, the child generally is your qualifying child for head of household filing status even though the child is not a qualifying child for whom you can claim an exemption.
[3]This person is a qualifying person if the only reason you cannot claim the exemption is that you can be claimed as a dependent on someone else's return.
[4]The term "qualifying relative" is defined in chapter 3.
[5]If you can claim an exemption for a person only because of a multiple support agreement, that person is not a qualifying person. See *Multiple Support Agreement* in chapter 3.
[6]See *Special rule for parent* for an additional requirement.

VII. Qualifying Widow(er) with Dependent Child

If your spouse died in 2011, you can use married filing jointly as your filing status for 2011 if you otherwise qualify to use that status. The year of death is the last year for which you can file jointly with your deceased spouse. See *Married Filing Jointly,* earlier.

You may be eligible to use ***qualifying widow(er) with dependent child*** as your filing status for 2 years following the year of death of your spouse. For example, if your spouse died in 2010, and you have not remarried, you may be able to use this filing status for 2011 and 2012.

This filing status entitles you to use joint return tax rates and the highest standard deduction amount (if you do not itemize deductions). This status does not entitle you to file a joint return.

How to file. If you file as qualifying widow(er) with dependent child, you can use either Form 1040A or Form 1040. Indicate your filing status by checking the box on line 5 of either form. Write the year your spouse died in the space provided on line 5. Use the *Married filing jointly* column of the Tax Table or Section B of the Tax Computation Worksheet to figure your tax.

Eligibility rules. You are eligible to file your 2011 return as a qualifying widow(er) with dependent child if you meet all of the following tests.

1) You were entitled to file a joint return with your spouse for the year your spouse died. It does not matter whether you actually filed a joint return.
2) Your spouse died in 2009 or 2010 and you did not remarry before the end of 2011.
3) You have a child or stepchild for whom you can claim an exemption.
4) This child lived in your home all year, except for temporary absences.
5) You paid more than half the cost of keeping up a home for the year.

Caution. *As mentioned earlier, this filing status is only available for 2 years following the year of death of your spouse.*

Example. John Reed's wife died in 2009. John has not remarried. During 2010 and 2011, he continued to keep up a home for himself and his child (for whom he can claim an exemption). For 2009 he was entitled to file a joint return for himself and his deceased wife. For 2010 and 2011, he can file as qualifying widower with a dependent child. After 2011, he can file as head of household if he qualifies.

Death or birth. You may be eligible to file as a qualifying widow(er) with dependent child if the child who qualifies you for this filing status is born or dies during the year. You must have provided more than half of the cost of keeping up a home that was the child's main home during the entire part of the year he or she was alive.

CHAPTER 2 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Your filing status depends on whether you are considered married or unmarried, which is determined as of the first day of the tax year.

   a) true
   b) false

2. For a tax return to be considered a joint return, both husband and wife generally must sign the return. Which of the following is not a recognized exception allowing a one-party signature:

   a) signing as a guardian of spouse
   b) spouse in combat zone
   c) spouse is a nonresident alien
   d) there are no recognized exceptions

3. If you are married, you should figure your tax on both bases (as a joint return and on separate returns), so you can make sure you are using the method that results in the lowest combined tax.

   a) true
   b) false

4. To qualify for head of household status, you must pay more than half of the cost of keeping up a home. Which of the following items would not be included in the total:

   a) mortgage interest
   b) property taxes
   c) property insurance
   d) life insurance on the homeowner(s)

CHAPTER 2 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. You are considered married or unmarried based on your official status as of the last day of the tax year.

   B: False is correct. If you are divorced under a final decree by the last day of the year, you are considered unmarried for the whole year.

2. A: Incorrect. Being the guardian of your spouse is a valid situation where one spouse can sign a joint tax return for the other spouse.

   B: Incorrect. If your spouse is serving in a combat zone and you do not have a power of attorney or other statement, you can sign the joint tax return.

   C: Correct. This is not a recognized exception, as a nonresident alien cannot sign a joint tax return because they do not qualify to file joint returns.

   D: Incorrect. There are exceptions to the general requirement that both husband and wife must sign a joint return.

3. **A: True is correct.** You will generally pay more combined tax on separate returns than you would on a joint return because the tax rate is higher for married persons filing separately.

   B: False is incorrect. Special rules apply if you file married filing separately. There are several credits and deductions that will not apply.

4. A: Incorrect. Mortgage interest payments would be included when calculating a head of household status.

   B: Incorrect. Real estate taxes are a typical cost of keeping up a home, and would be included in the head of household status calculation.

   C: Incorrect. Homeowner's property insurance is included in the upkeep of a home, and therefore included in the calculation.

   D: Correct. The cost of a homeowner's life insurance policy is not a usual cost for determining home upkeep expenses, and therefore is not included in determining head of household filing status.

Chapter 3: Personal Exemptions and Dependents

I. Important Changes

Exemption amount. The amount you can deduct for each exemption has increased to $3,700 for 2011.

Exemption phaseout. There is no reduction in the exemption amount for 2011 and 2012.

II. Introduction

This chapter discusses exemptions. The following topics will be explained.

- Personal exemptions – You generally can take one for yourself and, if you are married, one for your spouse.
- Exemptions for dependents – You generally can take an exemption for each of your dependents. A dependent is your qualifying child or qualifying relative. If you are entitled to claim an exemption for a dependent, that dependent cannot claim a personal exemption on his or her own tax return.
- Phaseout of exemptions – You get less of a deduction when your adjusted gross income goes above a certain amount.
- Social security number (SSN) requirement for dependents – You must list the social security number of any dependent for whom you claim an exemption.

Deduction. Exemptions reduce your taxable income. Generally, you can deduct $3,700 for each exemption you claim in 2011.

How you claim an exemption. How you claim an exemption on your tax return depends on which form you file.

If you file Form 1040EZ, the exemption amount is combined with the standard deduction amount and entered on line 5.

If you file Form 1040A or Form 1040, follow the instructions for the form. The total number of exemptions you can claim is the total in the box on line 6d. Also complete line 26 (Form 1040A) or line 42 (Form 1040) by multiplying the total number of exemptions shown in the box on line 6d by $3,700.

III. Exemptions

There are two types of exemptions: personal exemptions and exemptions for dependents. While these are both worth the same amount ($3,700 for 2011), different rules apply to each type.

PERSONAL EXEMPTIONS

You are generally allowed one exemption for yourself and, if you are married, one exemption for your spouse. These are called personal exemptions.

YOUR OWN EXEMPTION

You can take one exemption for yourself unless you can be claimed as a dependent by another taxpayer. If another taxpayer is entitled to claim you as a dependent, you cannot take an exemption for yourself even if the other taxpayer does not actually claim you as a dependent.

YOUR SPOUSE'S EXEMPTION

Your spouse is never considered your dependent.

Joint return. On a joint return you can claim one exemption for yourself and one for your spouse.

Separate return. If you file a separate return, you can claim the exemption for your spouse only if your spouse had no gross income and was not the dependent of another taxpayer. This is true even if the other taxpayer does not actually claim your spouse as a dependent. This is also true if your spouse is a nonresident alien.

Death of spouse. If your spouse died during the year, you can generally claim your spouse's exemption under the rules just explained under *Joint return* and *Separate return.*

If you remarried during the year, you cannot take an exemption for your deceased spouse.

If you are a surviving spouse without gross income and you remarry in the year your spouse died, you can be claimed as an exemption on both the final separate return of your deceased spouse and the separate return of your new spouse for that year. If you file a joint return with your new spouse, you can be claimed as an exemption only on that return.

Divorced or separated spouse. If you obtained a final decree of divorce or separate maintenance by the end of the year, you cannot take your former spouse's exemption. This rule applies even if you provided all of your former spouse's support.

IV. Exemptions for Dependents

You are allowed one exemption for each person you can claim as a dependent. You can claim an exemption for a dependent even if your dependent files a return.

The term “dependent” means:

- A qualifying child, or
- A qualifying relative.

The terms “qualifying child” and “qualifying relative” are defined later.

You can claim an exemption for a qualifying child or qualifying relative only if these three tests are met.

1) Dependent taxpayer test.
2) Joint return test.
3) Citizen or resident test.

These three tests are explained in detail later.

All the requirements for claiming an exemption for a dependent are summarized in Table 3-1.

Table 3-1. **Overview of the Rules for Claiming an Exemption for a Dependent**
Caution: This table is only an overview of the rules. For details, see the rest of this chapter.

- You cannot claim any dependents if you, or your spouse if filing jointly, could be claimed as a dependent by another taxpayer.
- You cannot claim a married person who files a joint return as a dependent unless that joint return is only a claim for refund and there would be no tax liability for either spouse on separate returns.
- You cannot claim a person as a dependent unless that person is a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico.[1]
- You cannot claim a person as a dependent unless that person is your **qualifying child** or **qualifying relative.**

Tests To Be a Qualifying Child	Tests To Be a Qualifying Relative
1) The child must be your son, daughter, stepchild, eligible foster child, brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them.	**1)** The person cannot be your qualifying child or the qualifying child of any other taxpayer.
2) The child must be (a) under age 19 at the end of the year, (b) under age 24 at the end of the year and a full-time student, and younger than you (or your spouse, if filing jointly), or (c) any age if permanently and totally disabled.	**2)** The person either (a) must be related to you in one of the ways listed under *Relatives who do not have to live with you,* or (b) must live with you all year as a member of your household (and your relationship must not violate local law).[2]
3) The child must have lived with you for more than half of the year.[2]	**3)** The person's gross income for the year must be less than $3,700.[3]
4) The child must not have provided more than half of his or her own support for the year.	**4)** You must provide more than half of the person's total support for the year.[4]
5) The child is not filing a joint return for the year (unless that return is filed only as a claim for refund).	
6) If the child meets the rules to be a qualifying child of more than one person, you must be the person entitled to claim the child as a qualifying child.	

[1]There is an exception for certain adopted children.
[2]There are exceptions for temporary absences, children who were born or died during the year, children of divorced or separated parents, and kidnapped children.
[3]There is an exception if the person is disabled and has income from a sheltered workshop.
[4]There are exceptions for multiple support agreements, children of divorced or separated parents, and kidnapped children.

Dependent not allowed a personal exemption. *If you can claim an exemption for your dependent, the dependent cannot claim his or her own exemption on his or her own tax return. This is true even if you do not claim the dependent's exemption on return.*

Housekeepers, maids, or servants. If these people work for you, you cannot claim exemptions for them.

Child tax credit. You may be entitled to a child tax credit for each qualifying child who was under age 17 at the end of the year. For more information, see chapter 34.

Dependent Taxpayer Test

If you could be claimed as a dependent by another person, you cannot claim anyone else as a dependent. Even if you have a qualifying child or qualifying relative, you cannot claim that person as a dependent.

If you are filing a joint return and your spouse could be claimed as a dependent by someone else, you and your spouse cannot claim any dependents on your joint return.

Joint Return Test

You generally cannot claim a married person as a dependent if he or she files a joint return.

Example. You supported your 18-year-old daughter, and she lived with you all year while her husband was in the Armed Forces. The couple files a joint return. Even though your daughter is your qualifying child, you cannot take an exemption for her.

Exception. The joint return test does not apply if a joint return is filed by the dependent and his or her spouse merely as a claim for refund and no tax liability would exist for either spouse on separate returns.

Example. Your 18-year-old son and his 17-year-old wife had $800 of interest income and no earned income. Neither is required to file a tax return. Taxes were taken out of their interest income due to backup withholding, so they filed a joint return only to get a refund. The exception to the joint return test applies, so you are not disqualified from claiming their exemptions just because they file a joint return. You can claim their exemptions if you meet all the other requirements to do so.

Citizen or Resident Test

You cannot claim a person as a dependent unless that person is a U.S. citizen, U.S. resident, U.S. national, or a resident of Canada or Mexico, for some part of the year. However, there is an exception for certain adopted children, as explained next.

Adopted child. If you are a U.S. citizen who has legally adopted a child who is not a U.S. citizen, U.S. resident, or U.S. national, this test is met if the child lived with you as a member of your household all year. This also applies if the child was lawfully placed with you for legal adoption.

Child's place of residence. Children usually are citizens or residents of the country of their parents.

If you were a U.S. citizen when your child was born, the child may be a U.S. citizen even if the other parent was a nonresident alien and the child was born in a foreign country. If so, this test is met.

U.S. national. A U.S. national is an individual who, although not a U.S. citizen, owes his or her allegiance to the United States. U.S. nationals include American Samoans and Northern Mariana Islanders who chose to become U.S. nationals instead of U.S. citizens.

QUALIFYING CHILD

There are five tests that must be met for a child to be your qualifying child. The five tests are:

1) Relationship,
2) Age,
3) Residency,
4) Support, and
5) Special test for qualifying child of more than one person.

These tests are explained next.

Relationship Test

To meet this test, a child must be:

- Your son, daughter, stepchild, eligible foster child, or a descendant (for example, your grandchild) of any of them, or
- Your brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant (for example, your niece or nephew) of any of them.

Adopted child. An adopted child is always treated as your own child. The term "adopted child" includes a child who was lawfully placed with you for legal adoption.

Foster child. A foster child is an individual who is placed with you by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

Age Test

To meet this test, a child must be:

- Under age 19 at the end of the year and younger than you (or your spouse, if filing jointly),
- A full-time student under age 24 at the end of the year and younger than you (or your spouse, if filing jointly), or
- Permanently and totally disabled at any time during the year, regardless of age.

Example. Your son turned 19 on December 10. Unless he was disabled or a full-time student, he does not meet the age test because, at the end of the year, he was not **under** age 19.

Child must be younger than you or spouse. To be your qualifying child, a child who is not permanently and totally disabled must be younger than you. However, if you are married filing jointly, the child must be younger than you or your spouse but does not have to be younger than both of you.

Example 1 – child not younger than you or spouse. Your 23-year-old brother, who is a full-time student and unmarried, lives with you and your spouse. He is not disabled. Both you and your spouse are 21 years old, and you file a joint return. Your brother is not your qualifying child because he is not younger than you or your spouse.

Example 2 – child younger than your spouse but not younger than you. The facts are the same as in Example 1 except that your spouse is 25 years old. Because your brother is younger than your spouse and you and your spouse are filing a joint return, your brother is your qualifying child, even though he is not younger than you.

Full-time student. A full-time student is a student who is enrolled for the number of hours or courses the school considers to be full-time attendance.

Student defined. To qualify as a student, your child must be, during some part of each of any 5 calendar months of the year:

1) A full-time student at a school that has a regular teaching staff, course of study, and a regularly enrolled student body at the school, or
2) A student taking a full-time, on-farm training course given by a school described in (1), or by a state, county, or local government agency.

The 5 calendar months do not have to be consecutive.

School defined. A school can be an elementary school, junior and senior high school, college, university, or technical, trade, or mechanical school. However, an on-the-job training course, correspondence school, or Internet school does not count as a school.

Vocational high school students. Students who work on "co-op" jobs in private industry as a part of a school's regular course of classroom and practical training are considered full-time students.

Permanently and totally disabled. Your child is permanently and totally disabled if both of the following apply.

- He or she cannot engage in any substantial gainful activity because of a physical or mental condition.
- A doctor determines the condition has lasted or can be expected to last continuously for at least a year or can lead to death.

Residency Test

To meet this test, your child must have lived with you for more than half of the year. There are exceptions for temporary absences, children who were born or died during the year, kid-children, and children of divorced or separated parents.

Temporary absences. Your child is considered to have lived with you during periods of time when one of you, or both, are temporarily absent due to special circumstances such as:

- Illness,
- Education,
- Business,
- Vacation, or
- Military service.

Death or birth of child. A child who was born or died during the year is treated as having lived with you all year if your home was the child's home the entire time he or she was alive during the year. The same is true if the child lived with you all year except for any required hospital stay following birth.

Child born alive. You may be able to claim an exemption for a child who was born alive during the year, even if the child lived only for a moment. State or local law must treat the child as having been born alive. There must be proof of a live birth shown by an official document, such as a birth certificate. The child must be your qualifying child or qualifying relative, and all other tests to claim an exemption for a dependent must be met.

Stillborn child. You cannot claim an exemption for a stillborn child.

Kidnapped Child. You can treat your child as meeting the residency test even if the child has been kidnapped, but both of the following statements must be true.

1) The child is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of your family or the child's family.
2) In the year the kidnapping occurred, the child lived with you for more than half of the part of the year before the date of the kidnapping.

This treatment applies for all years until the child is returned. However, the last year this treatment can apply is the earlier of:

1) The year there is a determination that the child is dead, or
2) The year the child would have reached age 18.

Children of divorced or separated parents who live apart. In most cases, because of the residency test, a child of divorced or separated parents is the qualifying child of the custodial parent. However, the child will be treated as the qualifying child of the noncustodial parent if all four of the following statements are true.

1) The parents:
   a) Are divorced or legally separated under a decree of divorce or separate maintenance.
   b) Are separated under a written separation agreement, or
   c) Lived apart at all times during the last 6 months of the year, whether or not they are or were married.
2) The child received over half of his or her support for the year from the parents.
3) The child is in the custody of one or both parents for more than half of the year.
4) Either of the following statements is true.
   a) The custodial parent signs a written declaration, discussed later, that he or she will not claim the child as a dependent for the year, and the noncustodial parent attaches this written declaration to his or her return. (If the decree or agreement went into effect after 1984 and before 2009, see *Post-1984 and pre-2009 divorce decree or separation*

agreement, later. If the decree or agreement went into effect after 2008, see *Post-2008 divorce decree or separation agreement*, later.)

b) A pre-1985 decree of divorce or separate maintenance or written separation agreement that applies to 2011 states that the noncustodial parent can claim the child as a dependent, the decree or agreement was not changed after 1984 to say the noncustodial parent cannot claim the child as a dependent, and the noncustodial parent provides at least $600 for the child's support during the year.

Written declaration. The custodial parent may use either Form 8332 or a similar statement (containing the information required by the form) to make the written declaration to release the exemption to the noncustodial parent. The noncustodial parent must attach the form or statement to his or her tax return.

The exemption can be released for 1 year, for a number of specified years (for example, alternate years), or for all future years, as specified in the declaration. If the exemption is released for more than 1 year, the original release must be attached to the return of the noncustodial parent for the first year, and a copy must be attached for each later year.

Custodial parent and noncustodial parent. The custodial parent is the parent with whom the child lived for the greater part of the year. The other parent is the noncustodial parent. If the parents divorced or separated during the year and the child lived with both parents before the separation, the custodial parent is the one with whom the child lived for the greater part of the rest of the year.

A child is treated as living with a parent for a night if the child sleeps:

- At that parent's home, whether or not the parent is present, or
- In the company of the parent, when the child does not sleep at a parent's home (for example, the parent and child are on vacation together).

Equal number of nights. If the child lived with each parent for an equal number of nights during the year, the custodial parent is the parent with the higher adjusted gross income.

December 31. The night of December 31 is treated as part of the year in which it begins. For example, December 31, 2011, is treated as part of 2011.

Emancipated child. If a child is emancipated under state law, the child is treated as not living with either parent.

Absences. If a child was not with either parent on a particular night (because, for example, the child was staying at a friend's house), the child is treated as living with the parent with whom the child normally would have lived for that night, except for the absence. But if it cannot be determined with which parent the child normally would have lived or if the child would not have lived with either parent that night, the child is treated as not living with either parent that night.

Parent works at night. If, due to a parent's nighttime work schedule, a child lives for a greater number of days but not nights with the parent who works at night, that parent is treated as the custodial parent. On a school day, the child is treated as living at the primary residence registered with the school.

Post-1984 and pre-2009 divorce decree or separation agreement. If the divorce decree or separation agreement went into effect after 1984 and before 2009, the noncustodial parent may be able to attach certain pages from the decree or agreement instead of Form 8332. The decree or agreement must state all three of the following.

1) The noncustodial parent can claim the child as a dependent without regard to any condition, such as payment of support.

2) The custodial parent will not claim the child as a dependent for the year.

3) The years for which the noncustodial parent, rather than the custodial parent, can claim the child as a dependent.

The noncustodial parent must attach all of the following pages of the decree or agreement to his or her tax return.

- The cover page (write the other parent's social security number on this page).
- The pages that include all of the information identified in items (1) through (3) above.
- The signature page with the other parent's signature and the date of the agreement.

Post-2008 divorce decree or separation agreement. The noncustodial parent can no longer attach pages from the decree or agreement instead of Form 8332 if the decree or agreement went into effect after 2008. The noncustodial parent will have to attach Form 8332 or a similar statement signed by the custodial parent and whose only purpose is to release a claim to exemption.

Caution. *The noncustodial parent must attach the required information even if it was filed with a return in an earlier year.*

Revocation of release of claim to an exemption. For 2011, the rules allow the custodial parent to revoke a release of claim to exemption that the custodial parent previously released to the noncustodial parent on Form 8332 or a similar statement. If the custodial parent provides, or makes reasonable efforts to provide, the noncustodial parent with written notice of the revocation in 2011, the revocation can be effective no earlier than 2012. The custodial parent can use Part III of Form 8332 for this purpose and must attach a copy of the revocation to his or her return for each tax year he or she claims the child as a dependent as a result of the revocation.

Remarried parent. If you remarry, the support provided by your new spouse is treated as provided by you.

Example. Your child lived with you for 10 months of the year. The child lived with your former spouse for the other 2 months. You are considered the custodial parent.

Parents who never married. This special rule for divorced or separated parents also applies to parents who never married and lived apart at all times during the last 6 months of the year.

Support Test (To Be a Qualifying Child)

To meet this test, the child cannot have provided more than half of his or her own support for the year.

This test is different from the support test to be a qualifying relative, which is described later. However, to see what is or is not support, see *Support Test (To Be a Qualifying Relative)*, later. If you are not sure whether a child provided more than half of his or her own support, you may find Worksheet 3-1 helpful.

Scholarships. A scholarship received by a child who is a full-time student is not taken into account in determining whether the child provided more than half of his or her own support.

Joint Return Test (To Be a Qualifying Child)

To meet this test, the child cannot file a joint return for the year.

Example. You supported your 18-year-old daughter, and she lived with you all year while her husband was in the Armed Forces. The couple files a joint return. Because your daughter filed a joint return, she is not your qualifying child.

Exception. The joint return test does not apply if your child and his or her spouse file a joint return merely as a claim for refund.

Example. Your 18-year-old son and his 17-year-old wife had $800 of interest income and no earned income. Neither is required to file a tax return. Taxes were taken out of their interest income due to backup withholding so they filed a joint return only to get a refund. The exception to the joint return test applies, so your son may be your qualifying child if all the other tests are met.

Special Test for Qualifying Child of More Than One Person

Tip. *If your qualifying child is not a qualifying child for anyone else, this test does not apply to you and you do not need to read about it. This is also true if your qualifying child is not a qualifying child for anyone else except your spouse with whom you file a joint return.*

Caution. *If a child is treated as the qualifying child of the noncustodial parent under the rules for children of divorced or separated parents described earlier, see* Applying this special test to divorced or separated parents or parents who live apart*, later.*

Sometimes, a child meets the relationship, residency, and support tests to be a qualifying child of more than one person. Although the child is a qualifying child of each of these persons, only one person can actually treat the child as a qualifying child. To meet this special test, you must be the person who can treat the child as a qualifying child. Only that person can treat the child as a qualifying child to take all of the following tax benefits (provided the person is eligible for each benefit).

- The exemption for the child.
- The child tax credit.
- Head of household filing status.
- The credit for child and dependent care expenses.
- The exclusion from income for dependent care benefits.
- The earned income credit.

The other person cannot take any of these benefits based on this qualifying child. In other words, you and the other person cannot agree to divide these tax benefits between you. The other person cannot take any of these tax benefits unless he or she has a different qualifying child.

Tiebreaker rules. To determine which person can treat the child as a qualifying child to claim these six tax benefits, the following tie-breaker rules apply.

- If only one of the persons is the child's parent, the child is treated as the qualifying child of the parent.
- If the parents do not file a joint return together but both parents claim the child as a qualifying child, the IRS will treat the child as the qualifying child of the parent with whom the child lived for the longer period of time during the year. If the child lived with each parent for the same amount of time, the IRS will treat the child as the qualifying child of the parent who had the higher adjusted gross income (AGI) for the year.
- If no parent can claim the child as a qualifying child, the child is treated as the qualifying child of the person who had the highest AGI for the year.
- If a parent can claim the child as a qualifying child but no parent does so claim the child, the child is treated as the qualifying child of the person who had the highest AGI for the year, but only if that person's AGI is higher than the highest AGI of any of the child's parents who can claim the child. If the child's parents file a joint return with each other, this rule can be applied by dividing the parents' combined AGI equally between the parents. See Example 6.

Subject to these tiebreaker rules, you and the other person may be able to choose which of you claims the child as a qualifying child.

Example 1—child lived with parent and grandparent. You and your 3-year-old daughter Jane lived with your mother all year. You are 25 years old, unmarried, and your AGI is $9,000. Your mother's AGI is $15,000. Jane's father did not live with you or your daughter. The rule explained earlier for children of divorced or separated parents or parents who live apart does not apply. Jane is a qualifying child of both you and your mother because she meets the relationship, age, residency, support, and joint return tests for both you and your mother. However, only one of you can claim her. Jane is not a qualifying child of anyone else, including her father. You agree to let your mother claim Jane. This means your mother can claim Jane as a qualifying child for the dependency exemption, child tax credit, head of household filing status, credit for child and dependent care expenses, exclusion for dependent care benefits, and the earned income credit, if she qualifies for each of those tax benefits (and if you do not claim Jane as a qualifying child for any of those tax benefits).

Example 2—parent has higher AGI than grandparent. The facts are the same as in Example 1 except your AGI is $18,000. Because your mother's AGI is not higher than yours, she cannot claim Jane. Only you can claim Jane.

Example 3 — two persons claim same child. The facts are the same as in Example 1 except that you and your mother both claim Jane as a qualifying child. In this case, you as the child's parent will be the only one allowed to claim Jane as a qualifying child. The IRS will disallow your mother's claim to the six tax benefits listed earlier unless she has another qualifying child.

Example 4—qualifying children split between two persons. The facts are the same as in Example 1 except you also have two other young children who are qualifying children of both you and your mother. Only one of you can claim each child. However, if your mother's AGI is higher than yours, you can allow your mother to claim one or more of the children. For example, if you claim one child, your mother can claim the other two.

Example 5—taxpayer who is a qualifying child. The facts are the same as in Example 1 except you are only 18 years old and did not provide more than half of your own support for the year. This means you are your mother's qualifying child. If she can claim you as a dependent, then you cannot claim your daughter as a dependent because of the *Dependent Taxpayer Test* explained earlier.

Example 6—child lived with both parents and grandparent. The facts are the same as in Example 1 except that you and your daughter's father are married to each other, live with your daughter and your mother, and have AGI of $20,000 on a joint return. If you and your husband do not claim your daughter as a qualifying child, your mother can claim her instead. Even though the AGI on your joint return, $20,000, is more than your mother's AGI of $15,000, for this purpose each parent's AGI can be treated as $10,000, so your mother's $15,000 AGI is treated as higher than the highest AGI of any of the child's parents who can claim the child.

Example 7 — separated parents. You, your husband, and your 10-year-old son lived together until August 1, 2011, when your husband moved out of the household. In August and September, your son lived with you. For the rest of the year, your son lived with your husband, the boy's father. Your son is a qualifying child of both you and your husband because your son lived with each of you for more than half the year and because he met the relationship, age, support, and joint return tests for both of you. At the end of the year, you and your husband still were not divorced, legally separated, or separated under a written separation agreement, so the rule for children of divorced or separated parents or parents who live apart does not apply.

You and your husband will file separate returns. Your husband agrees to let you treat your son as a qualifying child. This means, if your husband does not claim your son as a qualifying child, you can claim your son as a qualifying child for the dependency exemption, child tax credit, and exclusion for dependent care benefits, if you qualify for each of those tax benefits. However, you cannot claim head of household filing status because you and your husband did not live apart for the last 6 months of the year. As a result, your filing status is married filing separately, so you cannot claim the earned income credit or the credit for child and dependent care expenses.

Example 8 — separated parents claim same child. The facts are the same as in Example 7 except that you and your husband both claim your son as a qualifying child. In this case, only your husband will be allowed to treat your son as a qualifying child. This is because, during 2011, the boy lived with him longer than with you. If you claimed an exemption, the child tax credit, or the exclusion for dependent care benefits for your son, the IRS will disallow your claim to all these tax benefits, unless you have another qualifying child. In addition, because you and your husband did not live apart for the last 6 months of the year, your husband cannot claim head of household filing status. As a result, his filing status is married filing separately, so he cannot claim the earned income credit or the credit for child and dependent care expenses.

Example 9 — unmarried parents. You, your 5-year-old son, and your son's father lived together all year. You and your son's father are not married. Your son is a qualifying child of both you and his father because he meets the relationship, age, residency, support, and joint return tests for both you and his father. Your AGI is $12,000 and your son's father's AGI is $14,000. Your son's father agrees to let you claim the child as a qualifying child. This means you can claim him as a qualifying child for the dependency exemption, child tax credit, head of household filing status, credit for child and dependent care expenses, exclusion for dependent care benefits, and the earned income credit, if you qualify for each of those tax benefits (and if your son's father does not, in fact, claim your son as a qualifying child for any of those tax benefits).

Example 10—unmarried parents claim same child. The facts are the same as in Example 9 except that you and your son's father both claim your son as a qualifying child. In this case, only your son's father will be allowed to treat your son as a qualifying child. This is because his AGI, $14,000, is more than your AGI, $12,000. If you claimed an exemption, the child tax credit, head of household filing status, credit for child and dependent care expenses, exclusion for dependent care benefits, or the earned income credit for your son, the IRS will disallow your claim to all these tax benefits, unless you have another qualifying child.

Example 11—child did not live with a parent. You and your 7-year-old niece, your sister's child, lived with your mother all year. You are 25 years old, and your AGI is $9,300. Your mother's AGI is $15,000. Your niece's parents file jointly, have an AGI of less than $9,000, and do not live with you or their child. Your niece is a qualifying child of both you and your mother because she meets the relationship, age, residency, support, and joint return tests for both you and your mother. However, only your mother can treat her as a qualifying child. This is because your mother's AGI, $15,000, is more than your AGI, $9,300.

Applying this special test to divorced or separated parents or parents who live apart. If a child is treated as the qualifying child of the noncustodial parent under the rules described earlier for children of divorced or separated parents or parents who live apart, only the noncustodial parent can claim an exemption and the child tax credit for the child. However, the custodial parent, if eligible, or other eligible person can claim the child as a qualifying child for head of household filing status, the credit for child and dependent care expenses, the exclusion for dependent care benefits, and the earned income credit. If the child is the qualifying child of more than one person for these benefits, then the tiebreaker rules will determine which person can treat the child as a qualifying child.

Example 1. You and your 5-year-old son lived all year with your mother, who paid the entire cost of keeping up the home. Your AGI is $10,000. Your mother's AGI is $25,000. Your son's father did not live with you or your son. Under the rules explained earlier for children of divorced or separated parents or parents who live apart, your son is treated as the qualifying child of his father, who can claim an exemption and the child tax credit for him. Because of this, you cannot claim an exemption or the child tax credit for your son. However, your son's father cannot claim your son as a qualifying child for head of household filing status, the credit for child and dependent care expenses, the exclusion for dependent care benefits, or the earned income credit. You and your mother did not have any child care expenses or dependent care benefits, but the boy is a qualifying child of both you and your mother for head of household filing status and the earned income credit because he meets the relationship, age, residency, support, and joint return tests for both you and your mother. (Note: The support test does not apply for the earned income credit.) However, you agree to let your mother claim your son. This means she can claim him for head of household filing status and the earned income credit if she qualifies for each and if you do not claim him as a qualifying child for the earned income credit. (You cannot claim head of household filing status because your mother paid the entire cost of keeping up the home.)

Example 2. The facts are the same as in Example 1 except that your AGI is $25,000 and your mother's AGI is $21,000. Your mother cannot claim your son as a qualifying child for any purpose because her AGI is not higher than yours.

Example 3. The facts are the same as in Example 1 except that you and your mother both claim your son as a qualifying child for the earned income credit. Your mother also claims him as a qualifying child for head of household filing status. You as the child's parent will be the only one allowed to claim your son as a qualifying child for the earned income credit. The IRS will disallow your mother's claim to the earned income credit and head of household filing status unless she has another qualifying child.

QUALIFYING RELATIVE

There are four tests that must be met for a person to be your qualifying relative. The four tests are:

1) Not a qualifying child test,
2) Member of household or relationship test,
3) Gross income test, and
4) Support test.

Age. Unlike a qualifying child, a qualifying relative can be any age. There is no age test for a qualifying relative.

Kidnapped Child. You can treat a child as your qualifying relative even if the child has been kidnapped, but both of the following statements must be true.

1) The child is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of your family or the child's family.
2) In the year the kidnapping occurred, the child met the tests to be your qualifying relative for the part of the year before the date of the kidnapping.

This treatment applies for all years until the child is returned. However, the last year this treatment can apply is the earlier of:

1) The year there is a determination that the child is dead, or
2) The year the child would have reached age 18.

Not a Qualifying Child Test

A child is not your qualifying relative if the child is your qualifying child or the qualifying child of any other taxpayer.

Example 1. Your 22-year-old daughter, who is a full-time student, lives with you and meets all the tests to be your qualifying child. She is not your qualifying relative.

Example 2. Your 2-year-old son lives with your parents and meets all the tests to be their qualifying child. He is not your qualifying relative.

Example 3. Your son lives with you but is not your qualifying child because he is 30 years old and does not meet the age test. He may be your qualifying relative if the gross income test and the support test are met.

Example 4. Your 13-year-old grandson lived with his mother for 3 months, with his uncle for 4 months, and with you for 5 months during the year. He is not your qualifying child because he does not meet the residency test. He may be your qualifying relative if the gross income test and the support test are met.

Member of Household or Relationship Test

To meet this test, a person must either:

1) Live with you all year as a member of your household, or
2) Be related to you in one of the ways listed under *Relatives who do not have to live with you*.

If at any time during the year the person was your spouse, that person cannot be your qualifying relative. However, see *Personal Exemptions,* earlier.

Relatives who do not have to live with you. A person related to you in any of the following ways does not have to live with you all year as a member of your household to meet this test.

- Your child, stepchild, eligible foster child, or a descendant of any of them (for example, your grandchild). (A legally adopted child is considered your child.)
- Your brother, sister, half brother, half sister, stepbrother, or stepsister.
- Your father, mother, grandparent, or other direct ancestor, but not foster parent.
- Your stepfather or stepmother.
- A son or daughter of your brother or sister.
- A brother or sister of your father or mother.
- Your son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

Any of these relationships that were established by marriage are not ended by death or divorce.

Foster child. A foster child is an individual who is placed with you by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

Joint return. If you file a joint return, the person can be related to either you or your spouse. Also, the person does not need to be related to the spouse who provides support.

For example, your spouse's uncle who receives more than half of his support from you may be your qualifying relative, even though he does not live with you. However, if you and your spouse file separate returns, your spouse's uncle can be your qualifying relative only if he lives with you all year as a member of your household.

Temporary absences. A person is considered to live with you as a member of your household during periods of time when one of you, or both, are temporarily absent due to special circumstances such as:

- Illness,
- Education,
- Business,
- Vacation, or
- Military service.

If the person is placed in a nursing home for an indefinite period of time to receive constant medical care, the absence may be considered temporary.

Death or birth. A person who died during the year, but lived with you as a member of your household until death, will meet this test. The same is true for a child who was born during the year and lived with you as a member of your household for the rest of the year. The test is also met if a child lived with you as a member of your household except for any required hospital stay following birth.

If your dependent died during the year and you otherwise qualified to claim an exemption for the dependent, you can still claim the exemption.

Example. Your dependent mother died on January 15. She met the tests to be your qualifying relative. The other tests to claim an exemption for a dependent were also met. You can claim an exemption for her on your return.

Local law violated. A person does not meet this test if at any time during the year the relationship between you and that person violates local law.

Example. Your girlfriend lived with you as a member of your household all year. However, your relationship with her violated the laws of the state where you live, because she was married to someone else. Therefore, she does not meet this test and you cannot claim her as a dependent.

Adopted child. An adopted child is always treated as your own child. The term "adopted child" includes a child who was lawfully placed with you for legal adoption.

Cousin. Your cousin meets this test only if he or she lives with you all year as a member of your household. A cousin is a descendant of a brother or sister of your father or mother.

Gross Income Test

To meet this test, a person's gross income for the year must be less than $3,700.

Gross income defined. Gross income is all income in the form of money, property, and services that is not exempt from tax.

In a manufacturing, merchandising, or mining business, gross income is the total net sales minus the cost of goods sold, plus any miscellaneous income from the business.

Gross receipts from rental property are gross income. Do not deduct taxes, repairs, etc., to determine the gross income from rental property.

Gross income includes a partner's share of the gross (not a share of the net) partnership income.

Gross income also includes all unemployment compensation and certain scholarship and fellowship grants. Scholarships received by degree candidates that are used for tuition, fees, supplies, books, and equipment required for particular courses may not be included in gross income.

Tax-exempt income, such as certain social security benefits, is not included in gross income.

Disabled dependent working at sheltered workshop. For purposes of this test (the gross test), the gross income of an individual who is permanently and totally disabled at any time during the year does not include income for services the individual performs at a sheltered workshop. The availability of medical care at the workshop must be the main reason for the individual's presence there. Also, the income must come solely from activities at the workshop that are incident to this medical care.

A "sheltered workshop" is a school that:

- Provides special instruction or training designed to alleviate the disability of the individual, and
- Is operated by certain tax-exempt organizations, or by a state, a U.S. possession, a political subdivision of a state or possession, the United States, or the District of Columbia.

Support Test (To Be a Qualifying Relative)

To meet this test, you generally must provide more than half of a person's total support during the calendar year.

However, if two or more persons provide support, but no one person provides more than half of a person's total support, see *Multiple Support Agreement,* later.

How to determine if support test is met. You figure whether you have provided more than half of a person's total support by comparing the amount you contributed to that person's support with the entire amount of support that person received from all sources. This includes support the person provided from his or her own funds.

You may find Worksheet 3-1 helpful in figuring whether you provided more than half of a person's support.

Person's own funds not used for support. A person's own funds are not support unless they are actually spent for support.

Example. Your mother received $2,400 in social security benefits and $300 in interest. She paid $2,000 for lodging and $400 for recreation. She put $300 in a savings account.

Even though your mother received a total of $2,700, she spent only $2,400 for her own support. If you spent more than $2,400 for her support and no other support was received, you have provided more than half of her support.

Child's wages used for own support. You cannot include in your contribution to your child's support any support that is paid for by the child with the child's own wages, even if you paid the wages.

Year support is provided. The year you provide the support is the year you pay for it, even if you do so with borrowed money that you repay a later year.

If you use a fiscal year to report your income, you must provide more than half of the support for the calendar year in which your fiscal year begins.

Armed Forces dependency allotments. The part of the allotment contributed by the government and the part taken out of your military pay are both considered provided by you in figuring whether you provide more than half of the support. If your allotment is used to support persons other than those you name, you can take the exemptions for them if they otherwise qualify.

Example. You are in the Armed Forces. You authorize an allotment for your widowed mother that she uses to support herself and her sister. If the allotment provides more than half of each person's support, you can take an exemption for each of them, if they otherwise qualify, even though you authorize the allotment only for your mother.

Tax-exempt military quarters allowances. These allowances are treated the same way as dependency allotments in figuring support. The allotment of pay and the tax-exempt basic allowance for quarters are both considered as provided by you for support.

Tax-exempt income. In figuring a person's total support, include tax-exempt income, savings, and borrowed amounts used to support that person. Tax-exempt income includes certain social security benefits, welfare benefits, nontaxable life insurance proceeds, Armed Forces family allotments, nontaxable pensions, tax-exempt interest.

Example 1. You provide $4,000 toward your mother's support during the year. She has earned income of $600, nontaxable social security benefits of $4,800, and tax-exempt interest of $200. She uses all these for her support. You cannot claim an exemption for your mother because the $4,000 you provide is not more than half of her total support of $9,600.

Example 2. Your brother's daughter takes out a student loan of $2,500 and uses it to pay her college tuition. She is personally responsible for the loan. You provide $2,000 toward her total support. You cannot claim an exemption for her because you provide less than half of her support.

Social security benefits. If a husband and wife each receive benefits that are paid by one check made out to both of them, half of the total paid is considered to be for the support of each spouse, unless they can show otherwise.

If a child receives social security benefits and uses them toward his or her own support, the benefits are considered as provided by the child.

Support provided by the state (welfare, food stamps, housing, etc.). Benefits provided by the state to a needy person generally are considered support provided by the state. However, payments based on the needs of the recipient will not be considered as used entirely for that person's support if it is shown that part of the payments were not used for that purpose.

Foster care payments and expenses. Payments you receive for the support of a foster child from a child placement agency are considered support provided by the agency. Similarly, payments you receive for the support of a foster child from a state or county are considered support provided by the state or county.

If you are not in the trade or business of providing foster care and your unreimbursed out-of-pocket expenses in caring for a foster child were mainly to benefit an organization qualified to receive deductible charitable contributions, the expenses are deductible as charitable contributions but are not considered support you provided. If your unreimbursed expenses are not deductible as charitable contributions, they are considered support you provided.

If you are in the trade or business of providing foster care, your unreimbursed expenses are not considered support provided by you.

Example. Lauren, an eligible foster child, lived with Mr. and Mrs. Smith for the last 3 months of the year. The Smiths cared for Lauren because they wanted to adopt her (although she had not been placed with them for adoption). They did not care for her as a trade or business or to benefit the agency that placed her in their home. The Smiths' unreimbursed expenses are not deductible as charitable contributions but are considered support they provided for Lauren.

Home for the aged. If you make a lump-sum advance payment to a home for the aged to take care of your relative for life and the payment is based on that person's life expectancy, the amount of support you provide each year is the lump-sum payment divided by the relative's life expectancy. The amount of support you provide also includes any other amounts you provided during the year.

Total Support

To figure if you provided more than half of a person's support, you must first determine the total support provided for that person. Total support includes amounts spent to provide food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities.

Generally, the amount of an item of support is the amount of the expense incurred in providing that item. For lodging, the amount of support is the fair rental value of the lodging.

Expenses that are not directly related to any one member of a household, such as the cost of food for the household, must be divided among the members of the household.

Example 1. Grace Brown, mother of Mary Miller, lives with Frank and Mary Miller and their two children. Grace gets social security benefits of $2,400, which she spends for clothing, transportation, and recreation. Grace has no other income. Frank and Mary's total food expense for the household is $5,200. They pay Grace's medical and drug expenses of $1,200. The fair rental value of the lodging provided for Grace is $1,800 a year, based on the cost of similar rooming facilities. Figure Grace's total support as follows:

Fair rental value of lodging	$1,800
Clothing, transportation and recreation	2,400
Medical expenses	1,200
Share of food (1/5 of $5,200)	1,040
Total support	$6,440

The support Frank and Mary provide ($1,800 lodging + $1,200 medical expenses + $1,040 food = $4,040) is more than half of Grace's $6,440 total support.

Example 2. Your parents live with you, your spouse, and your two children in a house you own. The fair rental value of your parents' share of the lodging is $2,000 a year ($1,000 each), which includes furnishings and utilities. Your father receives a nontaxable pension of $4,200, which he spends equally between your mother and himself for items of support such as clothing, transportation, and recreation. Your total food expense for the household is $6,000. Your heat and utility bills amount to $1,200. Your mother has hospital and medical expenses of $600, which you pay during the year. Figure your parents' total support as follows:

Support provided	**Father**	**Mother**
Fair rental value of lodging	$1,000	$1,000
Pension spent for their support	2,100	2,100
Share of food (1/6 of $6,000)	1,000	1,000
Medical expenses for mother		600
Parents' total support	$4,100	$4,700

You must apply the support test separately to each parent. You provide $2,000 ($1,000 lodging, $1,000 food) of your father's total support of $4,100 – less than half. You provide $2,600 to your mother ($1,000 lodging, $1,000 food, $600 medical) – more than half of her total support of $4,700. You meet the support test for your mother, but not your father. Heat and utility costs are included in the fair rental value of the lodging, so these are not considered separately

Lodging. If you provide a person with lodging, you are considered to provide support equal to the fair rental value of the room, apartment, house, or other shelter in which the person lives. Fair rental value includes a reasonable allowance for the use of furniture and appliances, and for heat and other utilities that are provided.

Fair rental value defined. This is the amount you could reasonably expect to receive from a stranger for the same kind of lodging. It is used instead of actual expenses such as taxes, interest, depreciation, paint, insurance, utilities, cost of furniture and appliances, etc. In some cases, fair rental value may be equal to the rent paid.

If you provide the total lodging, the amount of support you provide is the fair rental value of the room the person uses, or a share of the fair rental value of the entire dwelling if the person has use of your entire home. If you do not provide the total lodging, the total fair rental value must be divided depending on how much of the total lodging you provide. If you provide only a part and the person supplies the rest, the fair rental value must be divided between both of you according to the amount each provides.

Example. Your parents live rent free in a house you own. It has a fair rental value of $5,400 a year furnished, which includes a fair rental value of $3,600 for the house and $1,800 the furniture. This does not include heat and utilities. The house is completely furnished with furniture belonging to your parents. You pay $600 for their utility bills. Utilities are not usually included in rent for houses in the area where your parents live. Therefore, you consider the total fair rental value of the lodging to be $6,000 ($3,600 fair rental value of the unfurnished house, $1,800 allowance for the furnishings provided by your parents, and $600 cost of utilities) of which you are considered to provide $4,200 ($3,600 + $600).

Person living in his or her own home. The total fair rental value of a person's home that he or she owns is considered support contributed by that person.

Living with someone rent free. If you live with a person rent free in his or her home, you must reduce the amount you provide for support by the fair rental value of lodging he or she provides you.

Property. Property provided as support is measured by its fair market value. Fair market value is the price that property would sell for on the open market. It is the price that would be agreed upon between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts.

Capital expenses. Capital items, such as furniture, appliances, and cars that are bought for a person during the year can be included in total support under certain circumstances. The following examples show when a capital item is or is not support.

Example 1. You buy a $200 power lawn mower for your 13-year-old child. The child is given the duty of keeping the lawn trimmed. Because the lawn mower benefits all members of the household, you cannot include the cost of the lawn mower in the support of your child.

Example 2. You buy a $150 television set as a birthday present for your 12-year-old child. The television set is placed in your child's bedroom. You can include the cost of the television set in the support of your child.

Example 3. You pay $5,000 for a car and register it in your name. You and your 17-year-old daughter use the car equally. Because you own the car and do not give it to your daughter but merely let her use it, you cannot include the cost of the car in your daughter's total support. However, you can include in your daughter's support your out-of-pocket expenses of operating the car for her benefit.

Example 4. Your 17-year-old son, using personal funds, buys a car for $4,500. You provide all the rest of your son's support – $4,000. Since the car is bought and owned by your son, the car's fair market value ($4,500) must be included in his support. Your son has provided more than half of his own total support of $8,500 ($4,500 + $4,000), so he is not your qualifying child. You did not provide more than half of his total support, so he is not your qualifying relative. You cannot claim an exemption for your son.

Medical insurance premiums. Medical insurance premiums you pay, including premiums for supplementary Medicare coverage, are included in the support you provide.

Medical insurance benefits. Medical insurance benefits, including basic and supplementary Medicare benefits, are not part of support.

Tuition payments and allowances under the GI Bill. Amounts veterans receive under the GI Bill for tuition payments and allowances while they attend school are included in total support.

Example. During the year, your son receives $2,200 from the government under the GI Bill. He uses this amount for his education. You provide the rest of his support – $2,000. Because GI benefits are included in total support, your son's total support is $4,200 ($2,200 + $2,000). You have not provided more than half of his support.

Child care expenses. If you pay someone to provide child or dependent care, you can include these payments in the amount you provided for the support of your child or disabled dependent, even if you claim a credit for the payments.

Other support items. Other items may be considered as support depending on the facts in each case.

Do Not Include in Total Support

The following items are not included in total support.

1) Federal, state, and local income taxes paid by persons from their own income.
2) Social security and Medicare taxes paid by persons from their own income.
3) Life insurance premiums.
4) Funeral expenses.
5) Scholarships received by your child if your child is a full-time student.
6) Survivors' and Dependents' Educational Assistance payments used for the support of the child who receives them.

Multiple Support Agreement

Sometimes no one provides more than half of the support of a person. Instead, two or more persons, each of whom would be able to take exemption but for the support test, together provide more than half of the person's support.

When this happens, you can agree that any one of you who individually provides more than 10% of the person's support, but only one, can claim an exemption for that person as a qualifying relative. Each of the others must sign a statement agreeing not to claim the exemption for that year. The person who claims the exemption must keep these signed statements for his or her records. A multiple support declaration identifying each of the others who agreed not to claim the exemption must be attached to the return of the person claiming the exemption. Form 2120, Multiple Support Declaration, can used for this purpose.

You can claim an exemption under a multiple support agreement for someone related to you or for someone who lived with you all year as a member of your household.

Example 1. You, your sister, and your two brothers provide the entire support of your mother for the year. You provide 45%, your sister 35%, and your two brothers each provide 10%. Either you or your sister can claim an exemption for your mother. The other must sign a statement agreeing not to take an exemption for your mother. The one who claims the exemption must attach Form 2120, or a similar declaration, to his or her return and must keep the statement signed by the other for his or her records. Because neither brother provides more than 10% of the support, neither can take the exemption and neither has to sign a statement.

Example 2. You and your brother each provide 20% of your mother's support for the year. The remaining 60% of her support is provided equally by two persons who are not related to her. She does not live with them. Because more than half of her support is provided by persons who cannot claim an exemption for her, no one can take the exemption.

Example 3. Your father lives with you and receives 25% of his support from social security, 40% from you, 24% from his brother (your uncle), and 11% from a friend. Either you or your uncle can take the exemption for your father if the other signs a statement agreeing not to. The one who takes the exemption must attach Form 2120, or a similar declaration, to his return and must keep for his records the signed statement from the one agreeing not to take the exemption.

Support Test for Children of Divorced or Separated Parents

In most cases, a child of divorced or separated parents will be a qualifying child of one of the parents. See *Children of divorced or separated parents* under *Qualifying Child,* earlier. However, if the child does not meet the requirements to be a qualifying child of either parent, the child may be a qualifying relative of one of the parents. In that case, the following rules must be used in applying the support test.

A child will be treated as being the qualifying relative of his or her noncustodial parent if all of the following apply.

1) The parents:
   a) Are divorced or legally separated under a decree of divorce or separate maintenance,
   b) Are separated under a written separation agreement, or
   c) Lived apart at all times during the last 6 months of the year, whether or not they are or were married.
2) The child received over half of his or her support for the year from the parents (and the rules on multiple support agreements, explained earlier, do not apply).
3) The child is in the custody of one or both parents for more than half of the year.
4) Either of the following statements is true.
   a) The custodial parent signs a written declaration, discussed later, that he or she will not claim the child as a dependent for the year, and the noncustodial parent attaches this written declaration to his or her return. (If the decree or agreement went into effect after 1984 and before 2009, see *Post-1984 and pre-2009 divorce decree or separation agreement*, later. If the decree or agreement went into effect after 2008, see *Post-2008 divorce decree or separation agreement*, later.)
   b) A pre-1985 decree of divorce or separate maintenance or written separation agreement that applies to 2011 states that the noncustodial parent can claim the child as a dependent, the decree or agreement was not changed after 1984 to say the noncustodial parent cannot claim the child as a dependent, and the noncustodial parent provides at least $600 for the child's support during the year.

Custodial parent and noncustodial parent. The custodial parent is the parent with whom the child lived for the greater number of nights during the year. The other parent is the noncustodial parent.

If the parents divorced or separated during the year and the child lived with both parents before the separation, the custodial parent is the one with whom the child lived for the greater number of nights during the rest of the year.

A child is treated as living with a parent for a night if the child sleeps:

- At that parent's home, whether or not the parent is present, or
- In the company of the parent, when the child does not sleep at a parent's home (for example, the parent and child are on vacation together).

Equal number of nights. If the child lived with each parent for an equal number of nights during the year, the custodial parent is the parent with the higher adjusted gross income.

December 31. The night of December 31 is treated as part of the year in which it begins. For example, December 31, 2011, is treated as part of 2011.

Emancipated child. If a child is emancipated under state law, the child is treated as not living with either parent.

Absences. If a child was not with either parent on a particular night (because, for example, the child was staying at a friend's house), the child is treated as living with the parent with whom the child normally would have lived for that night, except for the absence. But if it cannot be determined with which parent the child normally would have lived or if the child would not have lived with either parent that night, the child is treated as not living with either parent that night.

Parent works at night. If, due to a parent's nighttime work schedule, a child lives for a greater number of days but not nights with the parent who works at night, that parent is treated as the custodial parent. On a school day, the child is treated as living at the primary residence registered with the school.

Written declaration. The custodial parent may use either Form 8332 or a similar statement (containing the information required by the form) to make the written declaration to release the exemption to the noncustodial parent. The noncustodial parent must attach the form or statement to his or her tax return.

The exemption can be released for 1 year, for a number of specified years (for example, alternate years), or for all future years, as specified in the declaration. If the exemption is released for more than 1 year, the original release must be attached to the return of the noncustodial parent for the first year, and a copy must be attached for each later year.

Post-1984 and pre-2009 divorce decree or separation agreement. If the divorce decree or separation agreement went into effect after 1984 and before 2009, the noncustodial parent may be able to attach certain pages from the decree or agreement instead of Form 8332. The decree or agreement must state all three of the following.

1) The noncustodial parent can claim the child as a dependent without regard to any condition, such as payment of support.
2) The custodial parent will not claim the child as a dependent for the year.
3) The years for which the noncustodial parent, rather than the custodial parent, can claim the child as a dependent.

The noncustodial parent must attach all of the following pages of the decree or agreement to his or her tax return.

- The cover page (write the other parent's social security number on this page).
- The pages that include all of the information identified in items (1) through (3) above.
- The signature page with the other parent's signature and the date of the agreement.

Post-2008 divorce decree or separation agreement. The noncustodial parent can no longer attach pages from the decree or agreement instead of Form 8332 if the decree or agreement went into effect after 2008. The noncustodial parent will have to attach Form 8332 or a similar statement signed by the custodial parent and whose only purpose is to release a claim to exemption.

Caution. *The noncustodial parent must attach the required information even if it was filed with a return in an earlier year.*

Remarried parent. If you remarry, the support provided by your new spouse is treated as provided by you.

Child support under pre-1985 agreement. All child support payments actually received from the noncustodial parent under a pre-1985 agreement are considered used for the support of the child.

Example. Under a pre-1985 agreement, the noncustodial parent provides $1,200 for the child's support. This amount is considered support provided by the noncustodial parent even if the $1,200 was actually spent on things other than support.

Alimony. Payments to a spouse that are includible in the spouse's gross income as either alimony, separate maintenance payments, or similar payments from an estate or trust, are not treated as a payment for the support of a dependent.

Parents who never married. This special rule for divorced or separated parents also applies to parents who never married and lived apart at all times during the last 6 months of the year.

Multiple support agreement. If the support of the child is determined under a multiple support agreement, this special support test for divorced or separated parents or parents who live apart does not apply.

Worksheet 3-1. Worksheet for Determining Support

Funds Belonging to the Person You Supported	
1. Enter the total funds belonging to the person you supported, including income received (taxable and nontaxable) and amounts borrowed during the year, plus the amount in savings and other accounts at the beginning of the year	1. ___________________
2. Enter the amount on line 1 that was used for the person's support	2. ___________________
3. Enter the amount on line 1 that was used for other purposes	3. ___________________
4. Enter the total amount in the person's savings and other accounts at the end of the year	4. ___________________
5. Add lines 2 through 4. (This amount should equal line 1.)	5. ___________________
Expenses for Entire Household (where the person you supported lived)	
6. Lodging (complete line 6a or 6b): **6a.** Enter the total rent paid **6b.** Enter the fair rental value of the home. If the person you supported owned the home, also include this amount in line 21.	6a. _________________ 6b. _________________
7. Enter the total food expenses	7. ___________________
8. Enter the total amount of utilities (heat, light, water, etc. not included in line 6a or 6b)	8. ___________________
9. Enter the total amount of repairs (not included in line 6a or 6b)	9. ___________________
10. Enter the total of other expenses. Do not include expenses of maintaining the home, such as mortgage interest, real estate taxes, and insurance	10. __________________
11. Add lines 6a through 10. These are the total household expenses	11. __________________
12. Enter total number of persons who lived in the household	12. __________________
Expenses for the Person You Supported	
13. Divide line 11 by line 12. This is the person's share of the household expenses	13. _________________
14. Enter the person's total clothing expenses	14. _________________
15. Enter the person's total education expenses	15. _________________
16. Enter the person's total medical and dental expenses not paid for or reimbursed by insurance	16. _________________
17. Enter the person's total travel and recreation expenses	17. _________________
18. Enter the total of the person's other expenses	18. _________________
19. Add lines 13 through 18. This is the total cost of the person's support for the year	**19.** _________________
Did the Person Provide More Than Half of His or Her Own Support?	
20. Multiply line 19 by 50% (.50)	20. _________________
21. Enter the amount from line 2, plus the amount from line 6b if the person you supported owned the home. This is the amount the person provided for his or her own support	21. _________________
22. Is line 21 more than line 20? ☐ **No.** You meet the support test for this person to be your qualifying child. If this person also meets the other tests to be a qualifying child, stop here; do not complete lines 23 – 26. Otherwise, go to line 23 and fill out the rest of the worksheet to determine if this person is your qualifying relative. ☐ **Yes.** You do not meet the support test for this person to be either your qualifying child or your qualifying relative. **Stop here.**	

Did You Provide More Than Half?	
23. Enter the amount others provided for the person's support. Include amounts provided by state, local, and other welfare societies or agencies. Do not include any amounts included on line 1	23. ________________
24. Add lines 21 and 23	24. ________________
25. Subtract line 24 from line 19. This is the amount you provided for the person's support	25. ________________
26. Is line 25 more than line 20? ☐ **Yes.** You meet the support test for this person to be your qualifying relative. ☐ **No.** You do not meet the support test for this person to be your qualifying relative. You cannot claim an exemption for this person unless you can do so under a multiple support agreement or the support test for children of divorced or separated parents. See *Multiple Support Agreement, Support Test for Children of Divorced or Separated Parents or Parents Who Live Apart,* or *Kidnapped Child* under *Qualifying Relative.*	

V. Phaseout of Exemptions

There is no phaseout of the personal exemptions in 2011 and 2012..

VI. Social Security Numbers for Dependents

You must list the social security number (SSN) of any person for whom you claim an exemption in column (2) of line 6c of your Form 1040 or Form 1040A.

No social security number. If a person for whom you expect to claim an exemption on your return does not have an SSN, either you or that person should apply for an SSN as soon as possible by filing Form SS-5**,** *Application for a Social Security Card,* with the Social Security Administration (SSA). Information about applying for an SSN and Form SS-5 is available at your local SSA office.

It usually takes about 2 weeks to get an SSN. If you do not have a required SSN by the filing due date, you can file Form 4868 for an extension of time to file.

Born and died in 2011. If your child was born and died in 2011, and you do not have an SSN for the child, you may attach a copy of the child's birth certificate instead. The document must show the child was born alive. If you do this, enter "DIED" in column (2) of line 6c of your Form 1040 or Form 1040A.

Taxpayer identification numbers for aliens. If your dependent is a resident or nonresident alien who does not have and is not eligible to get an SSN, your dependent must apply for an individual taxpayer identification number (ITIN). Write the number in column (2) of line 6c of your Form 1040 or Form 1040A. To apply for an ITIN, use Form W-7, *Application for IRS Individual Taxpayer Identification Number.*

Taxpayer identification numbers for adoptees. If you have a child who was placed with you by an authorized placement agency, you may be able to claim an exemption for the child. However, if you cannot get an SSN or an ITIN for the child, you must get an adoption taxpayer identification number (ATIN) for the child from the IRS. See Form W-7A, *Application for Taxpayer Identification Number for Pending U.S. Adoptions,* for details.

CHAPTER 3 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. If another taxpayer is entitled to claim you as a dependent, you cannot take an exemption for yourself unless the other taxpayer does not actually claim your exemption.

   a) true
   b) false

2. To claim an exemption for a qualifying child, the child must pass all of the following tests <u>except</u>:

   a) relationship and age
   b) residency
   c) support provided
   d) citizenship

3. To claim an exemption for a qualifying relative, the person must pass all of the following tests <u>except</u>:

   a) not a qualifying child
   b) gross income test
   c) age test
   d) support test

4. When calculating the amount of total support provided for a qualifying child exemption claim, all of the following expenses should be included <u>except</u>:

   a) fair rental value of lodging
   b) food and clothing
   c) medical and dental
   d) scholarships received by a full-time student

5. You must list the social security number of any person you claim an exemption on your Form 1040 or Form 1040A.

   a) true
   b) false

CHAPTER 3 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. Even if the other taxpayer does not actually claim your exemption, you cannot take an exemption for yourself.

   B: False is correct. On a joint return, you can claim one exemption for yourself and one for your spouse.

2. A: Incorrect. Passing both the relationship and age tests are necessary for a qualifying child to be claimed as a dependent.

   B: Incorrect. Residency is one of the five tests needed to determine if a child is a qualifying child, and therefore whether he or she may also be a dependent.

   C: Incorrect. To be a dependent, a child cannot have provided more than half of his or her own support for the year.

   D: Correct. The citizenship of the qualifying child is not a factor when determining if he or she is a dependent and whether an exemption can be taken.

3. A: Incorrect. This is a necessary condition to determine if a person is a qualifying relative.

   B: Incorrect. Gross income is a valid test for qualifying a relative.

   C: Correct. Unlike the qualifying child test, a relative can be of any age.

   D: Incorrect. Providing support is one of the necessary tests to determine a qualifying relative.

4. A: Incorrect. This expense category would be included in a total support calculation.

   B: Incorrect. Food and clothing would be included when calculating support payments.

   C: Incorrect. Any expenditures for medical or dental care made for a child would also be included in a support calculation.

   D: Correct. A scholarship received by a child who is a full-time student is not taken into account in determining whether the child provided more than half of his or her own support for the year. With this being the case, another person may be able to claim the exemption – assuming other tests are met.

5. **A: True is correct.** If a person for whom you expect to claim an exemption on your return does not have a social security number, either you or that person should apply for one by filing Form SS-5.

   B: False is incorrect. If you do not have a social security number for the person you are claiming an exemption by the filing due date, you can file for an extension of time to file.

Chapter 4: Tax Withholding and Estimated Tax

I. Important

Estimated tax safe harbor for higher income taxpayers. If your adjusted gross income was more than $150,000 ($75,000 if you are married filing a separate return), you will have to deposit the smaller of 90% of your expected tax for 2012 or ***110%*** of the tax shown on your 2011 return to avoid an estimated tax penalty.

II. Introduction

This chapter discusses how to pay your tax as you earn or receive income during the year. In general, the federal income tax is a pay-as-you-go tax. There are two ways to pay as you go.

- ***Withholding.*** If you are an employee, your employer probably withholds income tax from your pay. Tax may also be withheld from certain other income – including pensions, bonuses, commissions, and gambling winnings. In each case, the amount withheld is paid to the Internal Revenue Service (IRS) in your name.
- ***Estimated tax.*** If you do not pay your tax through withholding, or do not pay enough tax that way, you might have to pay estimated tax. People who are in business for themselves generally will have to pay their tax this way. You may have to pay estimated tax if you receive income such as dividends, interest, capital gains, rent, and royalties. Estimated tax is used to pay not only income tax, but self-employment tax and alternative minimum tax as well.

This chapter explains both of these methods. In addition, it explains:

- ***Credit for withholding and estimated tax.*** When you file your 2011 income tax return, take credit for all the income tax withheld from your salary, wages, pensions, etc., and for the estimated tax you paid for 2011. Also take credit for any excess social security or railroad retirement tax withheld, (discussed in chapter 37).
- ***Underpayment penalty.*** If you did not pay enough tax during the year either through withholding or by making estimated tax payments, you may have to pay a penalty. The IRS usually can figure this penalty for you. See *Underpayment Penalty* at the end of this chapter.

Form (and Instructions)

- **W-4** Employee's Withholding Allowance Certificate
- **W-4P** Withholding Certificate for Pension or Annuity Payments
- **W-4S** Request for Federal Income Tax Withholding From Sick Pay
- **W-4V** Voluntary Withholding Request
- **1040-ES** Estimated Tax for Individuals
- **2210** Underpayment of Estimated Tax by Individuals, Estates, and Trusts

III. Withholding

This chapter discusses withholding on these types of income:

- Salaries and wages,
- Tips,
- Taxable fringe benefits,

- Sick pay,
- Pensions and annuities,
- Gambling winnings,
- Unemployment compensation, and
- Certain federal payments.

This chapter explains in detail the rules for withholding tax from each of these types of income.

This chapter also covers backup withholding on interest, dividends, and other payments.

SALARIES AND WAGES

Income tax is withheld from the pay of most employees. Your pay includes your regular pay, bonuses, commissions, and vacation allowances. It also includes reimbursements and other expense allowances paid under a nonaccountable plan. See *Supplemental Wages,* later, for more information about reimbursements and allowances paid under a nonaccountable plan.

Military retirees. Military retirement pay is treated in the same manner as regular pay for income tax withholding purposes, even though it is treated as a pension or annuity for other tax purposes.

Household workers. If you are a household worker, you can ask your employer to withhold income tax from your pay. Tax is withheld only if you want it withheld and your employer agrees to withhold it. If you do not have enough income tax withheld, you may have to make estimated tax payments, as discussed later under *Estimated Tax.*

Farmworkers. Income tax is generally withheld from your cash wages for work on a farm unless your employer both:

1) Pays you cash wages of less than $150 during the year, and
2) Has expenditures for agricultural labor totaling less than $2,500 during the year.

If you receive either noncash wages or cash wages not subject to withholding, you can ask your employer to withhold income tax. If your employer does not agree to withhold tax, or if not enough is withheld, you may have to make estimated tax payments, as discussed later under *Estimated Tax.*

Determining Amount of Tax Withheld Using Form W-4

The amount of income tax your employer withholds from your regular pay depends on two things.

1) The amount you earn.
2) The information you give your employer on **Form W-4.**

Form W-4 includes three types of information that your employer will use to figure your withholding.

1) Whether to withhold at the single rate or at the lower married rate.
2) How many withholding allowances you claim. (Each allowance reduces the amount withheld.)
3) Whether you want an additional amount withheld.

Note. You must specify a filing status and a number of withholding allowances on Form W-4. You cannot specify only a dollar amount of withholding.

New Job

When you start a new job, you must fill out Form W-4 and give it to your employer. Your employer should have copies of the form. If you need to change the information, you must fill out a new form.

If you work only part of the year (for example, you start working after the beginning of the year), too much tax may be withheld. You may be able to avoid overwithholding if your employer agrees to use the part-year method.

Changing Your Withholding

Events during the year may change your marital status or the exemptions, adjustments, deductions, or credits you expect to claim on your return. When this happens, you may need to give your employer a new Form W-4 to change your withholding status or number of allowances.

If the event changes your withholding status or the number of allowances you are claiming, you ***must*** give your employer a new Form W-4 within 10 days after either of the following.

1) Your divorce, if you have been claiming married status.
2) Any event that decreases the number of withholding allowances you can claim.

Generally, you can submit a new Form W-4 whenever you wish to change the number of your withholding allowances for any other reason.

Changing your withholding for 2013. If events in 2012 will decrease the number of your withholding allowances for 2013, you ***must*** give your employer a new Form W-4 by December 1, 2012. If the event occurs in December 2012, submit a new Form W-4 within 10 days.

Checking Your Withholding

After you have given your employer a Form W-4, you can check to see whether the amount of tax withheld from your pay is too little or too much. See *Getting the Right Amount of Tax Withheld,* later. If too much or too little tax is being withheld, you should give your employer a new Form W-4 to change your withholding.

Note. You cannot give your employer a payment to cover withholding for past pay periods or a payment for estimated tax.

Completing Form W-4 and Worksheets

Form W-4 has worksheets to help you figure how many withholding allowances you can claim. The worksheets are for your own records. Do not give them to your employer.

Multiple jobs. If you have income from more than one job at the same time, complete only one set of Form W-4 worksheets. Then split your allowances between the Forms W-4 for each job. You cannot claim the same allowances with more than one employer at the same time. You can claim all your allowances with one employer and none with the other, or divide them any other way.

Married individuals. If both you and your spouse are employed and expect to file a joint return, figure your withholding allowances using your combined income, adjustments, deductions, exemptions, and credits. Use only one set of worksheets. You can divide your total allowances any way, but you cannot claim an allowance that your spouse also claims.

If you and your spouse expect to file separate returns, figure your allowances separately based on your own individual income, adjustments, deductions, exemptions, and credits.

Deductions and adjustments worksheet. Fill out this worksheet to adjust the number of your withholding allowances for deductions, adjustments to income, and tax credits.

Two-earner/multiple jobs worksheet. You may need to complete this worksheet if you have more than one job or a working spouse. You can also add to the amount, if any, on line 8 of this worksheet, any additional withholding necessary to cover any amount you expect to owe other than income tax, such as self-employment tax.

Getting The Right Amount of Tax Withheld

In most situations, the tax withheld from your pay will be close to the tax you figure on your return if you follow these two rules.

1) You accurately complete all the Form W-4 worksheets that apply to you.
2) You give your employer a new Form W-4 when changes occur.

But because the worksheets and withholding methods do not account for all possible situations, you may not be getting the right amount withheld. This is most likely to happen in the following situations.

- You are married and both you and your spouse work.
- You have more than one job at a time.
- You have nonwage income, such as interest, dividends, alimony, unemployment compensation, or self-employment income.
- You will owe additional amounts with your return, such as self-employment tax.
- Your withholding is based on obsolete Form W-4 information for a substantial part of the year.
- Your earnings are more than $130,000 if you are single or $180,000 if you are married.
- You work only part of the year.
- You change the number of your withholding allowances during the year.

Cumulative wage method. If you change the number of your withholding allowances during the year, too much or too little tax may have been withheld for the period before you made the change. You may be able to compensate for this if your employer agrees to use the cumulative wage withholding method for the rest of the year. You must ask in writing that your employer use this method.

To be eligible, you must have been paid for the same kind of payroll period (weekly, biweekly, etc.) since the beginning of the year.

Rules Your Employer Must Follow

New Form W-4. When you start a new job, your employer should give you a Form W-4 to fill out. Your employer will use the information you give on the form to figure your withholding beginning with your first payday.

If you later fill out a new Form W-4, your employer can put it into effect as soon as possible. The deadline for putting it into effect is the start of the first payroll period ending 30 or more days after you turn it in.

No Form W-4. If you do not give your employer a completed Form W-4, your employer must withhold at the highest rate – as if you were single and claimed no withholding allowances.

Repaying withheld tax. If you find you are having too much tax withheld because you did not claim all the withholding allowances you are entitled to, you should give your employer a new Form W-4. Your employer cannot repay any of the tax previously withheld. Instead, claim the full amount withheld when you file your tax return.

However, if your employer has withheld more than the correct amount of tax for the Form W-4 you have in effect, you do not have to fill out a new Form W-4 to have your withholding lowered to the correct amount. Your employer can repay the amount that was incorrectly withheld. If you are not repaid, your Form W-2 will reflect the full amount actually withheld, which you would claim when you file your tax return.

Exemption From Withholding

If you claim exemption from withholding, your employer will not withhold federal income tax from your wages. The exemption applies only to income tax, not to social security or Medicare tax.

You can claim exemption from withholding for 2012 only if ***both*** the following situations apply.

1) For **2011** you had a right to a refund of all federal income tax withheld because you had no tax liability.
2) For **2012** you expect a refund of all federal income tax withheld because you expect to have no tax liability.

Student. If you are a student, you are not automatically exempt. See chapter 1 to see whether you must file a return. If you work only part time or only during the summer, you may qualify for exemption from withholding.

Age 65 or older or blind. If you are 65 or older or blind, use one of the worksheets in chapter 1 of Publication 505, under *Exemption From Withholding,* to help you decide whether you can claim exemption from withholding. Do not use either worksheet if you will itemize deductions or claim exemptions for dependents or claim tax credits on your 2012 return.

Claiming exemption from withholding. To claim exemption, you must give your employer a Form W-4. Print "EXEMPT" on line 7.

If you claim exemption, but later your situation changes so that you will have to pay income tax after all, you must file a new Form W-4 within 10 days after the change. If you claim exemption in 2012, but you expect to owe income tax for 2013, you must file a new Form W-4 by December 1, 2012.

Your claim of exempt status may be reviewed by the IRS.

An exemption is good for only one year. You must give your employer a new Form W-4 by February 15 each year to continue your exemption.

Supplemental Wages

Supplemental wages include bonuses, commissions, overtime pay, and certain sick pay. The payer can figure withholding on supplemental wages using the same method used for your regular wages. If these payments are identified separately from your regular wages, your employer or other payer of supplemental wages can withhold income tax from these wages at a flat rate.

Expense allowances. Reimbursements or other expense allowances paid by your employer under a nonaccountable plan are treated as supplemental wages.

Reimbursements or other expense allowances paid under an accountable plan that are more than your proven expenses are treated as paid under a nonaccountable plan if you do not return the excess payments within a reasonable period of time.

For more information about accountable and nonaccountable expense allowance plans, see *Reimbursements* in chapter 26.

Penalties

You may have to pay a penalty of $500 if both of the following apply.

1) You make statements or claim withholding allowances on your Form W-4 that reduce the amount of tax withheld.
2) You have no reasonable basis for those statements or allowances at the time you prepare your Form W-4.

There is also a criminal penalty for willfully supplying false or fraudulent information on your Form W-4 or for willfully failing to supply information that would increase the amount withheld. The penalty upon conviction can be either a fine of up to $1,000 or imprisonment for up to one year, or both.

These penalties will apply if you deliberately and knowingly falsify your Form W-4 in an attempt to reduce or eliminate the proper withholding of taxes. A simple error – an honest mistake – will not result in one of these penalties. For example, a person who has tried to figure the number of withholding allowances correctly, but claims seven when the proper number is six, will not be charged a W-4 penalty.

TIPS

The tips you receive while working on your job are considered part of your pay. You must include your tips on your tax return on the same line as your regular pay. However, tax is not withheld directly from tip income, as it is from your regular pay. Nevertheless, your employer will take into account the tips you report when figuring how much to withhold from your regular pay.

How employer figures amount to withhold. The tips you report to your employer are counted as part of your income for the month you report them. Your employer can figure your withholding in either of two ways.

1) By withholding at the regular rate on the sum of your pay plus your reported tips.
2) By withholding at the regular rate on your pay plus a percentage of your reported tips.

Not enough pay to cover taxes. If your regular pay is not enough for your employer to withhold all the tax (including income tax, social security tax, Medicare tax, or railroad retirement tax) due on your pay plus your tips, you can give your employer money to cover the shortage.

Allocated tips. Your employer should not withhold income tax, social security tax, Medicare tax, or railroad retirement tax on any allocated tips. Withholding is based only on your pay plus your ***reported tips.*** Your employer should refund to you any incorrectly withheld tax. See *Allocated Tips* in chapter 6 for more information.

TAXABLE FRINGE BENEFITS

The value of certain fringe benefits you receive from your employer is considered part of your pay. Your employer generally must withhold income tax on these benefits from your regular pay.

Although the value of your personal use of an employer-provided car, truck, or other highway motor vehicle is taxable, your employer can choose not to withhold income tax on that amount. Your employer must notify you if this choice is made.

SICK PAY

Sick pay is a payment to you to replace your regular wages while you are temporarily absent from work due to sickness or personal injury. To qualify as sick pay, it must be paid under a plan to which your employer is a party.

If you receive sick pay from your employer or an agent of your employer, income tax must be withheld. An agent who does not pay regular wages to you may choose to withhold income tax at a flat rate.

However, if you receive sick pay from a third party who is not acting as an agent of your employer, income tax will be withheld only if you choose to have it withheld. See *Form W-4S,* later.

If you receive payments under a plan in which your employer does not participate (such as an accident or health plan where you paid all the premiums), the payments are not sick pay and usually are not taxable.

PENSIONS AND ANNUITIES

Income tax usually will be withheld from your pension or annuity distributions unless you choose not to have it withheld. This rule applies to distributions from:

- A traditional individual retirement arrangement (IRA),
- A life insurance company under an endowment, annuity, or life insurance contract,
- A pension, annuity, or profit-sharing plan,
- A stock bonus plan, and
- Any other plan that defers the time you receive compensation.

The amount withheld depends on whether you receive payments spread out over more than one year (periodic payments), within one year (nonperiodic payments), or as an eligible rollover distribution (ERD). Income tax withholding from an ERD is mandatory.

GAMBLING WINNINGS

Income tax is withheld at a flat 25% rate from certain kinds of gambling winnings.

Gambling winnings of more than $5,000 from the following sources are subject to income tax withholding.

- Any sweepstakes; wagering pool, including payments made to winners of poker tournaments; or lottery.
- Any other wager, if the proceeds are at least 300 times the amount of the bet.

It does not matter whether your winnings are paid in cash, in property, or as an annuity. Winnings not paid in cash are taken into account at their fair market value.

Gambling winnings from bingo, keno, and slot machines generally are not subject to income tax withholding. However, you may need to provide the payer with a social security number to avoid withholding.

Form W-2G. If a payer withholds income tax from your gambling winnings, you should receive a Form W-2G, *Certain Gambling Winnings,* showing the amount you won and the amount withheld. Report the tax withheld on line 62 of Form 1040.

UNEMPLOYMENT COMPENSATION

You can choose to have income tax withheld from unemployment compensation. To make this choice, you will have to fill out **Form W-4V,** *Voluntary Withholding Request,* (or a similar form provided by the payer) and give it to the payer.

Unemployment compensation is taxable. So, if you do not have income tax withheld, you may have to make estimated tax payments.

If you do not pay enough tax either through withholding or estimated tax, or a combination of both, you may have to pay a penalty.

FEDERAL PAYMENTS

You can choose to have income tax withheld from certain federal payments you receive. These payments are:

1) Social security benefits,
2) Tier 1 railroad retirement benefits,
3) Commodity credit loans you choose to include in your gross income, and
4) Payments under the Agricultural Act of 1949 (7 U.S.C. 1421 et. seq.), or title II of the Disaster Assistance Act of 1988, as amended, that are treated as insurance proceeds and that you receive because:
    a) Your crops were destroyed or damaged by drought, flood, or any other natural disaster, or
    b) You were unable to plant crops because of a natural disaster described in (a).

To make this choice, you will have to fill out **Form W-4V,** *Voluntary Withholding Request,* (or a similar form provided by the payer) and give it to the payer.

BACKUP WITHHOLDING

Banks and other businesses that pay you certain kinds of income must file an information return (Form 1099) with the IRS. The information return shows how much you were paid during the year. It also includes your name and taxpayer identification number (TIN). TINs are explained in chapter 1.

These payments generally are not subject to withholding. However, "backup" withholding is required in certain situations. Backup withholding can apply to most kinds of payments that are reported on Form 1099.

The payer must withhold at a flat 28% rate in the following situations.

- You do not give the payer your TIN in the required manner.
- The IRS notifies the payer that the TIN you gave is incorrect.
- You are required, but fail, to certify that you are not subject to backup withholding.
- The IRS notifies the payer to start withholding on interest or dividends because you have underreported interest or dividends on your income tax return. The IRS will do this only after it has mailed you four notices over at least a 210-day period.

Penalties. There are civil and criminal penalties for giving false information to avoid backup withholding. The civil penalty is $500. The criminal penalty, upon conviction, is a fine of up to $1,000 or imprisonment of up to 1 year, or both.

IV. Estimated Tax

Estimated tax is the method used to pay tax on income that is not subject to withholding. This includes income from self-employment, interest, dividends, alimony, rent, gains from the sale of assets, prizes, and awards. You also may have to pay estimated tax if the amount of income tax being withheld from your salary, pension, or other income is not enough.

Estimated tax is used to pay both income tax and self-employment tax, as well as other taxes and amounts reported on your tax return. If you do not pay enough through withholding or by making estimated tax payments, you may be charged a penalty. If you do not pay enough by the due date of each payment period (see *When To Pay Estimated Tax,* later), you may be charged a penalty even if you are due a refund when you file your tax return. For information on when the penalty applies, see *Underpayment Penalty,* later.

WHO MUST PAY ESTIMATED TAX PAYMENTS?

If you had a tax liability for 2011, you may have to pay estimated tax for 2012.

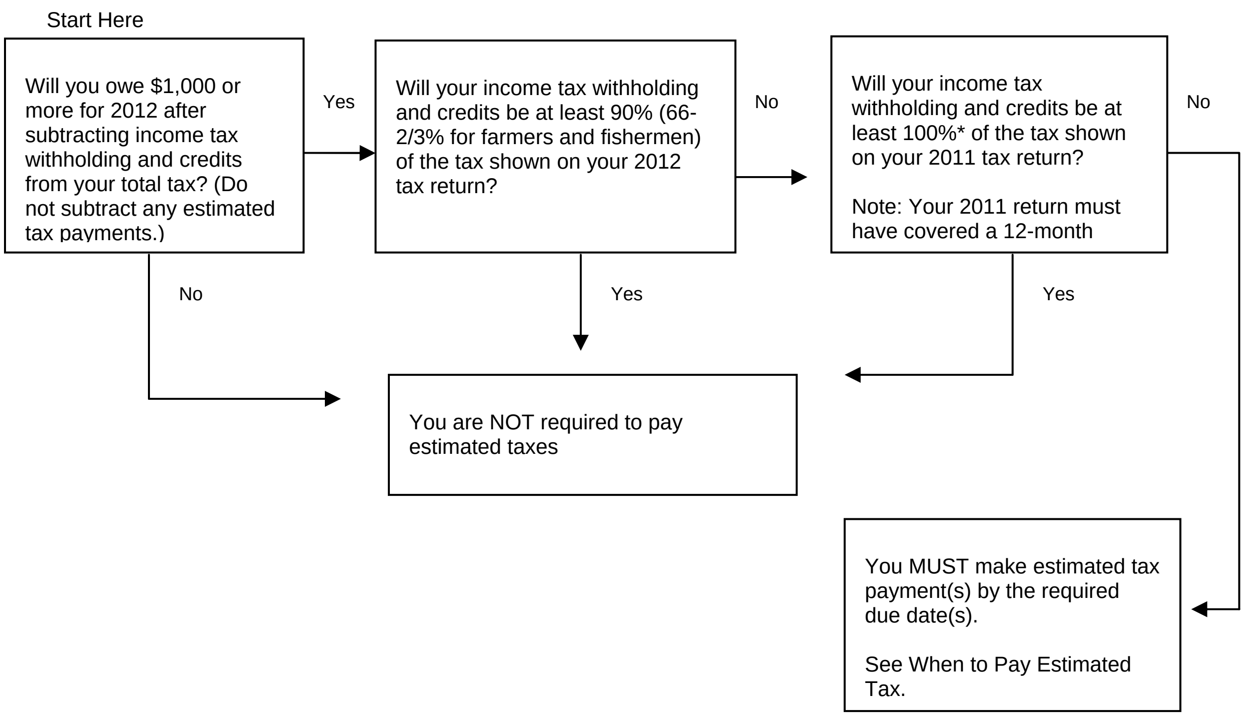
General rule. You must make estimated tax payments for 2012 if both of the following apply.

1) You expect to owe at least $1,000 in tax for 2012 after subtracting your withholding and credits.
2) You expect your withholding and credits to be less than the smaller of:

   - 90% of the tax to be shown on your 2012 tax return, or
   - 100% of the tax shown on your 2011 tax return. Your 2011 tax return must cover all 12 months.

Special rules for farmers, fishermen, and higher income taxpayers. There are exceptions to the general rule for farmers, fishermen, and certain higher income taxpayers. See *Figure 4-A.*

Figure 4-A. Do You Have to Pay Estimated Tax?



*110% if less than two-thirds of your gross income for 2011 and 2012 is from farming or fishing and your 2011 adjusted gross income was more than $150,000 ($75,000 if your filing status for 2012 is married filing a separate return).

Aliens. Resident and nonresident aliens may also have to make estimated tax payments. Resident aliens should follow the rules in this chapter unless noted otherwise. Nonresident aliens should get **Form 1040-ES(NR),** *U.S. Estimated Tax for Nonresident Alien Individuals.*

Married taxpayers. To figure whether you must make estimated tax payments, apply the rules discussed here to your separate estimated income. If you can make joint estimated tax payments, you can apply these rules on a joint basis.

You and your spouse can make joint estimated tax payments even if you are not living together.

You and your spouse cannot make joint estimated tax payments if:

1) You are legally separated under a decree of divorce or separate maintenance,
2) Either spouse is a nonresident alien, or
3) You and your spouse have different tax years.

Whether you and your spouse make joint estimated tax payments or separate payments will not affect your choice of filing a joint tax return or separate returns for 2012.

2011 separate returns and 2012 joint return. If you plan to file a joint return with your spouse for 2012, but you filed separate returns for 2011, your 2011 tax is the total of the tax shown on your separate returns. You filed a separate return if you filed as single, head of household, or married filing separately.

2011 joint return and 2012 separate returns. If you plan to file a separate return for 2012, but you filed a joint return for 2011, your 2011 tax is your share of the tax on the joint return. You file a separate return if you file as single, head of household, or married filing separately. To figure your share of the tax on the joint return, first figure the tax both you and your spouse would have paid had you filed separate returns for 2011 using the same filing status as for 2012. Then multiply the tax on the joint return by the following fraction:

$$\frac{\text{The tax you would have paid had you filed a separate return}}{\text{The total tax you and your spouse would have paid had you filed separate returns}}$$

WHEN TO PAY ESTIMATED TAX

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. If you do not pay enough tax by the due date of each of the payment periods, you may be charged a penalty even if you are due a refund when you file your income tax return. The following chart gives the payment periods and due dates for estimated tax payments.

For the period:	Due date:
Jan. 1* through Mar. 31	Apr. 15
April 1 through May 31	June 15
June 1 through Aug. 31	Sept. 15
Sept. 1 through Dec. 31	Jan. 15 next year**

*If your tax year does not begin on January 1, see the Form 1040-ES instructions.
**See *January payment,* later.

Saturday, Sunday, holiday rule. If the due date for making an estimated tax payment falls on a Saturday, Sunday, or legal holiday, the payment will be on time if you make it on the next day that is not a Saturday, Sunday, or legal holiday.

January payment. If you file your 2012 Form 1040 or Form 1040A by January 31, 2013, and pay the rest of the tax you owe, you do not need to make your estimated tax payment that would be due on January 15, 2013.

No income subject to estimated tax during first period. If you do not have income subject to estimated tax until a later payment period, you can make your first payment by the due date for that period. You can pay your entire estimated tax by the due date for that period, or you can pay it in installments by the due date for that period and the due dates for the remaining periods. The following chart shows when to make installment payments.

If you first have income on which you must pay estimated tax:	Make a payment by:	Make later installments by:
Before Apr. 1	- Apr. 15	- June 15 - Sept. 15 - Jan. 15 next year*
After Mar. 31 and before June 1	- June 15	- Sept. 15 - Jan. 15 next year*
After May 31 and before Sept. 1	- Sept. 15	- Jan. 15 next year*
After Aug. 31	- Jan. 15 next year*	(None)

*If your tax year does not begin on January 1, see the Form 1040-ES instructions.
**See *January payment*, earlier.

Change in estimated tax. After making your first estimated tax payment, changes in your income, adjustments, deductions, credits, or exemptions may make it necessary for you to refigure your estimated tax. Pay the unpaid balance of your amended estimated tax by the next payment due date after the change or in installments by that date and the due dates for the remaining payment periods.

Underpayment penalty. If your estimated tax payment for a previous period is less than one-fourth of your amended estimated tax, you may be charged a penalty for underpayment of estimated tax for that period when you file your tax return.

ESTIMATED TAX PAYMENTS NOT REQUIRED

You do not have to make estimated tax payments if your withholding in each payment period is at least one-fourth of your required annual payment or at least your required annualized income installment for that period. You also do not have to make estimated tax payments if you will pay enough through withholding to keep the amount you owe with your return under $1,000.

HOW TO PAY ESTIMATED TAX

There are five ways to pay estimated tax.

1) By crediting an overpayment on your 2011 return to your 2012 estimated tax.
2) By sending in your payment with a payment-voucher from Form 1040-ES.
3) By using the Electronic Federal Tax Payment System.
4) By electronic funds withdrawal if you are filing Form 1040 or Form 1040A electronically.
5) By credit or debit card using a pay-by-phone system or the Internet.

Crediting an Overpayment

When you file your Form 1040 or Form 1040A for 2011 and you have an overpayment of tax, you can apply part or all of it to your estimated tax for 2012. On line 75 of Form 1040, or line 44 of Form 1040A, write the amount you want credited to your estimated tax rather than refunded. The amount you have credited should be taken into account when figuring your estimated tax payments.

You cannot have any of that amount refunded to you until you file your tax return for the following year. You also cannot use that overpayment in any other way.

Using the Payment-Vouchers

Each payment of estimated tax by check or money order must be accompanied by a payment-voucher from Form 1040-ES. If you made estimated tax payments last year, you should receive a copy of the 2012 Form 1040-ES in the mail. It will have payment-vouchers preprinted with your name, address, and social security number. Using the preprinted vouchers will speed processing, reduce the chance of error, and help save processing costs.

If you did not pay estimated tax last year, you will have to get a copy of Form 1040-ES from the IRS. After you make your first payment, a Form 1040-ES package with the preprinted vouchers will be mailed to you. Follow the instructions in the package to make sure you use the vouchers correctly.

If you file a joint return and you are making joint estimated tax payments, please enter the names and social security numbers on the payment voucher in the same order as they will appear on the joint return.

Change of address. You must notify the IRS if you are making estimated tax payments and you changed your address during the year. You must send a clear and concise written statement to the IRS Service Center where you filed your last return and provide all of the following:

- Your full name (and your spouse's full name),
- Your signature (and spouse's signature),
- Your old address (and spouse's old address if different),
- Your new address, and
- Your social security number (and spouse's social security number).

You can use Form 8822, *Change of Address,* for this purpose.

V. Credit for Withholding and Estimated Tax

When you file your 2011 income tax return, take credit for all the income tax and excess social security or railroad retirement tax withheld from your salary, wages, pensions, etc. Also, take credit for the estimated tax you paid for 2011. These credits are subtracted from your tax. You should file a return and claim these credits, even if you do not owe tax.

If you had two or more employers and were paid wages of more than $106,800 during 2011, too much social security or railroad retirement tax may have been withheld from your wages. You may be able to claim the excess as a credit against your income tax when you file your return.

WITHHOLDING

If you had income tax withheld during 2011, you should receive a statement by January 31, 2012, showing your income and the tax withheld. Depending on the source of your income, you will receive:

- Form W-2, *Wage and Tax Statement,*
- Form W-2G, *Certain Gambling Winnings,* or
- A form in the 1099 series.

Forms W-2 and W-2G. You file Form W-2 with your income tax return. File Form W-2G with your return if it shows any federal income tax withheld from your winnings.

You should get at least two copies of each form you receive. Attach one copy to the front of your federal income tax return. Keep one copy for your records. You should also receive copies to file with your state and local returns.

Form W-2

Your employer should give you a Form W-2 for 2011 by January 31, 2012. You should receive a separate Form W-2 from each employer you worked for.

If you stop working before the end of the year, your employer can give you your Form W-2 at any time after you leave your job. However, your employer must give it to you by January 31 of the following year (or the next day that is not a Saturday, Sunday, or holiday if January 31 is a Saturday, Sunday, or holiday).

Form W-2G

If you had gambling winnings in 2011, the payer may have withheld income tax. If tax was withheld, the payer will give you a Form W-2G showing the amount you won and the amount of tax withheld.

Report the amounts you won on line 21 of Form 1040. Take credit for the tax withheld on line 62 of Form 1040. If you had gambling winnings, you must use Form 1040; you cannot use Form 1040A or Form 1040EZ.

The 1099 Series

Most forms in the 1099 series are not filed with your return. You should receive these forms by February 1, 2012. Keep these forms for your records. There are several different forms in this series, including:

- Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions,*
- Form 1099-C, *Cancellation of Debt,*
- Form 1099-DIV, *Dividends and Distributions,*
- Form 1099-G, *Certain Government Payments,*
- Form 1099-INT, *Interest Income,*
- Form 1099-MISC, *Miscellaneous Income,*
- Form 1099-OID, *Original Issue Discount,*
- Form 1099-Q, *Payments From Qualified Education Programs,*
- Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,*
- Form SSA-1099, *Social Security Benefit Statement*, and
- Form RRB-1099, *Payments by the Railroad Retirement Board.*

If you received the types of income reported on some forms in the 1099 series, you may not be able to use Form 1040A or Form 1040EZ. See the instructions to these forms for details.

Form 1099-R. Attach Form 1099-R to your return if box 4 shows federal income tax withheld. Include the amount withheld in the total on line 62 of Form 1040 or line 38 of Form 1040A. You cannot use Form 1040EZ if you received payments reported on Form 1099-R.

Backup withholding. If you were subject to backup withholding on income you received during 2011, include the amount withheld, as shown on your Form 1099, in the total on line 62 of Form 1040, line 36 of Form 1040A, or line 7 of Form 1040EZ.

Separate Returns

If you are married but file a separate return, you can take credit only for the tax withheld from your own income. Do not include any amount withheld from your spouse's income. However, different rules may apply if you live in a community property state.

Fiscal Years

If you file your tax return on the basis of a fiscal year (a 12-month period ending on the last day of any month except December), you must follow special rules to determine your credit for federal income tax withholding.

ESTIMATED TAX

Take credit for all your estimated tax payments for 2011 on line 63 of Form 1040 or line 37 of Form 1040A. Include any overpayment from 2010 that you had credited to your 2011 estimated tax. You must use Form 1040 or Form 1040A if you paid estimated tax. You cannot use Form 1040EZ.

Name changed. If you changed your name, and you made estimated tax payments using your old name, attach a brief statement to the front of your tax return indicating:

- When you made the payments,
- The amount of each payment,
- The IRS address to which you sent the payments,
- Your name when you made the payments, and
- Your social security number.

The statement should cover payments you made jointly with your spouse as well as any you made separately.

Separate Returns

If you and your spouse made separate estimated tax payments for 2011 and you file separate returns, you can take credit only for your own payments.

If you made joint estimated tax payments, you must decide how to divide the payments between your returns. One of you can claim all of the estimated tax paid and the other none, or you can divide it in any other way you agree on. If you cannot agree, you must divide the payments in proportion to each spouse's individual tax as shown on your separate returns for 2011.

Divorced Taxpayers

If you made joint estimated tax payments for 2011, and you were divorced during the year, either you or your former spouse can claim all of the joint payments, or you each can claim part of them. If you cannot agree on how to divide the payments, you must divide them in proportion to each spouse's individual tax as shown on your separate returns for 2011.

If you claim any of the joint payments on your tax return, enter your former spouse's social security number (SSN) in the space provided on the front of Form 1040 or Form 1040A. If you divorced and remarried in 2011, enter your present spouse's SSN in that space and write your former spouse's SSN, followed by "DIV," to the left of line 63, Form 1040, or line 37, Form 1040A.

VI. <u>Underpayment Penalty</u>

If you did not pay enough tax either through withholding or by making estimated tax payments, you will have an underpayment of estimated tax and you may have to pay a penalty. Generally, you will ***not*** have to pay a penalty for 2011 if any of the following situations apply.

- The total of your withholding and estimated tax payments was at least as much as your 2010 tax (or 110% of your 2010 tax if your adjusted gross income was more than $150,000 – $75,000 if your 2011 filing status is married filing separately) and you paid all required estimated tax payments on time.
- The tax balance due on your return is no more than 10% of your total 2011 tax, and you paid all required estimated tax payments on time.
- Your total 2011 tax minus your withholding is less than $1,000.
- You did not have a tax liability for 2010 and your 2010 tax year was 12 months.
- You did not have any withholding taxes and your current year tax less any household employment taxes is less than $1,000.

CHAPTER 4 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Estimated tax payments can be used to pay all of the following taxes except:

    a) income taxes
    b) self-employment taxes
    c) alternative minimum taxes
    d) social security withholding taxes

2. The amount of income tax your employer withholds from your regular pay depends strictly on the amount you earn.

    a) true
    b) false

3. When claiming a federal exemption from withholding, your employer will continue to withhold all of the following except:

    a) social security tax
    b) federal income tax
    c) Medicare tax
    d) state income tax

4. An exemption from withholding is only good for one year.

    a) true
    b) false

5. Income tax withholding should be on reported and allocated tips.

    a) true
    b) false

6. Estimated tax is the method used to pay tax on income that is not subject to withholding.

    a) true
    b) false

7. Generally, estimated tax payments are not required if the taxpayer expects net additional taxes due when filing a return to be <u>less than</u>:

   a) $500
   b) $1,000
   c) $1,500
   d) $2,500

8. Joint estimated tax payments made during a tax year in which a couple later becomes divorced can be divided by any of these methods <u>except</u>:

   a) you or your spouse can claim the entire joint payment amount
   b) you and your spouse can split the amount in any proportion agreed upon
   c) without mutual agreement, each spouse must claim a payment amount in proportion to individual taxes due
   d) you and your spouse can each take the full amount of estimated taxes paid on your respective individual tax returns

CHAPTER 4 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Income taxes are usually payable for self-employed individuals through quarterly estimated tax payments.

   B: Incorrect. Self-employment taxes can be paid through quarterly estimated tax payments.

   C: Incorrect. Alternative minimum taxes can be paid through quarterly estimated tax payments.

   D: Correct. Social security withholding taxes are typically paid by you and your employer through payroll deductions, and then frequently remitted to the IRS.

2. A: True is incorrect. The amount withheld depends on both the amount you earned and the information given to your employer on Form W-4.

   B: False is correct. The information given to your employer on Form W-4 also impacts the amount withheld.

3. A: Incorrect. Social security taxes are not affected by a Form W-4 exemption filing.

   B: Correct. Federal income tax withholding will be ended by an employer upon the employee filing "Exempt" on Form W-4.

   C: Incorrect. Medicare taxes are not affected by an employee's withholding exemption filing.

   D: Incorrect. State income taxes are not affected by a federal exemption claim. Exemption from state income taxes must be separately requested.

4. **A: True is correct.** You must give your employer a new Form W-4 by February 15 each year to continue your exemption.

   B: False is incorrect. To claim the exemption, you must give your employer a completed Form W-4 by February 15 of each year.

5. A: True is incorrect. Your employer should only withhold income tax, social security tax, Medicare tax, or railroad retirement tax on any reported tips.

   B: False is correct. Your employer should not withhold taxes on allocated tips.

6. **A: True is correct.** It is used to pay both income tax and self-employment tax, as well as other taxes and amounts reported on your tax return.

   B: False is incorrect. You may have to pay estimated tax if the amount withheld from your salary, pension, or other income is not enough.

7. A: Incorrect. Paying estimated taxes is not required based on this threshold.

   B: Correct. Estimated taxes must be paid if you expect to owe at least $1,000 for 2011 after subtracting withholding payments and credits.

   C: Incorrect. The correct threshold for required estimated tax payments is less than $1,500.

   D: Incorrect. In most situations, making estimated tax payments is required when additional taxes due with the return are equal or greater than $1,000 and other prior year conditions are met.

8. A: Incorrect. Divorced taxpayers who previously made joint estimated tax payments can decide to allow one party to claim the full amount of those payments.

   B: Incorrect. Joint estimated tax payments may be split by newly divorced taxpayers on their individual returns in any proportion agreed upon, so long as the total amount claimed on both returns does not exceed the total of the original joint estimated tax payments made.

   C: Incorrect. In cases where divorced taxpayers cannot agree, joint estimated tax payments made prior to the divorce must be claimed in proportion to each spouse's individual taxes due on their respective tax returns for the same tax year.

   D: Correct. This choice is not a valid method for allocating joint estimated tax payments among newly divorced taxpayers. This would result in the total allocation being greater than the total estimated taxes paid.

PART TWO. INCOME

The eight chapters in this part discuss many kinds of income. They explain which income is and is not taxed. See Part Three for information on gains and losses you report on Schedule D (Form 1040) and for information on selling your home.

Chapter 5: Wages, Salaries and Other Earnings

I. What's New

For 2011, the social security tax on employees is only 4.2 percent of wages up to the $106,800 threshold (a 2 percent reduction from 2010), and self-employed individuals will pay 10.4 percent on self-employment income up to the $106,800 threshold.

II. Introduction

This chapter discusses wages, salaries, fringe benefits, and other compensation received for services as an employee. The topics include:

- Bonuses and awards,
- Sickness and injury benefits, and
- Special rules for certain employees.

The chapter explains what income is included in the employee's gross income and what is not included.

III. Employee Compensation

This section discusses many types of employee compensation followed by a detailed explanation of fringe benefits.

If you are an employee, you should receive Form W-2 from your employer showing the pay you received for your services. Include your pay on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ, even if you do not receive a Form W-2.

MISCELLANEOUS COMPENSATION

This section discusses many types of employee compensation. The subjects are arranged in alphabetical order.

Advance commissions and other earnings. If you receive advance commissions or other amounts for services to be performed in the future and you are a cash method taxpayer, you must include these amounts in your income in the year you receive them.

If you repay unearned commissions or other amounts in the same year you receive them, reduce the amount included in your income by the repayment. If you repay them in a later tax year, you can deduct the repayment as an itemized deduction on your Schedule A (Form 1040), or you may be able to take a credit for that year. See *Repayments* in chapter 12.

Back pay awards. Include in income amounts you are awarded in a settlement or judgment for back pay. These include payments made to you for damages, unpaid life insurance premiums, and unpaid health insurance premiums. They should be reported to you by your employer on Form W-2.

Bonuses and awards. Bonuses or awards you receive for outstanding work are included in your income and should be shown on your Form W-2. These include prizes such as vacation trips for meeting sales goals. If the prize or award you receive is goods or services, you must include the fair market value of the goods or services in your income. However, if your employer merely promises to pay you a bonus or award at some future time, it is not taxable until you receive it or it is made available to you.

Employee achievement award. If you receive tangible personal property (other than cash, a gift certificate, or an equivalent item) as an award for length of service or safety achievement, you can generally exclude its value from your income. However, the amount you can exclude is limited to your employer's cost and cannot be more than $1,600 ($400 for awards that are not qualified plan awards) for all such awards you receive during the year. Your employer can tell you whether your award is a qualified plan award. Your employer must make the award as part of a meaningful presentation, under conditions and circumstances that do not create a significant likelihood of it being disguised pay. However, the exclusion does not apply to the following awards.

- A length-of-service award if you received it for less than 5 years of service or if you received another length-of-service award during the year or the previous 4 years.
- A safety achievement award if you are a manager, administrator, clerical employee, or other professional employee or if more than 10% of eligible employees previously received safety achievement awards during the year.

Example. Ben Green received three employee achievement awards during the year: a nonqualified plan award of a watch valued at $250, and two qualified plan awards of a stereo valued at $1,000 and a set of golf clubs valued at $500. Assuming that the requirements for qualified plan awards are otherwise satisfied, each award by itself would be excluded from income. However, since the $1,750 total value of the awards is more than $1,600, Ben must include $150 ($1,750 - $1,600) in his income.

Government cost-of-living allowances. Cost-of-living allowances are generally included in your income. However, they are not included in your income if you are a federal civilian employee or a federal court employee who is stationed in Alaska, Hawaii, or outside the United States. Beginning January 1, 2011, these federal employees will be transitioned from a non-taxable cost-of-living adjustment to a taxable locality-based comparability payment.

Allowances and differentials that increase your basic pay as an incentive for taking a less desirable post of duty are part of your compensation and must be included in income. For example, your compensation includes Foreign Post, Foreign Service, and Overseas Tropical differentials.

Severance pay. Amounts you receive as severance pay are taxable. A lump-sum payment for cancellation of your employment contract must be included in your income in the tax year you receive it.

Accrued leave payment. If you are a federal employee and receive a lump-sum payment for accrued annual leave when you retire or resign, this amount will be included as wages on your Form W-2.

If you resign from one agency and are reemployed by another agency, you may have to repay part of your lump-sum annual leave payment to the second agency. You can reduce gross wages by the amount you repaid in the same tax year in which you received it. Attach to your tax return a copy of the receipt or statement given to you by the agency you repaid to explain the difference between the wages on the return and the wages on your Forms W-2.

Sick pay. Pay you receive from your employer while you are sick or injured is part of your salary or wages. In addition, you must include in your income sick pay benefits received from any of the following payers.

1) A welfare fund.
2) A state sickness or disability fund.
3) An association of employers or employees.
4) An insurance company, if your employer paid for the plan.

However, if you paid the premiums on an accident or health insurance policy, the benefits you receive under the policy are not taxable.

Social security and Medicare taxes paid by employer. If you and your employer have an agreement that your employer pays your social security and Medicare taxes without deducting them from your gross wages, you must report the amount of tax paid for you as taxable wages on your tax return. The payment is also treated as wages for figuring your social security and Medicare taxes and your social security and Medicare benefits. However, these payments are not treated as social security and Medicare wages if you are a household worker or a farm worker.

Stock appreciation rights. Do not include a stock appreciation right granted by your employer in income until you exercise (use) the right. When you use the right, you are entitled to a cash payment equal to the fair market value of the corporation's stock on the date of use minus the fair market value on the date the right was granted. You include the cash payment in your income in the year you use the right.

FRINGE BENEFITS

Fringe benefits you receive in connection with the performance of your services are included in your income as compensation unless you pay fair market value for them or they are specifically excluded by law. Abstaining from the performance of services (for example, under a covenant not to compete) is treated as the performance of services for purposes of these rules.

Accounting period. You must use the same accounting period your employer uses to report your taxable noncash fringe benefits. Your employer has the option to report taxable noncash fringe benefits by using either of the following rules.

1) The ***general rule:*** benefits are reported for a full calendar year (January 1- December 31).
2) The ***special accounting period rule:*** benefits provided during the last 2 months of the calendar year (or any shorter period) are treated as paid during the following calendar year. For example, each year your employer reports the value of benefits provided during the last 2 months of the prior year and the first 10 months of the current year.

Your employer does not have to use the same accounting period for each finge benefit, but must use the same period for all employees who receive a particular benefit.

You must use the same accounting period that you use to report the benefit to claim an employee business deduction (for use of a car, for example).

Accident or Health Plan

Generally, the value of accident or health plan coverage provided to you by your employer is not included in your income. Benefits you receive from the plan may be taxable, as explained later under *Sickness and Injury Benefits*.

Long-term care coverage. Contributions by your employer to provide coverage for long-term care services are generally not included in income. However, contributions made through a flexible spending or similar arrangement (such as a cafeteria plan) must be included in your income. This amount will be reported as wages in box 1 of your Form W-2.

Archer MSA contributions. Contributions by your employer to your Archer MSA (previously called a medical savings account) are not included in your income. Their total will be reported in box 12 of Form W-2 with code R. You must report this amount on Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts*. Attach the form to your return.

De Minimis (Minimal) Benefits

If your employer provides you with a product or service and the cost of it is so small that it would be unreasonable for the employer to account for it, the value is not included in your income. Generally, the value of benefits such as discounts at company cafeterias, cab fares home when working overtime, and company picnics are not included in your income.

Holiday gifts. If your employer gives you a turkey, ham, or other item of nominal value at Christmas or other holidays, do not include the value of the gift in your income. However, if your employer gives you cash, a gift certificate, or a similar item that you can easily exchange for cash, you include the value of that gift as extra salary or wages regardless of the amount involved.

Educational Assistance

You can exclude from your income up to $5,250 of qualified employer-provided educational assistance. The exclusion applies to undergraduate and graduate-level courses.

Group-Term Life Insurance

Generally, the cost of up to $50,000 of group-term life insurance coverage provided to you by your employer (or former employer) is not included in your income. However, you must include in income the cost of employer-provided insurance that is more than the cost of $50,000 of coverage reduced by any amount you pay toward the purchase of the insurance.

Group-term life insurance. This insurance is term life insurance protection (insurance for a fixed period of time) that:

1) Provides a general death benefit,
2) Is provided to a group of employees,
3) Is provided under a policy carried by the employer, and
4) Provides an amount of insurance for each employee based on a formula that prevents individual selection.

Permanent benefits. If your group-term life insurance policy includes permanent benefits, such as a paid-up or cash surrender value, you must include in your income, as wages, the cost of the permanent benefits minus the amount you pay for them. Your employer should be able to tell you the amount to include in your income.

Accidental death benefits. Insurance that provides accidental or other death benefits but does not provide general death benefits (travel insurance, for example) is not group-term life insurance.

Entire cost excluded. You are not taxed on the cost of group-term life insurance if any of the following circumstances apply.

1) You are permanently and totally disabled and have ended your employment.
2) Your employer is the beneficiary of the policy for the entire period the insurance is in force during the tax year.
3) A charitable organization (defined in chapter 24) is the only beneficiary of the policy for the entire period the insurance is in force during the tax year. (You are not entitled to a deduction for a charitable contribution for naming a charitable organization as the beneficiary of your policy.)

Entire cost taxed. You are taxed on the entire cost of group-term life insurance if either of the following circumstances apply.

1) The insurance is provided by your employer through a qualified employees' trust, such as a pension trust or a qualified annuity plan.
2) You are a key employee and your employer's plan discriminates in favor of key employees.

More than $50,000 from one employer. If you have only one employer and you were insured at any time during the tax year for more than $50,000 under a group-term life insurance policy, your taxable income from this source is included as other compensation on the Form W-2 you receive.

More than $50,000 from two or more employers. If two or more employers provide you group-term life insurance coverage totaling more than $50,000, you must figure how much to include in your income. You must include the cost of life insurance provided to you during the tax year, regardless of when your employers paid the premiums.

Figuring the taxable cost. You figure the taxable cost for each month of coverage by multiplying the number of thousands of dollars of insurance coverage for the month (figured to the nearest tenth), less 50, by the cost from the following table. Use your age on the last day of the tax year. You must prorate the cost from the table if less than a full month of coverage is involved.

COST PER $1,000 OF PROTECTION FOR ONE MONTH

Age	Cost
Under 25	$.05
25 through 29	.06
30 through 34	.08
35 through 39	.09
40 through 44	.10
45 through 49	.15
50 through 54	.23
55 through 59	.43
60 through 64	.66
65 through 69	1.27
70 and older	2.06

Transportation

If your employer provides you with a qualified transportation fringe benefit, it can be excluded from your income, up to certain limits. A qualified transportation fringe benefit is:

- Transportation in a commuter highway vehicle (such as a van) between your home and work place,
- A transit pass,
- Qualified parking, or
- Qualified bicycle commuting reimbursement.

Cash reimbursement by your employer for these expenses under a *bona fide* reimbursement arrangement also is excludable. However, cash reimbursement for a transit pass is excludable only if a voucher or similar item that can be exchanged only for a transit pass is not readily available for direct distribution to you.

Exclusion limit. The exclusion for commuter highway vehicle transportation and transit pass fringe benefits is $230 a month in 2011.

The exclusion for the qualified parking fringe benefit cannot be more than $230 per month.

The exclusion for qualified bicycle commuting in a calendar year is $20 multiplied by the number of qualified bicycle commuting months that year.

If the benefits have a value that is more than these limits, the excess must be included in your income. You are not entitled to these exclusions if the reimbursements are made under a compensation reduction agreement.

Commuter highway vehicle. This is a highway vehicle that seats at least six adults (not including the driver). At least 80% of the vehicle's mileage must reasonably be expected to be:

- For transporting employees between their homes and work place, and
- On trips during which employees occupy at least half of the vehicle's adult seating capacity (not including the driver).

Transit pass. This is any pass, token, farecard, voucher, or similar item entitling a person to ride mass transit (whether public or private) free or at a reduced rate or to ride in a commuter highway vehicle operated by a person in the business of transporting persons for compensation.

Qualifying parking. This is parking provided to an employee at or near the employer's place of business. It also includes parking provided on or near a location from which the employee commutes to work by mass transit, in a commuter highway vehicle, or by carpool. It does not include parking at or near the employee's home.

Qualified bicycle commuting. This is reimbursement based on the number of qualified bicycle commuting months for the year. A qualified bicycle commuting month is any month you use the bicycle regularly for a substantial portion of the travel between your home and place of employment and you do not receive any of the other qualified transportation fringe benefits. The reimbursement can be for expenses you incurred during the year for the purchase of a bicycle and bicycle improvements, repair, and storage.

IV. Special Rules for Certain Employees

CLERGY

If you are a member of the clergy, you must include in your income offerings and fees you receive for marriages, baptisms, funerals, masses, etc., in addition to your salary. If the offering is made to the religious institution, it is not taxable to you.

Housing. Special rules for housing apply to members of the clergy. Under these rules, you do not include in your income the rental value of a home (including utilities) or a housing allowance provided to you as part of your pay. However, the exclusion cannot be more than the reasonable pay for your service. If you pay for the utilities, you can exclude any allowance designated for utility cost, up to your actual cost. The home or allowance must be provided as compensation for your duties as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home or the housing allowance as earnings from self-employment on Schedule SE (Form 1040) if you are subject to the self-employment tax.

Pension. A pension or retirement pay for a member of the clergy is usually treated the same as any other pension or annuity. It must be reported on lines 16a and 16b of Form 1040 or on lines 12a and 12b of Form 1040A.

MEMBERS OF RELIGIOUS ORDERS

If you are a member of a religious order who has taken a vow of poverty, how you treat earnings that you renounce and turn over to the order depends on whether your services are performed for the order.

Services performed for the order. If you are performing the services as an agent of the order in the exercise of duties required by the order, do not include in your income the amounts turned over to the order.

Example. You are a member of a church order and have taken a vow of poverty. You renounce any claims to your earnings and turn over to the order any salaries or wages you earn. You are a registered nurse, so your order assigns you to work in a hospital that is an associated institution of the church. However, you remain under the general direction and control of the order. You are considered to be an agent of the order and any wages you earn at the hospital that you turn over to your order are not included in your income.

Services performed outside the order. If you are directed to work outside the order, your services are not an exercise of duties required by the order unless they meet both of the following requirements.

1) They are the kind of services that are ordinarily the duties of members of the order.
2) They are part of the duties that you must exercise for, or on behalf of, the religious order as its agent.

If you are an employee of a third party, the services you perform for the third party will not be considered directed or required of you by the order. Amounts you receive for these services are included in your income, even if you have taken a vow of poverty.

Example. Mark Brown is a member of a religious order and has taken a vow of poverty. He renounces all claims to his earnings and turns over his earnings to the order.

Mark is a school teacher. He was instructed by the superiors of the order to get a job with a private tax-exempt school. Mark became an employee of the school, and, at his request, the school made the salary payments directly to the order.

Because Mark is an employee of the school, he is performing services for the school rather than as an agent of the order. The wages Mark earns working for the school are included in his income.

FOREIGN EMPLOYER

Special rules apply if you work for a foreign employer.

U.S. citizen. If you are a U.S. citizen who works in the United States for a foreign government, an international organization, a foreign embassy, or any foreign employer, you must include your salary in your income.

Social security and Medicare taxes. You are exempt from social security and Medicare taxes if you are employed in the United States by an international organization or a foreign government. However, you must pay self-employment tax on your earnings from services performed in the United States, even though you are not self-employed. This rule also applies if you are an employee of a qualifying wholly-owned instrumentality of a foreign government.

Employees of international organizations or foreign governments. Your compensation for official services to an international organization is exempt from federal income tax if you are not a citizen of the United States or you are a citizen of the Philippines (whether or not you are a citizen of the United States).

Your compensation for official services to a foreign government is exempt from federal income tax if all of the following are true:

- You are not a citizen of the United States or you are a citizen of the Philippines (whether or not you are a citizen of the United States).
- Your work is like the work done by employees of the United States in foreign countries.
- The foreign government gives an equal exemption to employees of the United States in its country.

Waiver of alien status. If you are an alien who works for a foreign government or international organization and you file a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status, different rules may apply.

MILITARY

Payments you receive as a member of a military service generally are taxed as wages except for retirement pay, which is taxed as a pension. Allowances generally are not taxed.

Military retirement pay. If your retirement pay is based on age or length of service, it is taxable and must be included in your income as a pension on lines 16a and 16b of Form 1040, or on lines 12a and 12b of Form 1040A. Do not include in your income the amount of any reduction in retirement or retainer pay to provide a survivor annuity for your spouse or children under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan.

Veterans' benefits. Do not include in your income any veterans' benefits paid under any law, regulation, or administrative practice administered by the Department of Veterans Affairs (VA). The following amounts paid to veterans or their families are not taxable.

- Education, training, and subsistence allowances.
- Disability compensation and pension payments for disabilities paid either to veterans or their families.
- Grants for homes designed for wheelchair living.
- Grants for motor vehicles for veterans who lost their sight or the use of their limbs.
- Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including the proceeds of a veteran's endowment policy paid before death.
- Interest on insurance dividends you leave on deposit with the VA.
- Benefits under a dependent-care assistance program.
- The death gratuity paid to a survivor of a member of the Armed Forces who dies after September 10, 2001.
- Payments made under the compensated work therapy program.
- Any bonus payment by a state or political subdivision because of service in a combat zone.

VOLUNTEERS

Peace Corps. Living allowances you receive as a Peace Corps volunteer or volunteer leader for housing, utilities, household supplies, food, and clothing are exempt from tax.

Taxable allowances. The following allowances must be included in your income and reported as wages.

- Allowances paid to your spouse and minor children while you are a volunteer leader training in the United States.
- Living allowances designated by the Director of the Peace Corps as basic compensation. These are allowances for personal items such as domestic help, laundry and clothing maintenance, entertainment and recreation, transportation, and other miscellaneous expenses.
- Leave allowances.
- Readjustment allowances or termination payments. These are considered received by you when credited to your account.

Example. Gary Carpenter, a Peace Corps volunteer, gets $175 a month as a readjustment allowance during his period of service, to be paid to him in a lump sum at the end of his tour of duty. Although the allowance is not available to him until the end of his service, Gary must include it in his income on a monthly basis as it is credited to his account.

Volunteers in Service to America (VISTA). If you are a VISTA volunteer, you must include meal and lodging allowances paid to you in your income as wages.

National Senior Services Corps programs. Do not include in your income amounts you receive for supportive services or reimbursements for out-of-pocket expenses from the following programs.

- Retired Senior Volunteer Program (RSVP).
- Foster Grandparent Program.
- Senior Companion Program.

Service Corps of Retired Executives (SCORE). If you receive amounts for supportive services or reimbursements for out-of-pocket expenses from SCORE, do not include these amounts in income.

V. <u>Sickness and Injury Benefits</u>

Disability income. Generally, you must report as income any amount you receive for personal injury or sickness through an accident or health plan that is paid for by your employer. If both you and your employer pay for the plan, only the amount you receive that is due to your employer's payments is reported as income. However, certain payments may not be taxable to you. Your employer should be able to give you specific details about your pension plan and tell you the amount you paid for your disability pension. In addition to disability pensions and annuities, you may be receiving other payments for sickness and injury.

Cafeteria plans. Generally, if you are covered by an accident or health insurance plan through a cafeteria plan, and the amount of the insurance premiums was not included in your income, you are not considered to have paid the premiums and you must include any benefits you receive in your income. If the amount of the premiums was included in your income, you are considered to have paid the premiums, and any benefits you receive are not taxable.

DISABILITY PENSIONS

Generally, if you retire on disability, you must report your pension or annuity as income. There is a tax credit for people who are permanently and totally disabled when they retired. For information on this credit and the definition of permanent and total disability, see chapter 33.

Accrued leave payment. If you retire on disability, any lump-sum payment you receive for accrued annual leave is a salary payment. The payment is not a disability payment. Include it in your income in the tax year you receive it.

Retirement and profit-sharing plans. If you receive payments from a retirement or profit-sharing plan that does not provide for disability retirement, do not treat the payments as a disability pension. The payments must be reported as a pension or annuity. For more information on pensions, see chapter 10.

Military and Government Disability Pensions

Certain military and government disability pensions are not taxable.

Service-connected disability. You may be able to exclude from income amounts you receive as a pension, annuity, or similar allowance for personal injury or sickness resulting from active service in one of the following government services.

- The armed forces of any country.
- The National Oceanic and Atmospheric Administration.
- The Public Health Service.
- The Foreign Service.

Pension based on years of service. If you receive a disability pension based on years of service, you generally must include it in your income. But if it is a result of active service in one of the listed government services and one of the listed conditions applies, do not include in income the part of your pension that you would have received if the pension had been based on a percentage of disability. You must include the rest of your pension in your income.

Terrorist attack or military action. Do not include in your income disability payments you receive for injuries resulting directly from a terrorist or military action.

LONG-TERM CARE INSURANCE CONTRACTS

Long-term care insurance contracts are generally treated as accident and health insurance contracts. Amounts you receive from them (other than policyholder dividends or premium refunds) generally are excludable from income as amounts received for personal injury or sickness. To claim an exclusion for payments made on a per diem or other periodic basis under a long-term care insurance contract, you must file Form 8853 with your return.

A long-term care insurance contract is an insurance contract that only provides coverage for ***qualified long-term care services***. The contract must:

- Be guaranteed renewable,
- Not provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed,

- Provide that refunds, other than refunds on the death of the insured or complete surrender or cancellation of the contract, and dividends under the contract may be used only to reduce future premiums or increase future benefits, and
- Generally not pay or reimburse expenses incurred for services or items that would be reimbursed under Medicare, except where Medicare is a secondary payer or the contract makes per diem or other periodic payments without regard to expenses.

Qualified long-term care services. Qualified long-term care services are:

- Necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance and personal care services, and
- Required by a ***chronically ill individual*** and provided pursuant to a plan of care as prescribed by a licensed health care practitioner.

Chronically ill individual. A chronically ill individual is one who has been certified by a licensed health care professional within the previous 12 months as one of the following.

- An individual who, for at least 90 days, is unable to perform at least two activities of daily living without substantial assistance due to loss of functional capacity. Activities of daily living are: eating, toileting, transferring, bathing, dressing, and continence.
- An individual who requires substantial supervision to be protected from threats to health and safety due to sever cognitive impairment.

Limit on exclusion. You can generally exclude from gross income up to $300 a day for 2011. This limit is indexed for inflation.

WORKERS' COMPENSATION

Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act. The exemption also applies to your survivors. The exemption, however, does not apply to retirement plan benefits you receive based on your age, length of service, or prior contributions to the plan, even if you retired because of an occupational sickness or injury.

OTHER SICKNESS AND INJURY BENEFITS

Railroad sick pay. Payments you receive as sick pay under the Railroad Unemployment Insurance Act are taxable and you must include them in your income. However, do not include them in your income if they are for an on-the-job injury.

Federal Employees' Compensation Act (FECA). Payments received under this Act for personal injury or sickness, including payments to beneficiaries in case of death, are not taxable. However, you are taxed on amounts you receive under this Act as ***continuation of pay*** for up to 45 days while a claim is being decided. Report this income on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. Also, pay for sick leave while a claim is being processed is taxable and must be included in your income as wages.

Caution. *If part of the payments you receive under FECA reduces your social security or equivalent railroad retirement benefits received, that part is considered social security (or equivalent railroad retirement) benefits and may be taxable.*

You can deduct the amount you spend to buy back sick leave for an earlier year to be eligible for nontaxable FECA benefits for that period. It is a miscellaneous deduction subject to the 2% limit on Schedule A (Form 1040). If you buy back sick leave in the same year you use it, the amount reduces your taxable sick leave pay. Do not deduct it separately.

Other compensation. Many other amounts you receive as compensation for sickness or injury are not taxable. These include the following amounts.

- Compensatory damages you receive for physical injury or physical sickness, whether paid in a lump sum or in periodic payments.
- Benefits you receive under an accident or health insurance policy on which either you paid the premiums or your employer paid the premiums but you had to include them in your income.
- Disability benefits you receive for loss of income or earning capacity as a result of injuries under a no-fault car insurance policy.
- Compensation you receive for permanent loss or loss of use of a part or function of your body, or for your permanent disfigurement. This compensation must be based only on the injury and not on the period of your absence from work. These benefits are not taxable even if your employer pays for the accident and health plan that provides these benefits.

Reimbursement for medical care. A reimbursement for medical care is generally not taxable. However, it may reduce your medical expense deduction.

CHAPTER 5 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. If you receive advance commissions or other amounts for services to be performed in the future and you are a cash method taxpayer, you must include these amounts in your income in the year you receive them.

   a) true
   b) false

2. Generally, the cost of up to $50,000 of group-term life insurance coverage provided to you by your employer (or former employer) is not included in your income.

   a) true
   b) false

3. The exclusion limit for a qualified parking fringe benefit for 2011 is:

   a) $120 per month
   b) $230 per month
   c) $300 per month
   d) $500 per month

4. A member of the clergy must report as taxable income compensation received directly by him for all of the following <u>except</u>:

   a) fees received for performing marriages
   b) fees received for performing funerals
   c) offerings for performing baptisms and masses
   d) a housing allowance provided as compensation for services performed by an ordained clergy member

5. Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act.

   a) true
   b) false

CHAPTER 5 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** If you repay unearned commissions or other amounts in the same year you receive them, you should reduce the amount included in your income by the repayment.

   B: False is incorrect. If you repay the unearned commission in a later tax year, you can deduct the repayment as an itemized deduction on your Schedule A, or you may be able to take a credit for that year.

2. **A: True is correct.** You must include in income the cost of employer-provided insurance that is more than the cost of $50,000 of coverage.

   B: False is incorrect. If you pay any part of the cost of the insurance, your entire payment reduces, dollar for dollar, the amount you would otherwise include in your income.

3. A: Incorrect. This amount is significantly lower than the allowed fringe benefit exclusion.

   B: Correct. The exclusion limit for a qualified parking fringe benefit is $230 per month. If the benefit has a value greater than this limit, the excess must be included in the taxpayers' income.

   C: Incorrect. This amount is not related to any fringe benefit exclusion limit.

   D: Incorrect. This amount is not related to any fringe benefit exclusion limit discussed.

4. Incorrect. Fees received directly by a member of the clergy for performing services, such as conducting marriages, are taxable income to the person receiving payment.

   B: Incorrect. Fees received directly by a member of the clergy, and not paid to the religious order, are taxable to the individual regardless of the nature of the service performed.

   C: Incorrect. Offerings received by a member of the clergy for baptisms and masses, and not paid to the religious institution, must be included in taxable income.

   D: Correct. The value of rental housing provided, or cash housing allowances given to a member of the clergy as compensation for services provided qualifies for special tax reporting rules. Generally, such compensation is not taxable income to the clergy member, but must be reported as self-employment income on Schedule SE if the member of the clergy is subject to self-employment tax.

5. **A: True is correct.** The exemption also applies to your survivors.

   B: False is incorrect. The exemption does not apply to retirement plan benefits you receive based on your age, length of service, or prior contributions to the plan, even if you retired because of an occupational sickness or injury.

Chapter 6: Tip Income

I. <u>Introduction</u>

This chapter is for employees who receive tips.

All tips you receive are income and are subject to federal income tax. You must include in gross income all tips you receive directly from customers, tips from charge customers that are paid to you by your employer, and your share of any tips you receive under a tip-splitting or tip-pooling arrangement.

The value of noncash tips, such as tickets, passes, or other items of value are also income and subject to tax.

Reporting your tip income correctly is not difficult. You must do three things.

1) Keep a daily tip record.
2) Report tips to your employer.
3) Report all your tips on your income tax return.

This chapter will show you how to do these three things and what to do on your tax return if you have not done the first two. This chapter will also show you how to treat allocated tips.

II. <u>Keeping a Daily Tip Record</u>

How to keep a daily tip record. There are two ways to keep a daily tip record. You can either:

1) Write information about your tips in a tip diary, or
2) Keep copies of documents that show your tips, such as restaurant bills and credit card charge slips.

You should keep your daily tip record with your personal records. You must keep your records for as long as they are important for administration of the federal tax law.

If you keep a tip diary, you can use Form 4070A, *Employee's Daily Record of Tips* . To get Form 4070A, ask the Internal Revenue Service (IRS) or your employer for Publication 1244. Publication 1244 includes a year's supply of Form 4070A. Each day, write in the information asked for on the form.

If you do not use Form 4070A, start your records by writing your name, your employer's name, and the name of the business if it is different from your employer's name. Then, each workday, write the date and the following information.

- Cash tips you get directly from customers or from other employees.
- Tips from credit card charge customers that your employer pays you. (Also include tips from debit card charge customers.)
- The value of any noncash tips you get, such as tickets, passes, or other items of value.
- The amount of tips you paid out to other employees through tip pools or tip splitting, or other arrangements, and the names of the employees to whom you paid the tips.

III. <u>Reporting Tips to Your Employer</u>

What tips to report. Report to your employer only cash, check, or credit card tips you receive.

If your total tips for any one month from any one job are less than $20, do not report them to your employer.

Do not report the value of any noncash tips, such as tickets or passes, to your employer. You do not pay social security and Medicare taxes or railroad retirement tax on these tips.

How to report. If your employer does not give you any other way to report tips, you can use Form 4070. To get a year's supply of the form, ask the IRS or your employer for Publication 1244. Fill in the information asked for on the form, sign and date the form, and give it to your employer.

If you do not use Form 4070, give your employer a statement with the following information.

- Your name, address, and social security number.
- Your employer's name, address, and business name (if it is different from the employer's name).
- The month (or the dates of any shorter period) in which you received tips.
- The total tips required to be reported for that period.

You must sign and date the statement. You should keep a copy with your personal records.

Your employer may require you to report your tips more than once a month. However, the statement cannot cover a period of more than one calendar month.

Electronic tip statement. Your employer can have you furnish your tip statements electronically.

When to report. Give your report for each month to your employer by the 10th of the next month. If the 10th falls on a Saturday, Sunday, or legal holiday, give your employer the report by the next day that is not a Saturday, Sunday, or legal holiday.

Example. You must report your tips received in October 2012 by November 10, 2012.

Final report. If your employment ends during the month, you can report your tips when your employment ends.

Penalty for not reporting tips. If you do not report tips to your employer as required, you may be subject to a penalty equal to 50% of the social security and Medicare taxes or railroad retirement tax you owe on the unreported tips. (For information about these taxes, see *Reporting social security and Medicare taxes on tips not reported to your employer* under *Reporting Tips on Your Tax Return*, later.) The penalty amount is in addition to the taxes you owe.

Giving your employer money for taxes. Your regular pay may not be enough for your employer to withhold all the taxes you owe on your regular pay plus your reported tips. If this happens, you can give your employer money until the close of the calendar year to pay the rest of the taxes.

If you do not give your employer enough money, your employer will apply your regular pay and any money you give to the taxes in the following order.

1) All taxes on your regular pay.
2) Social security and Medicare taxes or railroad retirement tax on your reported tips.
3) Federal, state, and local income taxes on your reported tips.

Any taxes that remain unpaid can be collected by your employer from your next paycheck. If withholding taxes remain uncollected at the end of the year, you may be subject to a penalty for underpayment of estimated taxes.

Caution. Uncollected taxes. *You must report on your tax return any social security and Medicare taxes or railroad retirement tax that remained uncollected at the end of 2011. See Reporting uncollected social security and Medicare taxes on tips under Reporting Tips on Your Tax Return, later. These uncollected taxes will be shown in box 12 of your 2011 Form W-2 (codes A and B).*

IV. Reporting Tips on Your Tax Return

What tips to report. You must report all tips you received in 2011, including both cash tips and noncash tips, on your tax return. Any tips you reported to your employer for 2011 are included in the wages shown in box 1 of your Form W-2. Add to the amount in box 1 only the tips you did not report to your employer.

If you kept a daily tip record and reported tips to your employer as required under the rules explained earlier, add the following tips to the amount in box 1 of your Form W-2.

- Cash and charge tips you received that totaled less than $20 for any month.
- The value of noncash tips, such as tickets, passes, or other items of value.

Example. John Allen began working at the Diamond Restaurant (his only employer in 2011) on June 30 and received $10,000 in wages during the year. John kept a daily tip record showing that his tips for June were $18 and his tips for the rest of the year totaled $7,000. He was not required to report his June tips to his employer, but he reported all of the rest of his tips to his employer as required.

John's Form W-2 from Diamond Restaurant shows $17,000 ($10,000 wages plus $7,000 reported tips) in box 1. He adds the $18 unreported tips to that amount and reports $17,018 as wages on his tax return.

Reporting social security and Medicare taxes on tips not reported to your employer. If you received $20 or more in cash and charge tips in a month from any one job and did not report all of those tips to your employer, you must report the social security and Medicare taxes on the unreported tips as additional tax on your return. To report these taxes, you must file a return even if you would not otherwise have to file. You must use Form 1040. (You cannot file Form 1040EZ or Form 1040A.)

Use **Form 4137** to figure these taxes. Enter the tax on line 57, Form 1040, and attach Form 4137 to your return.

Reporting uncollected social security and Medicare taxes on tips. If your employer could not collect all the social security and Medicare taxes or railroad retirement tax you owe on tips reported for 2011, the uncollected taxes will be shown in box 12 of your Form W-2 (codes A and B). You must report these amounts as additional tax on your return. You may have uncollected taxes if your regular pay was not enough for your employer to withhold all the taxes you owe and you did not give your employer enough money to pay the rest of the taxes.

To report these uncollected taxes, you must file a return even if you would not otherwise have to file. You must use Form 1040. (You cannot file Form 1040EZ or Form 1040A.) Include the taxes in your total tax amount on line 61, and write "UT" and the total of the uncollected taxes on the dotted line next to line 61.

V. Allocated Tips

If your employer allocated tips to you, they are shown separately in box 8 of your Form W-2. They are not included in box 1 with your wages and reported tips. If box 8 is blank, this discussion does not apply to you.

What are allocated tips? These are tips that your employer assigned to you in addition to the tips you reported to your employer for the year. Your employer will have done this only if:

- You worked in a restaurant, cocktail lounge, or similar business that must allocate tips to employees,
- The tips you reported to your employer were less than your share of 8% of food and drink sales, and
- You did not participate in your employer's Attributed Tip Income Program (ATIP).

How were your allocated tips figured? The tips allocated to you are your share of an amount figured by subtracting the reported tips of all employees from 8% (or an approved lower rate) of food and drink sales (other than carryout sales and sales with a service charge of 10% or more). Your share of that amount was figured using either a method provided by an employer-employee agreement or a method provided by IRS regulations based on employees' sales or hours worked. For information about the exact allocation method used, ask your employer.

Must you report your allocated tips on your return? You must report allocated tips on your tax return unless either of the following exceptions applies.

1) You kept a daily tip record, or other evidence that is as credible and as reliable as a daily tip record, as required under rules explained earlier.
2) Your tip record is incomplete, but it shows that your actual tips were more than the tips you reported to your employer plus the allocated tips. If either exception applies, report your actual tips on your return. Do not report the allocated tips. See *What tips to report* under *Reporting Tips on Your Tax Return*, earlier.

How to report allocated tips. If you must report allocated tips on your return, add the amount in box 8 of your Form W-2 to the amount in box 1. Report the total as wages on line 7 of Form 1040. (You cannot file Form 1040EZ or Form 1040A.)

Because social security and Medicare taxes were not withheld from the allocated tips, you must report those taxes as additional tax on your return. Complete Form 4137, and include the allocated tips on line 1 of the form. See *Reporting social security and Medicare taxes on tips not reported to your employer* under *Reporting Tips on Your Tax Return*, earlier.

CHAPTER 6 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Tip income must be correctly reported. Which of the following tasks is <u>not</u> required of employees receiving tips:

   a) keep a daily tip record
   b) separate and report only currency tips to your employer
   c) report all tips to your employer
   d) report all your tips on your income tax return

2. Allocated tips are tips that your employer assigned to you in addition to the tips you reported to your employer for the year.

   a) true
   b) false

CHAPTER 6 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Keeping a daily tip record in some form is required of all employees who regularly receive tip income.

   B: Correct. This task statement is incomplete for any employee receiving tip income. All cash (currency + coins), checks, and credit card tips received must be reported to your employer. These will be subject to social security taxes.

   C: Incorrect. Reporting all tips (except non-cash items such as tickets, passes etc.) to your employer is required.

   D: Incorrect. Reporting all of your tip income (including non-cash items of value such as tickets and passes) must be reported on your income tax return.

2. **A: True is correct.** They are not included in box 1 of Form W-2 with your wages and reported tips.

   B: False is incorrect. You must report allocated tips on your tax return unless you kept a reliable daily tip record as applicable, or your tip record is incomplete, but it shows that your actual tips were more than the tips you report to your employer plus the allocated tips.

Chapter 7: Interest Income

I. Important Reminder

Foreign-source income. If you are a U.S. citizen with interest income from sources outside the United States (foreign income), you must report that income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payer.

II. Introduction

This chapter discusses:

- Different types of interest income,
- What interest is taxable and what interest is nontaxable,
- When to report interest income, and
- How to report interest income on your tax return.

III. General Information

Tax on investment income of certain children. Part of a child's 2011 investment income may be taxed at the parent's tax rate. This may happen if all the following are true.

1) The child had more than $1,900 of investment income.
2) The child is required to file a tax return.
3) The child was:
   a) Under age 18 at the end of 2011,
   b) Age 18 at the end of 2011 and did not have earned income that was more than half of the child's support, or
   c) A full-time student over age 18 and under age 24 at the end of 2011 and did not have earned income that was more than half of the child's support.
4) At least one of the child's parents was alive at the end of 2011.
5) The child does not file a joint return for 2011.

A child born on January 1, 1994, is considered to be age 18 at the end of 2011; a child born on January 1, 1993, is considered to be age 19 at the end of 2011; a child born on January 1, 1988, is considered to be age 24 at the end of 2011.

If all these statements are true, **Form 8615,** *Tax for Certain Children With Investment Income of More Than $1,900,* must be completed and attached to the child's tax return. If any of these statements is not true, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, the parent can choose to include the child's interest and dividends on the parent's return if certain requirements are met. Use **Form 8814,** *Parents' Election To Report Child's Interest and Dividends,* for this purpose.

Beneficiary of an estate or trust. Interest you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a **Schedule K-1** (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.,* from the fiduciary. Your copy of Schedule K-1 and its instructions will tell you where to report the income on your Form 1040.

SSN for joint account. If the funds in a joint account belong to one person, list that person's name first on the account and give that person's SSN to the payer. If the joint account contains combined funds, give the SSN of the person whose name is listed first on the account.

Custodian account for your child. If your child is the actual owner of an account that is recorded in your name as custodian for the child, give the child's SSN to the payer. For example, you must give your child's SSN to the payer of dividends on stock owned by your child, even though the dividends are paid to you as custodian.

Backup withholding. Your interest income is generally not subject to regular withholding. However, it may be subject to backup withholding to ensure that income tax is collected on the income. Under backup withholding, the payer of interest must withhold, as income tax, a percentage of the amount you are paid. The percentage is 28%.

Income from property given to a child. Property you give as a parent to your child under the Model Gifts of Securities to Minors Act, the Uniform Gifts to Minors Act, or any similar law, becomes the child's property.

Income from the property is taxable to the child, except that any part used to satisfy a legal obligation to support the child is taxable to the parent or legal guardian having that legal obligation.

Savings account with parent as trustee. Interest income from a savings account opened for a child who is a minor, but placed in the name and subject to the order of the parents as trustees, is taxable to the child if, under the law of the state in which the child resides, both of the following are true.

1) The savings account legally belongs to the child.
2) The parents are not legally permitted to use any of the funds to support the child.

Form 1099-INT. Interest income is generally reported to you on Form 1099-INT, *Interest Income,* or a similar statement, by banks, savings and loans, and other payers of interest. This form shows you the interest you received during the year. Keep this form for your records. You do not have to attach it to your tax return.

Form 1099-OID. Reportable interest income may also be shown on Form 1099-OID, *Original Issue Discount.* For more information about amounts shown on this form, see *Original Issue Discount (OID),* later in this chapter.

Exempt-interest dividends. Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information-reporting requirement,* next.) Exempt-interest dividends should be shown in box 8 of Form 1099-INT.

Information-reporting requirement. Although exempt-interest dividends are not taxable, you must show them on your tax return if you have to file. This is an information-reporting requirement and does not change the exempt-interest dividends to taxable income.

Interest on VA dividends. Interest on insurance dividends that you leave on deposit with the Department of Veterans Affairs (VA) is not taxable. This includes interest paid on dividends on converted United States Government Life Insurance and on National Service Life Insurance policies.

IV. <u>Taxable Interest</u>

Taxable interest includes interest you receive from bank accounts, loans you make to others, and other sources. The following are some other sources of taxable interest.

Dividends that are actually interest. Certain distributions commonly called dividends are actually interest. You must report as interest so-called "dividends" on deposits or on share accounts in:

- Cooperative banks,
- Credit unions,
- Domestic building and loan associations,
- Domestic savings and loan associations,
- Federal savings and loan associations, and
- Mutual savings banks.

Money market funds. Generally, amounts you receive from money market funds should be reported as dividends, not as interest.

Certificates of deposit and other deferred interest accounts. If you open any of these accounts, interest may be paid at fixed intervals of 1 year or less during the term of the account. You generally must include this interest in your income when you actually receive it or are entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in 1 year or less and pay interest in a single payment at maturity. If interest is deferred for more than 1 year, see *Original Issue Discount (OID),* later.

Interest subject to penalty for early withdrawal. If you withdraw funds from a deferred interest account before maturity, you may have to pay a penalty. You must report the total amount of interest paid or credited to your account during the year, without subtracting the penalty.

Interest on insurance dividends. Interest on insurance dividends left on deposit with an insurance company that can be withdrawn annually is taxable to you in the year it is credited to your account. However, if you can withdraw it only on the anniversary date of the policy (or other specified date), the interest is taxable in the year that date occurs.

Prepaid insurance premiums. Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for you to withdraw.

U.S. obligations. Interest on U.S. obligations, such as U.S. Treasury bills, notes, and bonds, issued by any agency or instrumentality of the United States is taxable for federal income tax purposes.

Interest on tax refunds. Interest you receive on tax refunds is taxable income.

Interest on condemnation award. If the condemning authority pays you interest to compensate you for a delay in paying an award, the interest is taxable.

Installment sale payments. If a contract for the sale or exchange of property provides for deferred payments, it also usually provides for interest payable with the deferred payments. That interest is taxable when you receive it. If little or no interest is provided for in a deferred payment contract, part of each payment may be treated as interest.

Interest on annuity contract. Accumulated interest on an annuity contract you sell before its maturity date is taxable.

Usurious interest. Usurious interest is interest charged at an illegal rate. This is taxable as interest unless state law automatically changes it to a payment on the principal.

Interest income on frozen deposits. Exclude from your gross income interest on frozen deposits. A deposit is frozen if, at the end of the year, you cannot withdraw any part of the deposit because:

1) The financial institution is bankrupt or insolvent, or
2) The state where the institution is located has placed limits on withdrawals because other financial institutions in the state are bankrupt or insolvent.

The amount of interest you must exclude is the interest that was credited on the frozen deposits minus the sum of:

1) The net amount you withdrew from these deposits during the year, and
2) The amount you could have withdrawn as of the end of the year (not reduced by any penalty for premature withdrawals of a time deposit).

The interest you exclude is treated as credited to your account in the following year. You must include it in income in the year you can withdraw it.

Example. $100 of interest was credited on your frozen deposit during the year. You withdrew $80 but could not withdraw any more as of the end of the year. You must include $80 in your income for the year and exclude $20 from your income for the year. You must include the $20 in your income for the year you can withdraw it.

Bonds traded flat. If you buy a bond when interest has been defaulted or when the interest has accrued but has not been paid, that interest is not income and is not taxable as interest if paid later. When you receive a payment of that interest, it is a return of capital that reduces the remaining cost basis. Interest that accrues after the date of purchase, however, is taxable interest income for the year it is received or accrued. See *Bonds Sold Between Interest Dates,* later, for more information.

Below-market loans. A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate.

U.S. SAVINGS BONDS

Accrual method taxpayers. If you use an accrual method of accounting, you must report interest on U.S. savings bonds each year as it accrues. You cannot postpone reporting interest until you receive it or the bonds mature. Accrual methods of accounting are explained in chapter 1 under *Accounting Methods.*

Cash method taxpayers. If you use the cash method of accounting, as most individual taxpayers do, you generally report the interest on U.S. savings bonds when you receive it.

Series HH Bonds. These bonds were issued at face value. Interest is paid twice a year by direct deposit to your bank account. If you are a cash method taxpayer, you must report interest on these bonds as income in the year you receive it.

Series HH Bonds were first offered in 1980; they were last offered in August 2004. Before 1980, ***series H bonds*** were issued. Series H bonds are treated the same as series HH bonds. If you are a cash method taxpayer, you must report the interest when you receive it.

Series H bonds have a maturity period of 30 years. Series HH bonds mature in 20 years.

Series EE and series I bonds. Interest on these bonds is payable when you redeem the bonds. The difference between the purchase price and the redemption value is taxable interest.

Series EE bonds were first offered in July 1980. They have a maturity period of 30 years. Before July 1980, ***series E bonds*** were issued. The original 10-year maturity period of series E bonds has been extended to 40 years for bonds issued before December 1965 and 30 years for bonds issued after November 1965. Series EE and series E bonds are issued at a discount. The face value is payable to you at maturity.

Series I bonds were first offered in 1998. These are inflation-indexed bonds issued at their face amount with a maturity period of 30 years. The face value plus accrued interest is payable to you at maturity.

If you use the cash method of reporting income, you can report the interest on series EE, series E, and series I bonds in either of the following ways.

1) ***Method 1.*** Postpone reporting the interest until the earlier of the year you cash or dispose of the bonds or the year they mature.
2) ***Method 2.*** Choose to report the increase in redemption value as interest each year.

You must use the same method for all series EE, series E, and series I bonds you own. If you do not choose method 2 by reporting the increase in redemption value as interest each year, you must use method 1.

Tip. *If you plan to cash your bonds in the same year that you will pay for higher education expenses, you may want to use method 1 because you may be able to exclude the interest from your income. To learn how, see Education Savings Bond Program, later.*

Change from method 1. If you want to change your method of reporting the interest from method 1 to method 2, you can do so without permission from the IRS. In the year of change you must report all interest accrued to date and not previously reported for all your bonds.

Once you choose to report the interest each year, you must continue to do so for all series EE, series E, and series I bonds you own and for any you get later, unless you request permission to change, as explained next.

Change from method 2. To change from method 2 to method 1, you must request permission from the IRS. Permission for the change is automatically granted if you send the IRS a statement that meets all the following requirements.

1) You have typed or printed the following number at the top: “131”.
2) It includes your name and social security number under the label in (1).
3) It includes the year of change (both the beginning and ending dates).
4) It identifies the savings bonds for which you are requesting this change.
5) It includes your agreement to:

a) Report all interest on any bonds acquired during or after the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, and
b) Report all interest on the bonds acquired before the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, with the exception of the interest reported in prior tax years.

Co-owners. If a U.S. savings bond is issued in the names of co-owners, such as you and your child or you and your spouse, interest on the bond is generally taxable to the co-owner who bought the bond.

One co-owner's funds used. If you used your funds to buy the bond, you must pay the tax on the interest. This is true even if you let the other co-owner redeem the bond and keep all the proceeds. Under these circumstances, since the other co-owner will receive a Form 1099-INT at the time of redemption, the other co-owner must provide you with another Form 1099-INT showing the amount of interest from the bond that is taxable to you.

Both co-owners' funds used. If you and the other co-owner each contribute part of the bond's purchase price, the interest is generally taxable to each of you, in proportion to the amount each of you paid.

Community property. If you and your spouse live in a community property state and hold bonds as community property, one-half of the interest is considered received by each of you. If you file separate returns, each of you generally must report one-half of the bond interest.

These rules are also shown in *Table 7-1.*

Table 7-1. <u>Who Pays the Tax on U.S. Savings Bond Interest</u>

IF …	THEN the interest must be reported by …
you buy a bond in your name and the name of another person as co-owners, using only your own funds	you.
you buy a bond in the name of another person, who is the sole owner of the bond	the person for whom you bought the bond.
you and another person buy a bond as co-owners, each contributing part of the purchase price	both you and the other co-owner, in proportion to the amount each paid for the bond
you and your spouse, who live in a community property state, buy a bond that is community property	you and your spouse. If you file separate returns, both you and your spouse generally report one-half of the interest.

Ownership transferred. If you bought series E, series EE, or series I bonds ***entirely with your own funds*** and had them reissued in your co-owner's name or beneficiary's name alone, you must include in your gross income for the year of reissue all interest that you earned on these bonds and have not previously reported. But, if the bonds were reissued in your name alone, you do not have to report the interest accrued at that time.

Purchased jointly. If you and a co-owner each contributed funds to buy series E, series EE, or series I bonds ***jointly*** and later have the bonds reissued in the co-owner's name alone, you must include in your gross income for the year of reissue your share of all the interest earned on the bonds that you have not previously reported. At the time of reissue, the former co-owner does not have to include in gross income his or her share of the interest earned that was not reported before the transfer. This interest, however, as well as all interest earned after the reissue, is income to the former co-owner.

This income-reporting rule also applies when the bonds are reissued in the name of your former co-owner and a new co-owner. But the new co-owner will report only his or her share of the interest earned after the transfer.

If bonds that you and a co-owner bought ***jointly*** are reissued to each of you separately in the same proportion as your contribution to the purchase price, neither you nor your co-owner has to report at that time the interest earned before the bonds were reissued.

Example 1. You and your spouse each spent an equal amount to buy a $1,000 series EE savings bond. The bond was issued to you and your spouse as co-owners. You both postpone reporting interest on the bond. You later have the bond reissued as two $500 bonds, one in your name and one in your spouse's name. At that time neither you nor your spouse has to report the interest earned to the date of reissue.

Example 2. You bought a $1,000 series EE savings bond entirely with your own funds. The bond was issued to you and your spouse as co-owners. You both postpone reporting interest on the bond. You later have the bond reissued as two $500 bonds, one in your name and one in your spouse's name. You must report half the interest earned to the date of reissue.

Transfer to a trust. If you own series E, series EE, or series I bonds and transfer them to a trust, giving up all rights of ownership, you must include in your income for that year the interest earned to the date of transfer if you have not already reported it. However, if you are considered the owner of the trust and if the increase in value both before and after the transfer continues to be taxable to you, you can continue to defer reporting the interest earned each year. You must include the total interest in your income in the year you cash or dispose of the bonds or the year the bonds finally mature, whichever is earlier.

The same rules apply to previously unreported interest on series EE or series E bonds if the transfer to a trust consisted of series HH or series H bonds you acquired in a trade for the series EE or series E bonds. See *Savings bonds traded,* later.

Decedents. The manner of reporting interest income on series E, series EE, or series I bonds, after the death of the owner, depends on the accounting and income-reporting method previously used by the decedent.

Savings bonds traded. If you postponed reporting the interest on your series EE or series E bonds, you did not recognize taxable income when you traded the bonds for series HH or series H bonds, unless you received cash in the trade. (You cannot trade series I bonds for series HH bonds. After August 31, 2004, you cannot trade any other series of bonds for series HH bonds.) Any cash you received is income up to the amount of the interest earned on the bonds traded. When your series HH or series H bonds mature, or if you dispose of them before maturity, you report as interest the difference between their redemption value and your cost. Your cost is the sum of the amount you paid for the traded series EE or series E bonds plus any amount you had to pay at the time of the trade.

Example. In 2004, you traded series EE bonds (on which you postponed reporting the interest) for $2,500 in series HH bonds and $223 in cash. You reported the $223 as taxable income in 2004, the year of the trade. At the time of the trade, the series EE bonds had accrued interest of $523 and a redemption value of $2,723. You hold the series HH bonds until maturity, when you receive $2,500. You must report $300 as interest income in the year of maturity. This is the difference between their redemption value, $2,500, and your cost, $2,200 (the amount you paid for the series EE bonds). (It is also the difference between the accrued interest of $523 on the series EE bonds and the $223 cash received on the trade.)

Choice to report interest in year of trade. You can choose to treat all of the previously unreported accrued interest on the series EE or series E bonds traded for series HH bonds as income in the year of the trade. If you make this choice, it is treated as a change from method 1.

Form 1099-INT for U.S. savings bonds interest. When you cash a bond, the bank or other payer that redeems it must give you a Form 1099-INT if the interest part of the payment you receive is $10 or more. Box 3 of your Form 1099-INT should show the interest as the difference between the amount you received and the amount paid for the bond. However, your Form 1099-INT may show more interest than you have to include on your income tax return. For example, this may happen if any of the following are true.

1) You chose to report the increase in the redemption value of the bond each year. The interest shown on your Form 1099-INT will not be reduced by amounts previously included in income.
2) You received the bond from a decedent. The interest shown on your Form 1099-INT will not be reduced by any interest reported by the decedent before death, or on the decedent's final return, or by the estate on the estate's income tax return.
3) Ownership of the bond was transferred. The interest shown on your Form 1099-INT will not be reduced by interest that accrued before the transfer.
4) You were named as a co-owner and the other co-owner contributed funds to buy the bond. The interest shown on your Form 1099-INT will not be reduced by the amount you received as nominee for the other co-owner. (See *Co-owners,* earlier in this chapter, for more information about the reporting requirements.)
5) You received the bond in a taxable distribution from a retirement or profit-sharing plan. The interest shown on your Form 1099-INT will not be reduced by the interest portion of the amount taxable as a distributio*n from the* plan and not taxable as interest. (This amount is generally shown on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* for the year of distribution.)

For more information on including the correct amount of interest on your return, see *How To Report Interest Income,* later.

Tip. *Interest on U.S. savings bonds is exempt from state and local taxes. The Form 1099-INT you receive will indicate the amount that is for U.S. savings bond interest in box 3. Do not include this amount on your state or local income tax return.*

EDUCATION SAVINGS BOND PROGRAM

You may be able to exclude from income all or part of the interest you receive on the redemption of qualified U.S. savings bonds during the year if you pay qualified higher educational expenses during the same year. This exclusion is known as the *Education Savings Bond Program.*

You do not qualify for this exclusion if your filing status is married filing separately.

Form 8815. Use Form 8815 to figure your exclusion. Attach the form to your Form 1040 or Form 1040A.

Qualified U.S. savings bonds. A qualified U.S. savings bond is a series EE bond ***issued after 1989*** or a series I bond. The bond must be issued either in your name (sole owner) or in your and your spouse's names (co-owners). You must be at least 24 years old before the bond's issue date.

> ***Caution.*** *The issue date of a bond may be earlier than the date the bond is purchased because bonds are issued as of the first day of the month in which they are purchased.*

Beneficiary. You can designate any individual (including a child) as a beneficiary of the bond.

Qualified expenses. Qualified higher educational expenses are tuition and fees required for you, your spouse, or your dependent (for whom you can claim an exemption) to attend an eligible educational institution.

Qualified expenses include any contribution you make to a qualified tuition program or to a Coverdell education savings account.

Qualified expenses do not include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree or certificate granting program.

Eligible educational institutions. These institutions include most public, private, and nonprofit universities, colleges and vocational schools that are accredited and are eligible to participate in student aid programs run by the U.S. Department of Education.

Reduction for certain benefits. You must reduce your qualified higher educational expenses by certain benefits the student may have received. These benefits include:

1) Tax-free part of scholarships and fellowships (see scholarships and fellowships in chapter 12).
2) Expenses used to figure the tax-free portion of distributions from a Coverdell ESA.
3) Expenses used to figure the tax-free portion of distributions from a qualified tuition program.
4) Any tax-free payments (other than gifts, bequests, or inheritances) received for educational expenses, such as:
   a) Veterans' educational assistance benefits,
   b) Qualified tuition reductions, or
   c) Employer-provided educational assistance.
5) Any expense used in figuring the American opportunity and lifetime learning credits.

Amount excludable. If the total proceeds (interest and principal) from the qualified U.S. savings bonds you redeem during the year are not more than your qualified higher educational expenses for the year, you can exclude all of the interest. If the proceeds are more than the expenses, you can exclude only part of the interest.

To determine the excludable amount, multiply the interest part of the proceeds by a fraction. The numerator (top part) of the fraction is the qualified higher educational expenses you paid during the year. The denominator (bottom part) of the fraction is the total proceeds you received during the year.

Example. In February 2011, Mark and Joan, a married couple, cashed a qualified series EE U.S. savings bond they bought in April 1998. They received proceeds of $8,124, representing principal of $5,000 and interest of $3,124. In 2011, they paid $4,000 of their daughter's college tuition. They are not claiming an education credit for that amount, and their daughter does not have any tax-free educational assistance. They can exclude $1,538 ($3,124 X ($4,000 ÷ $8,124)) of interest in 2011. They must pay tax on the remaining $1,586 ($3,124 - $1,538) interest.

Modified adjusted gross income limit. The interest exclusion is limited if your modified adjusted gross income (modified AGI) is:

- $71,100 to $86,100 for taxpayers filing single or head of household, and
- $106,650 to $136,650 for married taxpayers filing jointly or for a qualifying widow(er) with dependent child.

You do not qualify for the interest exclusion if your modified AGI is equal to or more than the upper limit for your filing status.

Modified AGI, for purposes of this exclusion, is adjusted gross income (line 21 of Form 1040A or line 37 of Form 1040) figured before the interest exclusion, and modified by adding back any:

1) Foreign earned income exclusion,
2) Foreign housing exclusion or deduction,
3) Exclusion of income for bona fide residents of American Samoa,
4) Exclusion for income from Puerto Rico,
5) Exclusion for adoption benefits received under an employer's adoption assistance program,
6) Deduction for tuition and fees,
7) Deduction for student loan interest, and
8) Deduction for domestic production activities.

Use the worksheet in the instructions for line 9, Form 8815, to figure your modified AGI. If you claim any of the exclusion or deduction items listed above (except items 6, 7, and 8), add the amount of the exclusion or deduction (except any deduction for tuition and fees or student loan interest) to the amount on line 5 of the worksheet, and enter the total on Form 8815, line 9, as your modified AGI.

U.S. TREASURY BILLS, NOTES, AND BONDS

Treasury bills, notes, and bonds are direct debts (obligations) of the U.S. Government.

Taxation of interest. Interest income from Treasury bills, notes, and bonds is subject to federal income tax, but is exempt from all state and local income taxes. You should receive Form 1099-INT showing the amount of interest (in box 3) that was paid to you for the year.

Payments of principal and interest generally will be credited to your designated checking or savings account by direct deposit through the TREASURY DIRECT system.

Treasury bills. These bills generally have a 4-week, 13-week, or 26-week maturity period. They are issued at a discount in the amount of $100 and multiples of $100. The difference between the discounted price you pay for the bills and the face value you receive at maturity is interest income. Generally, you report this interest income when the bill is paid at maturity.

Treasury notes and bonds. Treasury notes have maturity periods of more than one year, ranging up to ten years. Maturity periods for Treasury bonds are longer than ten years. Both of these Treasury issues generally are issued in denominations of $100 to $1 million. Both notes and bonds generally pay interest every six months. Generally, you report this interest for the year paid.

BONDS SOLD BETWEEN INTEREST DATES

If you sell a bond between interest payment dates, part of the sales price represents interest accrued to the date of sale. You must report that part of the sales price as interest income for the year of sale.

If you buy a bond between interest payment dates, part of the purchase price represents interest accrued before the date of purchase. When that interest is paid to you, treat it as a return of your capital investment, rather than interest income, by reducing your basis in the bond. See *Accrued interest on bonds* under *How To Report Interest Income* in chapter 1 of Publication 550 for information on reporting the payment.

INSURANCE

Life insurance proceeds paid to you as beneficiary of the insured person are usually not taxable. But if you receive the proceeds in installments, you must usually report a part of each installment payment as interest income.

Annuity. If you buy an annuity with life insurance proceeds, the annuity payments you receive are taxed as pension and annuity income, not as interest income. See chapter 10 for information on pension and annuity income from nonqualified plans.

ORIGINAL ISSUE DISCOUNT (OID)

Original issue discount (OID) is a form of interest. You generally include OID in your income as it accrues over the term of the debt instrument, whether or not you receive any payments from the issuer.

A debt instrument generally has OID when the instrument is issued for a price that is less than its stated redemption price at maturity. OID is the difference between the stated redemption price at maturity and the issue price.

All debt instruments that pay no interest before maturity are presumed to be issued at a discount. Zero coupon bonds are one example of these instruments.

The OID accrual rules generally do not apply to short-term obligations (those with a fixed maturity date of 1 year or less from date of issue).

Example 1. You bought a 10-year bond with a stated redemption price at maturity of $1,000, issued at $980 with OID of $20. One-fourth of 1% of $1,000 (stated redemption price) times 10 (the number of full years from the date of original issue to maturity) equals $25. Because the $20 discount is less than $25, the OID is treated as zero. (If you hold the bond at maturity, you will recognize $20 ($1,000 - $980) of capital gain.)

Example 2. The facts are the same as in *Example 1,* except that the bond was issued at $950. The OID is $50. Because the $50 discount is more than the $25 figured in *Example 1,* you must include the OID in income as it accrues over the term of the bond.

Debt instrument bought after original issue. If you buy a debt instrument with de minimus OID at a premium, the discount is not includible in income. If you buy a debt instrument with de minimis OID at a discount, the discount is reported under the market discount rules.

Certificates of deposit (CDs). If you buy a CD with a maturity of more than 1 year, you must include in income each year a part of the total interest due and report it in the same manner as other OID.

This also applies to similar deposit arrangements with banks, building and loan associations, etc., including:

- Time deposits
- Bonus plans,
- Savings certificates,
- Deferred income certificates,
- Bonus savings certificates, and
- Growth savings certificates.

Bearer CDs. CDs issued after 1982 generally must be in registered form. Bearer CDs are CDs that are not in registered form. They are not issued in the depositor's name and are transferable from one individual to another.

Banks must provide the IRS and the person redeeming a bearer CD with a Form 1099-INT.

STATE OR LOCAL GOVERNMENT OBLIGATIONS

Generally, interest on obligations used to finance government operations is not taxable if the obligations are issued by a state, the District of Columbia, a possession of the United States, or any of their political subdivisions. This includes interest on certain obligations issued after 1982 by an Indian tribal government treated as a state.

V. <u>When to Report Interest Income</u>

Cash method. Most individual taxpayers use the cash method. If you use this method, you generally report your interest income in the year in which you actually or constructively receive it. However, there are special rules for reporting the discount on certain debt instruments. See *U.S. Savings Bonds* and *Original Issue Discount,* earlier.

Example. On September 1, 2009, you loaned another individual $2,000 at 12%, compounded annually. You are not in the business of lending money. The note stated that principal and interest would be due on August 31, 2011. In 2011, you received $2,508.80 ($2,000 principal and $508.80 interest). If you use the cash method, you must include in income on your 2011 return the $508.80 interest you received in that year.

Constructive receipt. You constructively receive income when it is credited to your account or made available to you. You do not need to have physical possession of it. For example, you are considered to receive interest, dividends, or other earnings on any deposit or account in a bank, savings and loan, or similar financial institution, or interest on life insurance policy dividends left to accumulate, when they are credited to your account and subject to your withdrawal. This is true even if they are not yet entered in your passbook.

You constructively receive income on the deposit or account even if you must:

1) Make withdrawals in multiples of even amounts,
2) Give a notice to withdraw before making the withdrawal,
3) Withdraw all or part of the account to withdraw the earnings, or
4) Pay a penalty on early withdrawals, unless the interest you are to receive on an early withdrawal or redemption is substantially less than the interest payable at maturity.

Accrual method. If you use an accrual method, you report your interest income when you earn it, whether or not you have received it. Interest is earned over the term of the debt instrument.

Example. If, in the previous example, you use an accrual method, you must include the interest in your income as you earn it. You would report the interest as follows: 2009, $80; 2010, $249.60; and 2011, $179.20.

Coupon bonds. Interest on coupon bonds is taxable in the year the coupon becomes due and payable. It does not matter when you mail the coupon for payment.

VI. <u>How to Report Interest Income</u>

Form 1040. You must use Form 1040 instead of Form 1040A or Form 1040EZ if:

1) You forfeited interest income because of the early withdrawal of a time deposit,
2) You acquired taxable bonds after 1987, you choose to reduce interest income from the bonds by any amortizable bond premium, and you are deducting the excess of bond premium amortization over the qualified stated interest for the period (see *Bond Premium Amortization* in chapter 3 of Publication 550),
3) You received tax-exempt interest from private activity bonds issued after August 7, 1986.

Schedule B. You must complete Part I of Schedule B (Form 1040) if you file Form 1040 and any of the following apply.

1) Your taxable interest income is more than $1,500.
2) You are claiming the interest exclusion under the Education Savings Bond Program (discussed earlier).
3) You had a foreign account or you received a distribution from, or were a grantor of, or transferor to, a foreign trust.
4) You received interest from a seller-financed mortgage, and the buyer used the property as a home.
5) You received a Form 1099-INT for U.S. savings bond interest that includes amounts you reported before 2011.
6) You received, as a nominee, interest that actually belongs to someone else.
7) You received a Form 1099-INT for interest on frozen deposits.
8) You received a Form 1099-INT for interest on a bond that you bought between interest payment dates.
9) You are reporting OID in an amount less than the amount shown on Form 1099-OID.
10) Statement (2) in the preceding list under Form 1040 is true.

On line 1, Part I, list each payer's name and the amount received from each. If you received a Form 1099-INT or Form 1099-OID from a brokerage firm, list the brokerage firm as the payer.

Form 1099-INT. Your taxable interest income, except for interest from U.S. savings bonds and Treasury obligations, is shown in box 1 of Form 1099-INT. Add this amount to any other taxable interest income you received. You must report all of your taxable interest income even if you do not receive a Form 1099-INT.

If you forfeited interest income because of the early withdrawal of a time deposit, the deductible amount will be shown on Form 1099-INT in box 2.

Box 3 of Form 1099-INT shows the amount of interest income you received from U.S. savings bonds, Treasury bills, Treasury notes, and Treasury bonds. Add the amount shown in box 3 to any other taxable interest income you received, unless part of the amount in box 3 was previously included in interest income.

Box 4 of Form 1099-INT (federal income tax withheld) will contain an amount if you were subject to backup withholding. Report the amount from box 4 on Form 1040EZ, line 7, on Form 1040A, line 36, or on Form 1040, line 62 (federal income tax withheld).

Box 5 of Form 1099-INT shows investment expenses you may be able to deduct as an itemized deduction.

CHAPTER 7 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. A U.S. citizen with interest income from sources outside of the United States must report the income on their tax return in all cases listed below except:

   a) when he resides outside of the U.S. year round
   b) when he resides inside the U.S. for a portion of the tax year
   c) when the foreign payer does not provide Form 1099
   d) when the specific interest income is exempt by U.S. law

2. Under backup withholding, the payer of interest income is required to withhold what percentage as income tax:

   a) 10%
   b) 15%
   c) 28%
   d) 35%

3. Interest on Series HH bonds is taxable when you redeem the bonds.

   a) true
   b) false

4. Which of the following U.S. savings bond series pay interest that is exempt from state and local income taxes:

   a) series HH bonds
   b) series EE bonds
   c) series I bonds
   d) all U.S. savings bonds are exempt from state and local income taxes

5. You must complete Part I of Schedule B (Form 1040) if you file Form 1040 and your taxable interest income is more than $1,500.

   a) true
   b) false

CHAPTER 7– SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Unless specifically excluded by law, U.S. citizens must report interest income regardless of the duration and location of residency.

   B: Incorrect. Unless specifically excluded by law, U.S. citizens must report interest income regardless of the duration and location of residency.

   C: Incorrect. The non-delivery of a 1099 to a U.S. taxpayer by a foreign payer has no effect on a U.S. taxpayer's legal reporting obligations.

   D: Correct. Only foreign payer interest income exempted by U.S. law can be excluded from a U.S. taxpayer's tax return.

2. A: Incorrect. This percentage rate is unrelated to back-up withholding.

   B: Incorrect. This percentage rate has no relationship to back-up withholding.

   C: Correct. The current back-up withholding rate on interest income payments is 28%.

   D: Incorrect. This amount is not the appropriate back-up withholding rate.

3. A: True is incorrect. Series HH bonds were issued at face value, and interest is paid twice a year. If you are a cash method taxpayer, you must report interest on these bonds as income in the year you receive it.

   B: False is correct. Interest on Series EE and Series I bonds is payable when you redeem the bonds.

4. A: Incorrect. While series HH bonds are exempt from state and local taxes, this is not the best or most complete answer.

   B: Incorrect. Interest from series EE bonds is not taxable for state and local purposes, but this is not the best answer.

   C: Incorrect. Interest from series I bonds is not taxable for state and local purposes, but this is not the best answer.

   D: Correct. This is the best answer, as all U.S. savings bond series provide interest payments that are exempt from state and local income taxes.

5. **A: True is correct.** You must also complete Part I of Schedule B if you are claiming the interest exclusion under the Education Savings Bond Program, you had a foreign account, or you received as a nominee, interest that actually belongs to someone else.

   B: False is incorrect. If your taxable interest is $1,500 or less, you do not have to complete Part I of Schedule B.

Chapter 8: Dividends and Other Corporate Distributions

I. What's New

Maximum tax rate on qualified dividends and net capital gain. For 2011 and 2012, the 5% maximum tax rate on qualified dividends and net capital gain (the excess of net long-term capital gain over net short-term capital loss) is reduced to 0 (zero)%. This reduction applies to both regular and alternative minimum tax. The 15% maximum tax rate on qualified dividends and net capital gain has not changed.

II. Introduction

This chapter discusses the tax treatment of:

- Ordinary dividends,
- Capital gain distributions,
- Nontaxable distributions, and
- Other distributions you may receive from a corporation or a mutual fund.

This chapter also explains how to report dividend income on your tax return.

Dividends are distributions of money, stock, or other property paid to you by a corporation. You also may receive dividends through a partnership, an estate, a trust, or an association that is taxed as a corporation. However, some amounts you receive that are called dividends are actually interest income. (See *Dividends that are actually interest* under *Taxable Interest* in chapter 7.)

Most distributions are paid in cash (or check). However, distributions can consist of more stock, stock rights, other property, or services.

III. General Information

Tax on investment income of certain children. Part of a child's 2011 investment income may be taxed at the parent's tax rate. This may happen if all of the following are true.

1) The child had more than $1,900 of investment income.
2) The child is required to file a tax return.
3) The child was:
   a) Under age 18 at the end of 2011,
   b) Age 18 at the end of 2011 and did not have earned income that was more than half of the child's support, or
   c) A full-time student over age 18 and under age 24 at the end of 2011 and did not have earned income that was more than half of the child's support.
4) At least one of the child's parents was alive at the end of 2011.
5) The child does not file a joint return for 2011.

A child born on January 1, 1994, is considered to be age 18 at the end of 2011; a child born on January 1, 1993, is considered to be age 19 at the end of 2011; a child born on January 1, 1988, is considered to be age 24 at the end of 2011.

If all of these statements are true, **Form 8615,** *Tax for Certain Children With Investment Income of More Than $1,900,* must be completed and attached to the child's tax return. If any of these statements is not true, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, the parent can choose to include the child's interest and dividends on the parent's return if certain requirements are met. Use **Form 8814,** *Parents' Election To Report Child's Interest and Dividends,* for this purpose.

Beneficiary of an estate or trust. Dividends and other distributions you receive as a beneficiary of an estate or trust are generally taxable income. You should receive a **Schedule K-1** (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.,* from the fiduciary. Your copy of Schedule K-1 and its instructions will tell you where to report the income on your Form 1040.

Backup withholding. Your dividend income is generally not subject to regular withholding. However, it may be subject to backup withholding to ensure that income tax is collected on the income. Under backup withholding, the payer of dividends must withhold, as income tax, a percentage of the amount you are paid. This percentage is 28%.

Backup withholding may also be required if the Internal Revenue Service (IRS) has determined that you underreported your interest or dividend income. For more information, see *Backup Withholding* in chapter 4.

Stock certificate in two or more names. If two or more persons hold stock as joint tenants, tenants by the entirety, or tenants in common, each person may receive a share of any dividends from the stock. Each person's share is determined by local law.

Form 1099-DIV. Most corporations use Form 1099-DIV, *Dividends and Distributions,* to show you the distributions you received from them during the year. Keep this form with your records. You do not have to attach it to your tax return. Even if you do not receive Form 1099-DIV, you must still report all of your taxable dividend income.

Reporting tax withheld. If tax is withheld from your dividend income, the payer must give you a Form 1099-DIV that indicates the amount withheld.

Nominees. If someone receives distributions as a nominee for you, that person will give you a Form 1099-DIV, which will show distributions received on your behalf.

Form 1099-MISC. Certain substitute payments in lieu of dividends or tax-exempt interest that are received by a broker on your behalf must be reported to you on Form 1099-MISC, *Miscellaneous Income,* or a similar statement.

Dividends on stock sold. If stock is sold, exchanged, or otherwise disposed of after a dividend is declared, but before it is paid, the owner of record (usually the payee shown on the dividend check) must include the dividend in income.

IV. <u>Ordinary Dividends</u>

Ordinary (taxable) dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are ordinary income to you. This means they are not capital gains. You can assume that any dividend you receive on common or preferred stock is an ordinary dividend unless the paying corporation tells you otherwise. Ordinary dividends will be shown in box 1a of the Form 1099-DIV you receive.

QUALIFIED DIVIDENDS

Qualified dividends are the ordinary dividends that are subject to the same 0% or 15% maximum tax rate that applies to net capital gain. They should be shown in box 1b of Form 1099-DIV you receive.

Qualified dividends are subject to the 15% rate if the regular tax rate that would apply is 25% or higher. If the regular tax rate that would apply is lower than 25%, qualified dividends are subject to the 0% rate.

To qualify for the 0% or 15% maximum rate, all of the following requirements must be met:

1) The dividends must have been paid by a U.S. corporation or a qualified foreign corporation.
2) The dividends are not of the type listed later under *Dividends that are not qualified dividends*.
3) You must meet the holding period (discussed next).

Holding period. You must have held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. The ex-dividend date is the first date following the declaration of a dividend on which the buyer of a stock will not receive the next dividend payment. Instead, the seller will get the dividend.

When counting the number of days you held the stock, include the day you disposed of the stock, but not the day you acquired it.

Exception for preferred stock. In the case of preferred stock, you must have held the stock more than 90 days during the 181-day period that begins 90 days before the ex-dividend date if the dividends are attributable to periods totaling more than 366 days. If the preferred dividends are attributable to periods totaling less than 367 days, the holding period in the previous paragraph applies.

Dividends that are not qualified dividends. The following dividends are not qualified dividends. They are not qualified dividends even if they are shown in box 1b of Form 1099-DIV.

- Capital gain distributions.
- Dividends paid on deposits with mutual savings banks, cooperative banks, credit unions, U.S. building and loan associations, U.S. savings and loan associations, federal savings and loan associations, and similar financial institutions. (Report these amounts as interest income.)
- Dividends from a corporation that is a tax-exempt organization or farmer's cooperative during the corporation's tax year in which the dividends were paid or during the corporation's previous tax year.
- Dividends paid by a corporation on employer securities which are held on the date of record by an employee stock ownership plan (ESOP) maintained by that corporation.
- Dividends on any share of stock to the extent that you are obligated (whether under a short sale or otherwise) to make related payments for positions in substantially similar or related property.

- Payments in lieu of dividends, but only if you know or have reason to know that the payments are not qualified dividends.
- Payments shown in Form 1099-DIV, box 1b, from a foreign corporation to the extent you know or have reason to know the payments are not qualified dividends.

DIVIDENDS USED TO BUY MORE STOCK

The corporation in which you own stock may have a ***dividend reinvestment plan.*** This plan lets you choose to use your dividends to buy (through an agent) more shares of stock in the corporation instead of receiving the dividends in cash. If you are a member of this type of plan and you use your dividends to buy more stock at a price equal to its fair market value, you still must report the dividends as income.

If you are a member of a dividend reinvestment plan that lets you buy more stock at a price less than its fair market value, you must report as dividend income the fair market value of the additional stock on the dividend payment date.

You also must report as dividend income any service charge subtracted from your cash dividends before the dividends are used to buy the additional stock. But you may be able to deduct the service charge. See chapter 28 for more information about deducting expenses of producing income.

In some dividend reinvestment plans, you can invest more cash to buy shares of stock at a price less than fair market value. If you choose to do this, you must report as dividend income the difference between the cash you invest and the fair market value of the stock you buy. When figuring this amount, use the fair market value of the stock on the dividend payment date.

MONEY MARKET FUNDS

Report amounts you receive from money market funds as dividend income. Money market funds are a type of mutual fund and should not be confused with bank money market accounts that pay interest.

V. Capital Gain Distributions

Capital gain distributions (also called capital gain dividends) are paid to you or credited to your account by ***regulated investment companies*** (commonly called ***mutual funds***) and ***real estate investment trusts (REITs).*** They will be shown in box 2a of the Form 1099-DIV you receive from the mutual fund or REIT.

Report capital gain distributions as long-term capital gains regardless of how long you owned your shares in the mutual fund or REIT.

Undistributed capital gains of mutual funds and REITs. Some mutual funds and REITs keep their long-term capital gains and pay tax on them. You must treat your share of these gains as distributions, even though you did not actually receive them. However, they are not included on Form 1099-DIV. Instead, they are reported to you on **Form 2439,** *Notice to Shareholder of Undistributed Long-Term Capital Gains.*

Report undistributed capital gains as long-term capital gains in column (f) on line 11 of Schedule D (Form 1040). The tax paid on these gains by the mutual fund or REIT is shown in box 2 of Form 2439. You take credit for this tax by including it on line 71, Form 1040, and checking box a on that line. Attach Copy B of Form 2439 to your return, and keep Copy C for your records.

Basis adjustment. Increase your basis in your mutual fund or your interest in a REIT by the difference between the gain you report and the credit you claim for the tax paid.

VI. Nondividend Distributions

Basis adjustment. A nondividend distribution reduces the basis of your stock. It is not taxed until your basis in the stock is fully recovered. If you buy stock in a corporation in different lots at different times, and you cannot definitely identify the shares subject to the return of capital, reduce the basis of your earliest purchases first.

When the basis of your stock has been reduced to zero, report any additional return of capital that you receive as a capital gain. Whether you report it as a long-term or short-term capital gain depends on how long you have held the stock. See *Holding Period* in chapter 14.

Example. You bought stock in 1998 for $100. In 2001, you received a return of capital of $80. You did not include this amount in your income, but you reduced the basis of your stock to $20. You received a return of capital of $30 in 2011. The first $20 of this amount reduced your basis to zero. You report the other $10 as a long-term capital gain for 2011. You must report as a long-term capital gain any return of capital you receive on this stock in later years.

LIQUIDATING DISTRIBUTIONS

Liquidating distributions, sometimes called liquidating dividends, are distributions you receive during a partial or complete liquidation of a corporation. These distributions are, at least in part, one form of a return of capital. They may be paid in one or more installments. You will receive a Form 1099-DIV from the corporation showing you the amount of the liquidating distribution in box 8 or 9.

DISTRIBUTIONS OF STOCK AND STOCK RIGHTS

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as "stock options") are distributions by a corporation of rights to acquire the corporation's stock. Generally, stock dividends and stock rights are not taxable to you, and you do not report them on your return.

Taxable stock dividends and stock rights. Distributions of stock dividends and stock rights are taxable to you if any of the following apply.

1) You or any other shareholder has the choice to receive cash or other property instead of stock or stock rights.
2) The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders.
3) The distribution is in convertible preferred stock and has the same result as in (2).
4) The distribution gives preferred stock to some common stock shareholders and common stock to other common stock shareholders.

5) The distribution is on preferred stock. (The distribution, however, is not taxable if it is an increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right.)

The term "stock" includes rights to acquire stock, and the term "shareholder" includes a holder of rights or of convertible securities.

If you receive taxable stock dividends or stock rights, include their fair market value at the time of the distribution in your income.

Preferred stock redeemable at a premium. If you hold preferred stock having a redemption price higher than its issue price, the difference (the redemption premium) generally is taxable as a constructive distribution of additional stock on the preferred stock.

Basis. Your basis in stock or stock rights received in a taxable distribution is their fair market value when distributed.

Fractional shares. You may not own enough stock in a corporation to receive a full share of stock if the corporation declares a stock dividend. However, with the approval of the shareholders, the corporation may set up a plan in which fractional shares are not issued, but instead are sold, and the cash proceeds are given to the shareholders. Any cash you receive for fractional shares under such a plan is treated as an amount realized on the sale of the fractional shares. You must determine your gain or loss and report it as a capital gain or loss on Schedule D (Form 1040). Your gain or loss is the difference between the cash you receive and the basis of the fractional shares sold.

Example. You own one share of common stock that you bought on January 3, 2002, for $100. The corporation declared a common stock dividend of 5% on June 30, 2011. The fair market value of the stock at the time the stock dividend was declared was $200. You were paid $10 for the fractional-share stock dividend under a plan described in the above paragraph. You figure your gain or loss as follows:

Fair market value of old stock	$200.00
Fair market value of stock dividend (cash received)	+10.00
Fair market value of old stock and stock dividend	$210.00
Basis (cost) of old stock after the stock dividend (($200 ÷ $210) x $100)	$95.24
Basis (cost) of stock dividend ($10 ÷ $210 x $100)	+ 4.76
Total	$100.00
Cash received	$10.00
Basis (cost) of stock dividend	4.76
Gain	$5.24

Because you had held the share of stock for more than 1 year at the time the stock dividend was declared, your gain on the stock dividend is a long-term capital gain.

Scrip dividends. A corporation that declares a stock dividend may issue you a scrip certificate that entitles you to a fractional share. The certificate is generally nontaxable when you receive it. If you choose to have the corporation sell the certificate for you and give you the proceeds, your gain or loss is the difference between the proceeds and the portion of your basis in the corporation's stock that is allocated to the certificate.

However, if you receive a scrip certificate that you can choose to redeem for cash instead of stock, the certificate is taxable when you receive it. You must include its fair market value in income on the date you receive it.

VII. Other Distributions

You may receive any of the following distributions during the year.

Exempt-interest dividends. Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. You will receive a notice from the mutual fund telling you the amount of the exempt-interest dividends you received. Exempt-interest dividends should be shown on box 8 of Form 1099-INT.

Information reporting requirement. Although exempt-interest dividends are not taxable, you must show them on your tax return if you have to file a return. This is an information reporting requirement and does not change the exempt-interest dividends to taxable income.

Alternative minimum tax treatment. Exempt-interest dividends paid from specified private activity bonds may be subject to the alternative minimum tax. See *Alternative Minimum Tax* in chapter 30 for more information.

Dividends on insurance policies. Insurance policy dividends that the insurer keeps and uses to pay your premiums are not taxable. However, you must report as taxable interest income the interest that is paid or credited on dividends left with the insurance company.

Dividends on veterans' insurance. Dividends you receive on veterans' insurance policies are not taxable. In addition, interest on dividends left with the Department of Veterans Affairs is not taxable.

Patronage dividends. Generally, patronage dividends you receive in money from a cooperative organization are included in your income.

Do not include in your income patronage dividends you receive on:

1) Property bought for your personal use, or
2) Capital assets or depreciable property bought for use in your business. But you must reduce the basis (cost) of the items bought. If the dividend is more than the adjusted basis of the assets, you must report the excess as income.

These rules are the same whether the cooperative paying the dividend is a taxable or tax-exempt cooperative.

Alaska Permanent Fund dividends. Do not report these amounts as dividends. Instead, report these amounts on line 21 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ.

VIII. How to Report Dividend Income

Form 1099-DIV. If you owned stock on which you received $10 or more in dividends and other distributions, you should receive a Form 1099-DIV. Even if you do not receive Form 1099-DIV, you must report all of your taxable dividend income.

See Form 1099-DIV for more information on how to report dividend income.

Form 1040A or 1040. You must complete Schedule B (Form 1040A or 1040), Part II and attach it to your Form 1040A or 1040, if:

1) Your ordinary dividends (box 1a of Form 1099-DIV) are more than $1,500, or
2) You received, as a nominee, dividends that actually belong to someone else.

If your ordinary dividends are more than $1,500, you must also complete Schedule B, Part III.

List on Schedule B, Part II, line 5 each payer's name and the amount of ordinary dividends you received. If you received a Form 1099-DIV from a brokerage firm, list the brokerage firm as the payer.

Enter on line 6 the total of the amounts listed on line 5. Also enter this total on line 9a, Form 1040A or 1040.

Expenses related to dividend income. You may be able to deduct expenses related to dividend income if you itemize your deductions on Schedule A (Form 1040). See chapter 28 for general information about deducting expenses of producing income.

CHAPTER 8 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Ordinary dividends are the most common type of distribution from a corporation, and are considered capital gain income.

   a) true
   b) false

2. Qualified dividends are taxable as ordinary income, but are subject to a lower tax rate. Which of the following is not one of the tests to be met to be treated as a qualified dividend:

   a) paid by a U.S. corporation or qualified foreign corporation
   b) the dividend is paid on deposits held by a U.S. savings bank or credit union
   c) not a capital gain distribution
   d) the taxpayer meets the appropriate stock holding period

CHAPTER 8 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. Ordinary (taxable) dividends are paid out of the earnings and profits of a corporation and are ordinary income to you.

   B: False is correct. They are ordinary income rather than capital gain to you.

2. A: Incorrect. Payment of a dividend by a U.S. corporation, or a qualified foreign corporation, is one of three necessary tests to determine whether a dividend payment qualifies for the favorable tax rates of a qualified dividend.

   B: Correct. Dividends paid on deposits with mutual savings banks, cooperative banks, credit unions, U.S. building and loan associations, and similar financial institutions do not qualify as qualified dividends. They therefore are not included in any three-factor test.

   C: Incorrect. To meet one of the three tests to qualify as a qualified dividend, the dividend cannot be a capital gain distribution.

   D: Incorrect. Meeting the holding period of the dividend's underlying stock is one of three necessary tests needed to establish a qualifying dividend from other payments.

Chapter 9: Rental Income and Expenses

I. Introduction

This chapter discusses rental income and expenses. It covers the following topics.

- Personal use of dwelling unit (including vacation home).
- Depreciation.
- Limits on rental losses.
- How to report your rental income and expenses.

II. Rental Income

You generally must include in your gross income all amounts you receive as rent. Rental income is any payment you receive for the use or occupation of property. In addition to amounts you receive as normal rent payments, there are other amounts that may be rental income.

When to report. Report rental income on your return for the year you actually or constructively receive it, if you are a cash basis taxpayer. You are a cash basis taxpayer if you report income in the year you receive it, regardless of when it was earned. You constructively receive income when it is made available to you, for example, by being credited to your bank account.

Advance rent. Advance rent is any amount you receive before the period that it covers. Include advance rent in your rental income in the year you receive it regardless of the period covered or the method of accounting you use.

Example. You sign a 10-year lease to rent your property. In the first year, you receive $5,000 for the first year's rent and $5,000 as rent for the last year of the lease. You must include $10,000 in your income in the first year.

Security deposits. Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. But if you keep part or all of the security deposit during any year because your tenant does not live up to the terms of the lease, include the amount you keep in your income for that year.

If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in your income when you receive it.

Payment for canceling a lease. If your tenant pays you to cancel a lease, the amount you receive is rent. Include the payment in your income in the year you receive it regardless of your method of accounting.

Expenses paid by tenant. If your tenant pays any of your expenses, the payments are rental income. You must include them in your income. You can deduct the expenses if they are deductible rental expenses. See *Rental Expenses,* later, for more information.

Property or services. If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income.

If the services are provided at an agreed upon or specified price, that price is the fair market value unless there is evidence to the contrary.

Rental of property also used as a home. If you rent property that you also use as your home and you rent it fewer than 15 days during the tax year, do not include the rent you receive in your income and do not deduct rental expenses. However, you can deduct on Schedule A (Form 1040) the interest, taxes, and casualty and theft losses that are allowed for nonrental property. See *Personal Use of Dwelling Unit (Including Vacation Home),* later.

Part interest. If you own a part interest in rental property, you must report your part of the rental income from the property.

III. <u>Rental Expenses</u>

This part discusses repairs and certain other expenses of renting property that you ordinarily can deduct from your rental income. It includes information on the expenses you can deduct if you rent part of your property, or if you change your property to rental use. Depreciation, which you can also deduct from your rental income, is discussed later.

When to deduct. You generally deduct your rental expenses in the year you pay them.

Vacant rental property. If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses (including depreciation) for managing, conserving, or maintaining the property while the property is vacant. However, you cannot deduct any loss of rental income for the period the property is vacant.

Pre-rental expenses. You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time you make it available for rent.

Depreciation. You can begin to depreciate rental property when it is ready and available for rent. See *Placed-in Service Date* under *Depreciation,* later.

Vacant while listed for sale. If you sell property you held for rental purposes, you can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold.

Personal use of rental property. If you sometimes use your rental property for personal purposes, you must divide your expenses between rental and personal use. Also, your rental expense deductions may be limited. See *Personal Use of Dwelling Unit (Including Vacation Home),* later.

Part interest. If you own a part interest in rental property, you can deduct expenses that you paid according to your percentage of ownership.

Uncollected rent. If you are a cash basis taxpayer, you do not report uncollected rent. Because you do not include it in your income, you cannot deduct it.

If you use an accrual method, you report income when you earn it. If you are unable to collect the rent, you may be able to deduct it as a business bad debt.

REPAIRS AND IMPROVEMENTS

You can deduct the cost of repairs to your rental property. You cannot deduct the cost of improvements. You recover the cost of improvements by taking depreciation (explained later).

Separate the costs of repairs and improvements, and keep accurate records. You will need to know the cost of improvements when you sell or depreciate your property.

Repairs. A repair keeps your property in good operating condition. It does not materially add to the value of your property or substantially prolong its life. Repainting your property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

If you make repairs as part of an extensive remodeling or restoration of your property, the whole job is an improvement.

Improvements. An improvement adds to the value of your property, prolongs its useful life, or adapts it to new uses. Improvements include the following items.

- Putting a recreation room in an unfinished basement.
- Paneling a den.
- Adding a bathroom or bedroom.
- Putting decorative grillwork on a balcony.
- Putting up a fence.
- Putting in new plumbing or wiring.
- Putting in new cabinets.
- Putting on a new roof.
- Paving a driveway.

If you make an improvement to property, the cost of the improvement must be capitalized. The capitalized cost can generally be depreciated as if the improvement were separate property.

OTHER EXPENSES

Other expenses you can deduct from your rental income include advertising, cleaning and maintenance services, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation, and other expenses, discussed next.

Rental of property. You can deduct the rent you pay for property that you use for rental purposes. If you buy a leasehold for rental purposes, you can deduct an equal part of the cost each year over the term of the lease.

Rental of equipment. You can deduct the rent you pay for equipment that you use for rental purposes. However, in some cases, lease contracts are actually purchase contracts. If so, you cannot deduct these payments. You can recover the cost of purchased equipment through depreciation.

Insurance premiums paid in advance. If you pay an insurance premium for more than one year in advance, each year you can deduct the part of the premium payment that will apply to that year. You cannot deduct the total premium in the year you pay it.

Local benefit taxes. Generally, you cannot deduct charges for local benefits that increase the value of your property, such as charges for putting in streets, sidewalks, or water and sewer systems. These charges are nondepreciable capital expenditures. You must add them to the basis of your property. You can deduct local benefit taxes if they are for maintaining, repairing, or paying interest charges for the benefits.

Travel expenses. You can deduct the ordinary and necessary expenses of traveling away from home if the primary purpose of the trip was to collect rental income or to manage, conserve, or maintain your rental property. You must properly allocate your expenses between rental and nonrental activities. For information on travel expenses, see chapter 26.

Local transportation expenses. You can deduct your ordinary and necessary local transportation expenses if you incur them to collect rental income or to manage, conserve, or maintain your rental property.

Generally, if you use your personal car, pickup truck, or light van for rental activities, you can deduct the expenses using one of two methods: actual expenses or the standard mileage rate. For 2011, the standard mileage rate for all business travel is 51 cents per mile from January 1, 2011 through June 30, 2011, and 55.5 cents per mile from July 1, 2011 through December 31, 2011. For more information, see chapter 26.

Records. To deduct car expenses under either method, you must keep records that follow the rules in chapter 26. In addition, you must complete Part V of Form 4562 and attach it to your tax return.

IV. Property Changed to Rental Use

If you change your home or other property, (or a part of it), to rental use at any time other than at the beginning of your tax year, you must divide yearly expenses, such as depreciation, taxes, and insurance, between rental use and personal use.

You can deduct as rental expenses only the part of the expense that is for the part of the year the property was used or held for rental purposes.

You cannot deduct depreciation or insurance for the part of the year the property was held for personal use. However, you can include the home mortgage interest and real estate tax expenses for the part of the year the property was held for personal use as an itemized deduction on Schedule A (Form 1040). Alternatively, some real estate taxes may be added to your standard deduction.

Example. Your tax year is the calendar year. You moved from your home in May and started renting it on June 1. You can deduct as rental expenses seven-twelfths of your yearly expenses, such as taxes and insurance.

Starting with June, you can deduct as rental expenses the amounts you pay for items generally billed monthly, such as utilities.

V. Renting Part of Property

If you rent part of your property, you must divide certain expenses between the part of the property used for rental purposes and the part of the property used for personal purposes as though you actually had two separate pieces of property.

You can deduct the expenses related to the part of the property used for rental purposes, such as home mortgage interest and real estate taxes, as rental expenses on Schedule E (Form 1040). You can deduct the expenses for the part of the property used for personal purposes, subject to certain limitations, only if you itemize your deductions on Schedule A (Form 1040). You can also deduct as a rental expense a part of other expenses that normally are nondeductible personal expenses, such as expenses for electricity or painting the outside of your house. You cannot deduct any part of the cost of the first phone line even if your tenants have unlimited use of it.

You do not have to divide the expenses that belong only to the rental part of your property. For example, if you paint a room that you rent, or if you pay premiums for liability insurance in connection with renting a room in your home, your entire cost is a rental expense. If you install a second phone line strictly for your tenants' use, all of the cost of the second line is deductible as a rental expense. You can deduct depreciation, discussed later, on the part of the property used for rental purposes as well as on the furniture and equipment you use for rental purposes.

How to divide expenses. If an expense is for both rental use and personal use, such as mortgage interest or heat for the entire house, you must divide the expense between the rental use and the personal use. You can use any reasonable method for dividing the expense. It may be reasonable to divide the cost of some items (for example, water) based on the number of people using them. However, the two most common methods for dividing an expense are one based on the number of rooms in your home and one based on the square footage of your home.

VI. <u>Personal Use of Dwelling Unit (Including Vacation Home)</u>

If you have ***any*** personal use of a dwelling unit (including vacation home) that you rent, you ***must*** divide your expenses between rental use and personal use. See *Figuring Days of Personal Use* and *How To Divide Expenses,* later.

If you used your dwelling unit for personal purposes, it will be considered a "dwelling unit used as a home." If so, you cannot deduct rental expenses that exceed rental income for that property. See *Dwelling Unit Used as Home* and *How To Figure Rental Income and Deductions*, later. If your dwelling unit is not considered a dwelling unit used as a home, you can deduct rental expenses that exceed rental income for that property subject to certain limits. See *Limits on Rental Losses,* later.

Exception for minimal rental use. If you use the dwelling unit as a home and you rent it fewer than 15 days during the year, do not include any of the rent in your income and do not deduct any of the rental expenses. See *Dwelling Unit Used as Home,* later.

Dwelling unit. A dwelling unit includes a house, apartment, condominium, mobile home, boat, vacation home, or similar property. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities.

A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment. Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

Example. You rent a room in your home that is always available for short-term occupancy by paying customers. You do not use the room yourself, and you allow only paying customers to use the room. The room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

DWELLING UNIT USED AS HOME

The tax treatment of rental income and expenses for a dwelling unit that you also use for personal purposes depends on whether you use it as a home. (See *How To Figure Rental Income and Deductions,* later.)

You use a dwelling unit as a home during the tax year if you use it for personal purposes more than the greater of:

1) 14 days, or
2) 10% of the total days it is rented to others at a fair rental price.

See *Figuring Days of Personal Use,* later.

If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, do not count that day as a day of rental use in applying (2) above. Instead, count it as a day of personal use in applying both (1) and (2) above. This rule does not apply when dividing expenses between rental and personal use.

Fair rental price. A fair rental price for your property generally is an amount that a person who is not related to you would be willing to pay. The rent you charge is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property in your area.

Examples

The following examples show how to determine whether you used your rental property as a home.

Example 1. You converted the basement of your home into an apartment with a bedroom, a bathroom, and a small kitchen. You rented the basement apartment at a fair rental price to college students during the regular school year. You rented to them on a 9-month lease (273 days). You figured 10% of the total days rented to others at a fair rental price is 27 days.

During June (30 days), your brothers stayed with you and lived in the basement apartment rent free.

Your basement apartment was used as a home because you used it for personal purposes for 30 days. Rent-free use by your brother is considered personal use. Your personal use (30 days) is more than the greater of 14 days or 10% of the total days it was rented (27 days).

Example 2. You rented the guest room in your home at a fair rental price during the local college's homecoming, commencement, and football weekends (a total of 27 days). Your sister-in-law stayed in the room, rent free, for the last 3 weeks (21 days) in July. You figured 10% of the total days rented to others at a fair rental price is 3 days.

The room was used as a home because you used it for personal purposes for 21 days. That is more than the greater of 14 days or 10% of the 27 days it was rented (3 days).

Example 3. You own a condominium apartment in a resort area. You rented it at a fair rental price for a total of 170 days during the year. For 12 of those days, the tenant was not able to use the apartment and allowed you to use it even though you did not refund any of the rent. Your family actually used the apartment for 10 of those days. Therefore, the apartment is treated as having been rented for 160 (170 - 10) days. Your family also used the apartment for 7 other days during the year.

You used the apartment as a home because you used it for personal purposes for 17 days. That is more than the greater of 14 days or 10% of the 160 days it was rented (16 days).

Use As Main Home Before or After Renting

For purposes of determining whether a dwelling unit was used as a home, do not count as days of personal use the days you used the property as your main home before or after renting it or offering it for rent in either of the following circumstances.

1) You rented or tried to rent the property for 12 or more consecutive months.
2) You rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because you sold or exchanged the property.

This special rule does not apply when dividing expenses between rental and personal use.

<u>FIGURING DAYS OF PERSONAL USE</u>

A day of personal use of a dwelling unit is any day that it is used by any of the following persons.

1) You or any other person who has an interest in it, unless you rent it to another owner as his or her main home under a shared equity financing agreement (defined later).
2) A member of your family or a member of the family of any other person who has a financial interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price. Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.).
3) Anyone under an arrangement that lets you use some other dwelling unit.
4) Anyone at less than a fair rental price.

Main home. If the other person or member of the family in (1) or (2) above has more than one home, his or her main home is ordinarily the one lived in most of the time.

Shared equity financing agreement. This is an agreement under which two or more persons acquire undivided interests for more than 50 years in an entire dwelling unit, including the land, and one or more of the co-owners is entitled to occupy the unit as his or her main home upon payment of rent to the other co-owner or owners.

Donation of use of property. You use a dwelling unit for personal purposes if:

- You donate the use of the unit to a charitable organization,
- The organization sells the use of the unit at a fund-raising event, and
- The "purchaser" uses the unit.

Examples

The following examples show how to determine days of personal use.

Example 1. You and your neighbor are co-owners of a condominium at the beach. You rent the unit to vacationers whenever possible. The unit is not used as a main home by anyone. Your neighbor used the unit for two weeks last year; you did not use it at all.

Because your neighbor has an interest in the unit, both of you are considered to have used the unit for personal purposes during those 2 weeks.

Example 2. You and your neighbors are co-owners of a house under a shared equity financing agreement. Your neighbors live in the house and pay you a fair rental price.

Even though your neighbors have an interest in the house, the days your neighbors live there are not counted as days of personal use by you. This is because your neighbors rent the house as their main home under a shared equity financing agreement.

Example 3. You own a rental property that you rent to your son. Your son has no interest in this dwelling unit. He uses it as his main home. He pays you a fair rental price for the property.

Your son's use of the property is not personal use by you because your son is using it as his main home, he owns no interest in the property, and he is paying you a fair rental price.

Example 4. You rent your beach house to Joshua. Joshua rents his house in the mountains to you. You each pay a fair rental price.

You are using your house for personal purposes on the days that Joshua uses it because your house is used by Joshua under an arrangement that allows you to use his house.

Days Used for Repairs and Maintenance

Any day that you spend working substantially full time repairing and maintaining your property is not counted as a day of personal use. Do not count such a day as a day of personal use even if family members use the property for recreational purposes on the same day.

HOW TO DIVIDE EXPENSES

If you use a dwelling unit for both rental and personal purposes, divide your expenses between the rental use and the personal use based on the number of days used for each purpose. Expenses for the rental use of the unit are deductible under the rules explained in *How To Figure Rental Income and Deductions,* later.

When dividing your expenses follow these rules.

1) Any day that the unit is rented at a fair rental price is a day of rental use even if you used the unit for personal purposes that day. This rule does not apply when determining whether you used the unit as a home.
2) Any day that the unit is available for rent but not actually rented is not a day of rental use.

Example. Your beach cottage was available for rent from June 1 through August 31 (92 days). Your family uses the cottage during the last 2 weeks in May (14 days). You were unable to find a renter for the first week in August (7 days). The person who rented the cottage for July allowed you to use it over a weekend (2 days) without any reduction in or refund of rent. The cottage was not used at all before May 17 or after August 31.

You figure the part of the cottage expenses to treat as rental expenses as follows.

1) The cottage was used for rental a total of 85 days (92 - 7). The days it was available for rent but not rented (7 days) are not days of rental use. The July weekend (2 days) you used it is rental use because you received a fair rental price for the weekend.
2) You used the cottage for personal purposes for 14 days (the last 2 weeks in May).
3) The total use of the cottage was 99 days (14 days personal use + 85 days rental use).
4) Your rental expenses are 85/99 (86%) of the cottage expenses.

When determining whether you used the cottage as a home, the July weekend (2 days) you used it is personal use even though you received a fair rental price for the weekend. Therefore, you had 16 days of personal use and 83 days of rental use for this purpose. Because you used the cottage for personal purposes more than 14 days and more than 10% of the days of rental use, you used it as a home. If you have a net loss, you may not be able to deduct all of the rental expenses. See *Property Used as a Home* in the following discussion.

HOW TO FIGURE RENTAL INCOME AND DEDUCTIONS

How you figure your rental income and deductions depends on whether the dwelling unit was used as a home (see *Dwelling Unit Used as Home,* earlier) and, if used as a home, how many days the property was rented at a fair rental price.

Property Not Used as a Home

If you do not use a dwelling unit as a home, report all the rental income and deduct all the rental expenses. See *How To Report Rental Income and Expenses,* later.

Your deductible rental expenses can be more than your gross rental income. However, see *Limits on Rental Losses,* later.

Property Used as a Home

If you use a dwelling unit as a home during the year (see *Dwelling Unit Used as Home,* earlier), how you figure your rental income and deductions depends on how many days the unit was rented at a fair rental price.

Rented fewer than 15 days. If you use a dwelling unit as a home and you rent it fewer than 15 days during the year, do not include any rental income in your income. Also, you cannot deduct any expenses as rental expenses.

Rented 15 days or more. If you use a dwelling unit as a home and rent it 15 days or more during the year, you include all your rental income in your income. See *How To Report Rental Income and Expenses,* later. If you had a net profit from the rental property for the year (that is, if your rental income is more than the total of your rental expenses, including depreciation), deduct all of your rental expenses. However, if you had a net loss, your deduction for certain rental expenses is limited.

Use *Worksheet 9-1* to figure your deductible expenses.

Worksheet 9-1. Worksheet for Figuring the Limit on Rental Deductions for a Dwelling Unit Used as a Home

Use this worksheet only if you answer "yes" to all the following questions. • Did you use the dwelling unit as a home this year? (See *Dwelling Unit Used as Home.*) • Did you rent the dwelling unit at a fair rental price 15 days or more this year? • Is the total of your rental expenses and depreciation more than your rental income?		
PART I. Rental Use Percentage		
A. Total days available for rent at fair rental price **B.** Total days available for rent (line A) but not rented **C. Total days of rental use.** Subtract line B from line A **D. Total days of personal use** (including days rented at less than fair rental price **E. Total days of rental and personal use.** Add lines C and D **F. Percentage of expenses allowed for rental.** Divide line C by line E	A. ________ B. ________ C. ________ D. ________ E. ________	F. ________
PART II. Allowable Rental Expenses		
1. Enter rents received		1.________
2 a. Enter the rental portion of deductible home mortgage interest and qualified mortgage insurance premiums (see instructions) **b.** Enter the rental portion of real estate taxes **c.** Enter the rental portion of deductible casualty and theft losses (see instructions) **d.** Enter direct rental expenses (see instructions) **e. Fully deductible rental expenses.** Add lines 2a – 2d. Enter here and on the appropriate lines on Schedule E (see instructions)	2a.________ b.________ c.________ d. ________	2e. ________
3. Subtract line 2e from line 1. If zero or less, enter -0-		3. ________
4. a. Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities) **b.** Enter the rental portion of excess mortgage interest and qualified mortgage insurance premiums (see instructions) **c.** Carryover of operating expenses from 2010 worksheet **d.** Add lines 4a – 4c **e. Allowable expenses.** Enter the **smaller** of line 3 or line 4d (see instructions)	4a. ________ b. ________ c. ________ d. ________	4e. _______
5. Subtract line 4e from line 3. If zero or less, enter -0-		5. ________
6. a. Enter the rental portion of excess casualty and theft losses (see instructions) **b.** Enter the depreciation for the rental portion of the dwelling unit **c. Carryover of excess casualty losses and depreciation from 2009 worksheet** **d.** Add lines 6a – 6c **e. Allowable excess casualty and theft losses and depreciation.** Enter the smaller of line 5 or line 6d (see instructions)	6a. ________ b. ________ c. ________ d. ________	6e. ________
PART III. Carryover of Unallowed Expenses to Next Year		
7. a. Operating expenses to be carried over to next year. Subtract line 4e from line 4d **b. Excess casualty and theft losses and depreciation to be carried over to next year.** Subtract line 6e from line 6d		7a. ________ b. ________

Worksheet 9-1 Instructions.

Caution. Use the percentage determined in Part I, line F, to figure the rental portions to enter on lines 2a–2c, 4a–4b, and 6a–6b of Part II.

Line 2a. Figure the mortgage interest on the dwelling unit that you could deduct on Schedule A (as if you were itemizing your deductions) if you had not rented the unit. Do not include interest on a loan that did not benefit the dwelling unit. For example, do not include interest on a home equity loan used to pay off credit cards or other personal loans, buy a car, or pay college tuition. Include interest on a loan used to buy, build, or improve the dwelling unit, or to refinance such a loan. Include the rental portion of this interest in the total you enter on line 2a of the worksheet.

Figure the qualified mortgage insurance premiums on the dwelling unit that you could deduct on line 13 of Schedule A, if you had not rented the unit. See page A-4 of the Schedule A instructions. However, figure your adjusted gross income (Form 1040, line 38) without your rental income and expenses from the dwelling unit. See Line 4b below to deduct the part of the qualified mortgage insurance premiums not allowed because of the adjusted gross income limit. Include the rental portion of the amount from Schedule A, line 13, in the total you enter on line 2a of the worksheet.

Note. Do not file this Schedule A or use it to figure the amount to deduct on line 13 of that schedule. Instead, figure the personal portion on a separate Schedule A. If you have deducted mortgage interest or qualified mortgage insurance premiums on the dwelling unit on other forms, such as Schedule C or F, remember to reduce your Schedule A deduction by that amount.

Line 2c. Figure the casualty and theft losses related to the dwelling unit that you could deduct on Schedule A if you had not rented the dwelling unit. To do this, complete Section A of Form 4684, Casualties and Thefts, treating the losses as personal losses. If any of the loss is due to a federally declared disaster, see the Instructions for Form 4684. On Form 4684, line 20, enter 10% of your adjusted gross income figured without your rental income and expenses from the dwelling unit. Enter the rental portion of the result from Form 4684, line 22, on line 2c of this worksheet.

Note. Do not file this Form 4684 or use it to figure your personal losses on Schedule A. Instead, figure the personal portion on a separate Form 4684.

Line 2d. Enter the total of your rental expenses that are directly related only to the rental activity. These include interest on loans used for rental activities other than to buy, build, or improve the dwelling unit. Also include rental agency fees, advertising, office supplies, and depreciation on office equipment used in your rental activity.

Line 2e. You can deduct the amounts on lines 2a, 2b, 2c, and 2d as rental expenses on Schedule E even if your rental expenses are more than your rental income. Enter the amounts on lines 2a, 2b, 2c, and 2d on the appropriate lines of Schedule E.

Line 4b. On line 2a, you entered the rental portion of the mortgage interest and qualified mortgage insurance premiums you could deduct on Schedule A if you had not rented the dwelling unit. If you had additional mortgage interest and qualified mortgage insurance premiums that would not be deductible on Schedule A because of limits imposed on them, enter on line 4b of this worksheet the rental portion of those excess amounts. Do not include interest on a loan that did not benefit the dwelling unit (as explained in the line 2a instructions).

Line 4e. You can deduct the amounts on lines 4a, 4b, and 4c as rental expenses on Schedule E only to the extent they are not more than the amount on line 4e.*

Line 6a. To find the rental portion of excess casualty and theft losses, use the Form 4684 you prepared for line 2c of this worksheet.

A. Enter the amount from Form 4684, line 10	_____________
B. Enter the rental portion of line A	_____________
C. Enter the amount from line 2c of this worksheet	_____________
D. Subtract line C from line B. Enter the result here and on line 6a of this worksheet	_____________

Line 6e. You can deduct the amounts on lines 6a, 6b, and 6c as rental expenses on Schedule E only to the extent they are not more than the amount on line 6e.*

***Allocating the limited deduction.** If you cannot deduct all of the amount on line 4d or 6d this year, you can allocate the allowable deduction in any way you wish among the expenses included on line 4d or 6d. Enter the amount you allocate to each expense on the appropriate line of Schedule E, Part I.

VII. Depreciation

You recover your cost in income producing property through yearly tax deductions. You do this by ***depreciating*** the property; that is, by deducting some of your cost on your tax return each year.

Three basic factors determine how much depreciation you can deduct. They are: (1) your basis in the property, (2) the recovery period for the property, and (3) the depreciation method used. You cannot simply deduct your mortgage or principal payments, or the cost of furniture, fixtures and equipment, as an expense.

You can deduct depreciation only on the part of your property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange.

You may have to use Form 4562 to figure and report your depreciation.

Claiming the correct amount of depreciation. You should claim the correct amount of depreciation each tax year. Even if you did not claim depreciation that you were entitled to deduct, you must still reduce your basis in the property by the full amount of depreciation that you could have deducted. If you did not deduct the correct amount of depreciation for property in any year, you may be able to make a correction for that year by filing Form 1040X. If you are not allowed to make the correction on an amended return, you can change your accounting method to claim the correct amount of depreciation.

Changing your accounting method to deduct unclaimed depreciation. To change your accounting method, you must file Form 3115, Application for Change in Accounting Method, to get the consent of the IRS. In some instances, that consent is automatic.

Land. You can never depreciate the cost of land because land does not wear out, become obsolete, or get used up. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and are not depreciable.

DEPRECIATION METHODS

There are three ways to figure depreciation. The depreciation method you use depends on the type of property and when the property was placed in service. For property used in rental activities you use one of the following.

- MACRS (Modified Accelerated Cost Recovery System) for property placed in service after 1986.
- ACRS (Accelerated Cost Recovery System) for property placed in service after 1980 but before 1987.
- Useful lives and either straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.

Caution. *This chapter discusses MACRS only. If you need more information about depreciating property placed in service before 1987, see Publication 534,* Depreciating Property Placed in Service Before 1987.

If you placed property in service before 2011, continue to use the same method of figuring depreciation that you used in the past.

Cooperative apartments. If you are a tenant-stockholder in a cooperative housing corporation and rent your cooperative apartment to others, you can deduct depreciation for the apartment even though it is owned by the corporation. Your depreciation deduction is your share of the corporation's depreciation.

MACRS

Most business and investment property placed in service after 1986 is depreciated using MACRS.

MACRS consists of two systems that determine how you depreciate your property. The main system is called the ***General Depreciation System (GDS).*** The second system is called the ***Alternative Depreciation System (ADS).*** GDS is used to figure your depreciation deduction for property used in most rental activities, unless you elect ADS.

To figure your MACRS deduction, you need to know the following information about your property:

1) Its recovery period,
2) Its placed-in-service date, and
3) Its depreciable basis.

Section 179 election. You cannot claim the section 179 deduction for property held to produce rental income (unless renting property is your trade or business).

No deduction greater than basis. The total of all your yearly depreciation deductions cannot be more than the cost or other basis of the property. For this purpose, your yearly depreciation deductions include any depreciation that you were allowed to claim, even if you did not claim it.

Personal home changed to rental use. You must use MACRS to figure the depreciation on property you used as your home and changed to rental property in 2011.

Excluded property. You cannot use MACRS for certain personal property placed in service in your rental property in 2011 if it had been previously placed in service before MACRS became effective in 1987 (before August 1, 1986, if election made).

Recovery Periods Under GDS

Each item of property that can be depreciated is assigned to a property class. The recovery period of the property depends on the class the property is in. Under GDS, the recovery period of an asset is generally the same as its property class. The property classes under GDS are:

- 3-year property,
- 5-year property,
- 7-year property,
- 10-year property,
- 15-year property,
- 20-year property,
- Nonresidential real property, and
- Residential rental property.

Recovery periods for property used in rental activities are shown in *Table 9-1*, next.

Table 9-1. **MACRS Recovery Periods for Property Used in Rental Activities**

	MACRS Recovery Period	
Type of Property	**General Depreciation System**	**Alternative Depreciation System**
Computers and their peripheral equipment	5 years	5 years
Office machinery, such as: Typewriters Calculators Copiers	5 years	6 years
Automobiles	5 years	5 years
Light trucks	5 years	5 years
Appliances, such as: Stoves Refrigerators	5 years	9 years
Carpets	5 years	9 years
Furniture used in rental property	5 years	9 years
Office furniture and equipment, such as: Desks Files	7 years	10 years
Any property that does not have a class life and that has not been designated by law as being in any other class	7 years	12 years
Roads	15 years	20 years
Shrubbery	15 years	20 years
Fences	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, water pipes, venting, etc.	27.5 years	40 years
Additions and improvements, such as a new roof	The same recovery period as that of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the addition or improvement.	

Additions or improvements to property. Treat depreciable additions or improvements you make to any property as separate property items for depreciation purposes. The recovery period for an addition or improvement to property begins on the later of:

1) The date the addition or improvement is placed in service, or
2) The date the property to which the addition or improvement was made is placed in service.

The class and recovery period of the addition or improvement is the one that would apply to the original property if it were placed in service at the same time as the addition or improvement.

Example. You own a residential rental house that you have been renting since 1986 and are depreciating under ACRS. You put an addition onto the house and you placed it in service in 2011. You must use MACRS for the addition. Under MACRS, the addition would be depreciated as residential rental property over 27.5 years.

Placed-in-Service Date

You can begin to depreciate property when you place it in service in your trade or business or for the production of income. Property is considered placed in service in a rental activity when it is ready and available for a specific use in that activity.

Depreciable Basis

To deduct the proper amount of depreciation each year, you must first determine your basis in the property you intend to depreciate. The basis used for figuring depreciation is your original basis in the property increased by any additions or improvements made to the property. Your original basis is usually your cost. However, if you acquire the property in some other way, such as by inheriting it, getting it as a gift, or building it yourself, you may have to figure your original basis in another way. Other adjustments could also affect your basis. See chapter 13.

Conventions

Under MACRS, conventions establish when the recovery period begins and ends. The convention you use determines the number of months for which you can claim depreciation in the year you place property in service and in the year you dispose of the property.

Mid-month convention. A mid-month convention is used for all residential rental property and nonresidential real property. Under this convention, you treat all property placed in service, or disposed of, during any month as placed in service, or disposed of, at the midpoint of that month.

Half-year convention. The half-year convention is used if neither the mid-quarter convention nor the mid-month convention applies. Under this convention, you treat all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, at the midpoint of that tax year.

If this convention applies, you deduct a half-year of depreciation for the first year and the last year that you depreciate the property. You deduct a full year of depreciation for any other year during the recovery period.

Mid-quarter convention. A mid-quarter convention must be used if the mid-month convention does not apply and the total depreciable basis of MACRS property you placed in service in the last 3 months of a tax year (excluding nonresidential real property, residential rental property, and property placed in service and disposed of in the same year) is more than 40% of the total basis of all such property you place in service during the tax year.

Under this convention, you treat all property placed in service, or disposed of, during any quarter of a tax year as placed in service, or disposed of, at the midpoint of the quarter.

Example. During the tax year, Jordan Gregory purchased the following items to use in his rental property.

- A dishwasher for $400 that he placed in service in January.
- Used furniture for $100 that he placed in service in September.
- A refrigerator for $500 that he placed in service in October.

Jordan uses the calendar year as his tax year. The total basis of all property placed in service in that year is $1,000. The $500 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds $400 (40% X $1,000). Jordan must use the mid-quarter convention instead of the half-year convention for all three items.

MACRS DEPRECIATION UNDER GDS

You can figure your MACRS depreciation deduction under GDS in one of two ways. The deduction is substantially the same both ways. (The difference, if any, is slight.) You can either:

1) Use the percentage from the optional MACRS tables, see *Table 9-2,* or
2) Actually figure the deduction using the depreciation method and convention that apply over the recovery period of the property.

Table 9-2. Optional MACRS Tables

Table 9-2A. MACRS 5-Year Property

	Half-year convention	**Mid-quarter convention**			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Fourth quarter**
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68
5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58

Table 9-2B. MACRS 7-Year Property

	Half-year convention	**Mid-quarter convention**			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Fourth quarter**
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.85	8.73
7	8.93	8.75	8.87	8.86	8.73
8	4.46	1.09	3.33	5.53	7.64

Table 9-2C. **MACRS 15-Year Property**

	Half-year convention	Mid-quarter convention			
Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00
5	6.93	6.65	6.83	7.02	7.20
6	6.23	5.99	6.15	6.31	6.48

Table 9-2D. **Residential Rental Property (27.5-year)**

	Use the row for the month of the taxable year placed in service.					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
January	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
February	3.182	3.636	3.636	3.636	3.636	3.636
March	2.879	3.636	3.636	3.636	3.636	3.636
April	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
June	1.970	3.636	3.636	3.636	3.636	3.636
July	1.667	3.636	3.636	3.636	3.636	3.636
August	1.364	3.636	3.636	3.636	3.636	3.636
September	1.061	3.636	3.636	3.636	3.636	3.636
October	0.758	3.636	3.636	3.636	3.636	3.636
November	0.455	3.636	3.636	3.636	3.636	3.636
December	0.152	3.636	3.636	3.636	3.636	3.636

USING THE OPTIONAL TABLES

You can use the tables in *Table 9-2* to compute annual depreciation under MACRS. The tables show the percentages for the first 6 years. The percentages in Tables 9-2-A, 9-2-B, and 9-2-C make the change from declining balance to straight line in the year that straight line will yield an equal or larger deduction.

How to use the tables. The following section explains how to use the optional tables.

Figure the depreciation deduction by multiplying your ***unadjusted basis*** in the property by the percentage shown in the appropriate table. Your unadjusted basis is your depreciable basis without reduction for depreciation previously claimed.

Once you begin using an optional table to figure depreciation, you must continue to use it for the entire recovery period unless there is an adjustment to the basis of your property for a reason other than:

1) Depreciation allowed or allowable, or
2) An addition or improvement that is depreciated as a separate item of property.

Tables 9-2-A, 9-2-B, and 9-2-C. The percentages in these tables take into account the half-year and mid-quarter conventions. Use *Table 9-2-A* for 5-year property, *Table 9-2-B* for 7-year property, and *Table 9-2-C* for 15-year property. Use the percentage in the second column (half-year convention) unless you must use the mid-quarter convention (explained earlier). If you must use the mid-quarter convention, use the column that corresponds to the calendar year quarter in which you placed the property in service.

Example 1. You purchased a stove and refrigerator and placed them in service in June. Your basis in the stove is $300 and your basis in the refrigerator is $500. Both are 5-year property. Using the half-year convention column in *Table 9-2-A*, you find the depreciation percentage for year 1 is 20%. For that year, your depreciation deduction is $60 ($300 X .20) for the stove and $100 ($500 X .20) for the refrigerator.

For year 2, you find your depreciation percentage is 32%. That year's depreciation deduction will be $96 ($300 X .32) for the stove and $160 ($500 X .32) for the refrigerator.

Example 2. Assume the same facts as in *Example 1*, except you buy the refrigerator in October instead of June. You must use the mid-quarter convention to figure depreciation on the stove and refrigerator. The refrigerator was placed in service in the last 3 months of the tax year and its basis ($500) is more than 40% of the total basis of all property placed in service during the year ($800 X .40 = $320).

Because you placed the refrigerator in service in October, you use the fourth quarter column of *Table 9-2-A* and find that the depreciation percentage for year 1 is 5%. Your depreciation deduction for the refrigerator is $25.00 ($500 x .05).

Because you placed the stove in service in June, you use the second quarter column of *Table 9-2-A* and find that the depreciation percentage for year 1 is 25%. For that year, your depreciation deduction for the stove is $75.00 ($300 X .25).

Table 9-2-D. Use this table for residential rental property. Find the row for the month that you placed the property in service. Use the percentages listed for that month to figure your depreciation deduction. The mid-month convention is taken into account in the percentages shown in the table.

Example. You purchased a single family rental house and placed it in service in February. Your basis in the house is $160,000. Using *Table 9-2-D,* you find that the percentage for property placed in service in February of year 1 is 3.182%. That year's depreciation deduction is $5,091 ($160,000 X .03182).

<u>MACRS DEPRECIATION UNDER ADS</u>

If you choose, you can use the ADS method for most property. Under ADS, you use the straight line method of depreciation.

Table 9-1 shows the recovery periods for property used in rental activities that you depreciate under ADS. See *Appendix B* in Publication 946 for other property. If your property is not listed, it is considered to have no class life. Under ADS, personal property with no class life is depreciated using a recovery period of 12 years and real property with no class life is depreciated using a recovery period of 40 years.

Use the mid-month convention for residential rental property and nonresidential real property. For all other property, use the half-year or mid-quarter convention.

Election. For property placed in service during 2011, you choose to use ADS by entering the depreciation on line 20, Part III of Form 4562.

The election of ADS for one item in a class of property generally applies to all property in that class that is placed in service during the tax year of the election. However, the election applies on a property-by-property basis for residential rental property and nonresidential real property.

Once you choose to use ADS, you cannot change your election.

OTHER RULES ABOUT DEPRECIABLE PROPERTY

In addition to the rules about what methods you can use, there are other rules you should be aware of with respect to depreciable property.

Gain from disposition. If you dispose of depreciable property at a gain, you may have to report, as ordinary income, all or part of the gain.

Alternative minimum tax. If you use accelerated depreciation, you may have to file Form 6251. Accelerated depreciation includes MACRS, ACRS, and any other method that allows you to deduct more depreciation than you could deduct using a straight line method.

VIII. Limits on Rental Losses

Rental real estate activities are generally considered passive activities, and the amount of loss you can deduct is limited. Generally, you cannot deduct losses from rental real estate activities unless you have income from other passive activities. However, you may be able to deduct rental losses without regard to whether you have income from other passive activities if you "materially" or "actively" participated in your rental activity. See *Passive Activity Limits,* later.

Losses from passive activities are first subject to the at-risk rules. At-risk rules limit the amount of deductible losses from holding most real property placed in service after 1986.

Exception. If your rental losses are less than $25,000 and you actively participated in the rental activity, the passive activity limits probably do not apply to you. See *Losses From Rental Real Estate Activities,* later.

Property used as a home. If you used the rental property as a home during the year, the passive activity rules do not apply to that home. Instead, you must follow the rules explained earlier under *Personal Use of Dwelling Unit (Including Vacation Home.)*

AT-RISK RULES

The at-risk rules place a limit on the amount you can deduct as losses from activities often described as tax shelters. Losses from holding real property (other than mineral property) placed in service before 1987 are not subject to the at-risk rules.

Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount you have at risk in the activity at the end of the tax year. You are considered at risk in an activity to the extent of cash and the adjusted basis of other property you contributed to the activity and certain amounts borrowed for use in the activity.

PASSIVE ACTIVITY LIMITS

In general, all rental activities (except those meeting the exception for real estate professionals, below) are passive activities. For this purpose, a rental activity is an activity from which you receive income mainly for the use of tangible property, rather than for services.

Limits on passive activity deductions and credits. Deductions for losses from passive activities are limited. You generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities. Any excess loss or credit is carried forward to the next tax year.

You may have to complete **Form 8582** to figure the amount of any passive activity loss for the current tax year for all activities and the amount of the passive activity loss allowed on your tax return.

Exception for real estate professionals. Rental activities in which you ***materially participated*** during the year are not passive activities if, for that year, you were a real estate professional.

LOSSES FROM RENTAL REAL ESTATE ACTIVITIES

If you or your spouse ***actively participated*** in a passive rental real estate activity, you can deduct up to $25,000 of loss from the activity from your nonpassive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. Similarly, you can offset credits from the activity against the tax on up to $25,000 of nonpassive income after taking into account any losses allowed under this exception.

If you are married, filing a separate return, and lived apart from your spouse for the entire tax year, your special allowance cannot be more than $12,500. If you lived with your spouse at any time during the year and are filing a separate return, you cannot use the special allowance to reduce your nonpassive income or tax on nonpassive income.

Active participation. You actively participated in a rental real estate activity if you (and your spouse) owned at least 10% of the rental property and you made management decisions in a significant and bona fide sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions.

Maximum special allowance. The maximum special allowance is:

- $25,000 for single individuals and married individuals filing a joint return for the tax year,
- $12,500 for married individuals who file separate returns for the tax year and lived apart from their spouses at all times during the tax year, and
- $25,000 for a qualifying estate reduced by the special allowance for which the surviving spouse qualified.

If your modified adjusted gross income is more than $100,000 (more than $50,000 if married filing separately), your special allowance is limited to 50% of the difference between $150,000 ($75,000 if married filing separately) and your modified adjusted gross income.

Generally, if your modified adjusted gross income is $150,000 or more ($75,000 or more if you are married filing separately), there is no special allowance.

IX. How To Report Rental Income and Expenses

If you rent buildings, rooms, or apartments, and provide only heat and light, trash collection, etc., you normally report your rental income and expenses in Part I of Schedule E (Form 1040). However, do not use that schedule to report a not-for-profit activity.

If you provide substantial services that are primarily for your tenant's convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C (Form 1040), *Profit or Loss From Business* or Schedule C-EZ, *Net Profit From Business (Sole Proprietorship).* Substantial services do not include the furnishing of heat and light, cleaning of public areas, trash collection, etc.

Form 1098. If you paid $600 or more of mortgage interest on your rental property to any one person, you should receive a Form 1098, *Mortgage Interest Statement,* or similar statement showing the interest you paid for the year. If you and at least one other person (other than your spouse if you file a joint return) were liable for, and paid interest on the mortgage, and the other person received the Form 1098, report your share of the interest on line 13 of Schedule E (Form 1040). Attach a statement to your return showing the name and address of the other person. In the left margin of Schedule E (Form 1040), next to line 13, write "See attached."

SCHEDULE E (FORM 1040)

Use Part I of Schedule E (Form 1040) to report your rental income and expenses. List your total income, expenses, and depreciation for each rental property. Be sure to answer the question on line 2.

If you have more than three rental or royalty properties, complete and attach as many Schedules E as are needed to list the properties. Complete lines 1 and 2 for each property. However, fill in the "Totals" column on only one Schedule E. The figures in the "Totals" column on that Schedule E should be the combined totals of all Schedules E.

Page 2 of Schedule E is used to report income or loss from partnerships, S corporations, estates, trusts, and real estate mortgage investment conduits. If you need to use page 2 of Schedule E, use page 2 of the same Schedule E you used to enter the combined totals in Part I.

On page 1, line 20 of Schedule E, enter the depreciation you are claiming. You must complete and attach Form 4562 for rental activities only if you are claiming:

- Depreciation on property placed in service during 2011,
- Depreciation on any property that is listed property (such as a car), regardless of when it was placed in service, or
- Any other car expenses, including the standard mileage rate or lease expenses.

Otherwise, figure your depreciation on your own worksheet. You do not have to attach these computations to your return.

CHAPTER 9 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. A security deposit should be included in your income when you receive it, unless it is to be used as a final payment of rent.

   a) true
   b) false

2. Which of the following expenditures <u>cannot</u> be deducted as an expense against rental income:

   a) advertising expenses
   b) cleaning and maintenance services
   c) fire and liability insurance
   d) paving the driveway

3. If during a tax year a dwelling unit is used for both rental and personal home use, what is the <u>maximum</u> number of days that it can be used as a home and still be claimed as a rental property:

   a) 10 days
   b) 14 days
   c) 21 days
   d) 30 days

4. Depreciation of a dwelling unit can only be deducted on the part of your property used for rental purposes.

   a) true
   b) false

5. There is no limit to the losses you can deduct from rental activities.

   a) true
   b) false

CHAPTER 9 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. Security deposits should not be included in income when you receive them if you plan to return them to your tenant at the end of the lease.

   B: False is correct. If an amount called a security deposit is to be used as a final payment of rent, it is advance rent, and should be included in your income when you receive it.

2. A: Incorrect. Pre-rental advertising expenses are generally ordinary and necessary to managing a property rental business and would be deductible from rental income.

   B: Incorrect. Cleaning and maintenance services are deductible expenses as long as they do not provide substantial improvement to the property.

   C: Incorrect. This expenditure is a typical rental property deductible expense.

   D: Correct. Any improvement made to a property that adds material value, prolongs its useful life, or adapts it to new uses is a capital expenditure and <u>not</u> a deductible business expense. Repaving a rental property driveway would substantially extend the useful life of the driveway.

3. A: Incorrect. A rental property can be used as a home by the owner for more than 10 days during a tax year.

   B: Correct. The maximum number of days a rental property can be used as a home and still retain its classification is 14 days. Additionally, if the property is used by the owner more than 10% of the total days it is rented to others at a fair market price it will also lose rental property status.

   C: Incorrect. This time period will result in the loss of rental property status.

   D: Incorrect. This time period is also too long and will result in the loss of rental property status.

4. **A: True is correct.** Depreciation reduces your basis for figuring gain or loss on a later sale or exchange.

   B: False is incorrect. The basic factors that determine how much depreciation you can deduct are the basis in the property, the recovery period for the property, and the depreciation method used.

5. A: True is incorrect. Rental real estate activities are considered passive activities and are subject to both passive activity limits as well as the at-risk rules.

   B: False is correct. You generally cannot offset income, other than passive income, with losses from passive activities. Also, usually any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount you have at risk in the activity at the end of the tax year.

Chapter 10: Retirement Plans, Pensions, and Annuities

I. Introduction

This chapter discusses the tax treatment of distributions you receive from:

1) An employee pension or annuity from a qualified plan,
2) A disability retirement, and
3) A purchased commercial annuity.

What is not covered in this chapter. The following topics are not discussed in this chapter:

1) **The General Rule.** This is the method generally used to determine the tax treatment of pension and annuity income from nonqualified plans (including commercial annuities). If your annuity starting date is after November 18, 1996, you generally cannot use the General Rule for a qualified plan.
2) **Individual retirement arrangements (IRAs).** Information on the tax treatment of amounts you receive from an IRA is in chapter 17.

II. General Information

Disability pensions. If you retired on disability, you generally must include in income any disability pension you receive under a plan that is paid for by your employer. You must report your taxable disability payments as wages on line 7 of Form 1040 or Form 1040A until you reach minimum retirment age. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled.

Tip. *You may be entitled to a tax credit if you were permanently and totally disabled when you retired. For information on this credit, see chapter 33.*

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension or annuity. Report the payments on Form 1040, lines 16a and 16b, or on Form 1040A, lines 12a and 12b.

Tip. *Disability payments for injuries incurred as a direct result of a terrorist attack directed against the United States (or its allies) are not included in income.*

For more information on how to report disability pensions, including military and certain government disability pensions, see chapter 5.

More than one program. If you receive benefits from more than one program, such as a pension plan and a profit-sharing plan, you may have to figure the taxable part of each separately. Your former employer or the plan administrator should be able to tell you if you have more than one pension or annuity contract.

Designated Roth accounts. A designated Roth account is a separate account created under a qualified Roth contribution program to which participants may elect to have part or all of their elective deferrals to a 401(k) or 403(b) plan designated as Roth contributions. Elective deferrals that are designated as Roth contributions are included in your income. However, qualified distributions are not included in your income.

Railroad retirement benefits. Part of the railroad retirement benefits you receive is treated for tax purposes like social security benefits, and part is treated like an employee pension.

Withholding and estimated tax. The payer of your pension, profit-sharing, stock bonus, annuity, or deferred compensation plan will withhold income tax on the taxable parts of amounts paid to you. You can choose not to have tax withheld unless they are eligible rollover distributions. See *Eligible rollover distributions* under *Rollovers*, later. You make this choice by filing Form W-4P.

For payments other than eligible rollover distributions, you can tell the payer how to withhold by filing Form W-4P. If you receive an eligible rollover distribution, 20% will generally be withheld. There is no withholding on a direct rollover of an eligible rollover distribution. See *Direct rollover option* under *Rollovers*, later. If you choose not to have tax withheld, you may have to pay estimated tax.

For more information, see *Pensions and Annuities* under *Withholding* in chapter 4.

Loans. If you borrow money from your qualified pension or annuity plan, tax-sheltered annuity program, government plan, or contract purchased under any of these plans, you may have to treat the loan as a nonperiodic distribution. This means that you may have to include in income all or part of the amount borrowed unless certain exceptions apply. Even if you do not have to treat the loan as a nonperiodic distribution, you may not be able to deduct the interest on the loan in some situations.

Qualified plans for self-employed individuals. Qualified plans set up by self-employed individuals are sometimes called Keogh or H.R. 10 plans. Qualified plans can be set up by sole proprietors, partnerships (but not a partner), and corporations. They can cover self-employed persons, such as the sole proprietor or partners, as well as regular (common-law) employees.

Distributions from a qualified plan are usually fully taxable because most recipients have no cost basis. If you have an investment (cost) in the plan, however, your pension or annuity payments from a qualified plan are taxed under the Simplified Method.

Section 457 deferred compensation plans. If you work for a state or local government or for a tax-exempt organization, you may be able to participate in a section 457 deferred compensation plan. If your plan is an eligible plan, you are not taxed currently on pay that is deferred under the plan or on any earnings from the plan's investment of the deferred pay. You are taxed on amounts deferred in an eligible state or local government plan only when they are distributed from the plan. You are taxed on amounts deferred in an eligible tax-exempt organization plan when they are distributed or otherwise made available to you.

Purchased annuities. If you receive pension or annuity payments from a privately purchased annuity contract from a commercial organization, such as an insurance company, you generally must use the General Rule to figure the tax-free part of each annuity payment.

Tax-free exchange. You do not recognize gain or loss on an exchange of an annuity contract for another annuity contract if the insured or annuitant remains the same. However, if an annuity contract is exchanged for a life insurance or endowment contract, any gain due to interest accumulated on the contract is ordinary income.

HOW TO REPORT

If you file Form 1040, report your total annuity on line 16a and the taxable part on line 16b. If your pension or annuity is fully taxable, enter it on line 16b; do not make an entry on line 16a.

More than one annuity. If you receive more than one annuity and at least one of them is not fully taxable, enter the total amount received from ***all*** annuities on line 16a, Form 1040, or line 12a, Form 1040A, and enter the taxable part on line 16b, Form 1040, or line 12b, Form 1040A. If all the annuities you receive are fully taxable, enter the total of all of them on line 16b, Form 1040, or line 12b, Form 1040A.

Joint return. If you file a joint return and you and your spouse each receive one or more pensions or annuities, report the total of the pensions and annuities on line 16a, Form 1040, or line 12a, Form 1040A, and report the taxable part on line 16b, Form 1040, or line 12b, Form 1040A.

III. Cost (Investment in the Contract)

Before you can figure how much, if any, of your pension or annuity benefits is taxable, you must determine your cost (your investment in the contract). Your total cost in the plan includes everything that you paid. It also includes amounts your employer paid that were taxable at the time paid. Cost does not include any amounts you deducted or excluded from income.

From this total cost paid or considered paid by you, subtract any refunds of premiums, rebates, dividends, unrepaid loans, or other tax-free amounts you received by the later of the annuity starting date or the date on which you received your first payment.

Your ***annuity starting date*** is the later of the first day of the first period for which you received a payment, or the date the plan's obligations became fixed.

Designated Roth accounts. Your cost in these accounts is your designated Roth contributions that were included in your income as wages subject to applicable withholding requirements.

Foreign employment contributions. If you worked in a foreign country and your employer contributed to your retirement plan, a part of those payments may be considered part of your cost.

IV. Taxation of Periodic Payments

Fully taxable payments. Generally, if you did not pay any part of the cost of your employee pension or annuity and your employer did not withhold part of the cost from your pay while you worked, the amounts you receive each year are fully taxable. You must report them on your income tax return.

Partly taxable payments. If you paid part of the cost of your annuity, you are not taxed on the part of the annuity you receive that represents a return of your cost. The rest of the amount you receive is generally taxable. You figure the tax-free part of the payment using either the

Simplified Method or the General Rule. Your annuity starting date and whether or not your plan is qualified determine which method you must or may use.

If the annuity starting date is after November 18, 1996, and your payments are from a qualified plan, you must use the Simplified Method. Generally, you must use the General Rule if your annuity is paid under a nonqualified plan, and you cannot use this method if your annuity is paid under a qualified plan.

If you had more than one partly taxable pension or annuity, figure the tax-free part and the taxable part of each separately.

If your annuity is paid under a qualified plan and your annuity starting date is after July 1, 1986, and before November 19, 1996, you could have chosen to use either the General Rule or the Simplified Method.

Exclusion limit. Your annuity starting date determines the total amount that you can exclude from your taxable income over the years.

Exclusion limited to cost. If your annuity starting date is after 1986, the total amount of annuity income that you can exclude over the years as a recovery of the cost cannot exceed your total cost. Any unrecovered cost at your (or the last annuitant's) death is allowed as a miscellaneous itemized deduction on the final return of the decedent. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

Exclusion not limited to cost. If your annuity starting date is before 1987, you can continue to take your monthly exclusion for as long as you receive your annuity. If you chose a joint and survivor annuity, your survivor can continue to take the survivor's exclusion figured as of the annuity starting date. The total exclusion may be more than your cost.

SIMPLIFIED METHOD

Under the Simplified Method, you figure the tax-free part of each monthly annuity payment by dividing your cost by the total number of expected monthly payments. For an annuity that is payable for the lives of the annuitants, this number is based on the annuitants' ages on the annuity starting date and is determined from a table. For any other annuity, this number is the number of monthly annuity payments under the contract.

Who must use the Simplified Method. You must use the Simplified Method if your annuity starting date is after November 18, 1996, ***and*** you receive pension or annuity payments from a qualified employee plan, qualified employee annuity, or a tax-sheltered annuity (403(b)) plan, and on your annuity starting date, you were either under age 75, or entitled to less than 5 years of guaranteed payments.

Who must use the General Rule. You must use the General Rule if you receive pension or annuity payments from:

1) A nonqualified plan (such as a private annuity, a purchased commercial annuity, or a nonqualified employee plan), or
2) A qualified plan if you are age 75 or older on your annuity starting date and your annuity payments are guaranteed for at least 5 years.

Annuity starting before November 19, 1996. If your annuity starting date is after July 1, 1986, and before November 19, 1996, you had to use the General Rule for either circumstance described above. You also had to use it for any fixed-period annuity. If you did not have to use the General Rule, you could have chosen to use it. If your annuity starting date is before July 2, 1986, you had to use the General Rule unless you could use the Three-Year Rule.

If you had to use the General Rule (or chose to use it), you must continue to use it each year that you recover your cost.

Who cannot use the General Rule. You cannot use the General Rule if you receive your pension or annuity from a qualified plan and none of the circumstances described in the preceding discussions apply to you. See *Who must use the Simplified Method,* earlier.

Guaranteed payments. Your annuity contract provides guaranteed payments if a minimum number of payments or a minimum amount (for example, the amount of your investment) is payable even if you and any survivor annuitant do not live to receive the minimum. If the minimum amount is less than the total amount of the payments you are to receive, barring death, during the first 5 years after payments begin (figured by ignoring any payment increases), you are entitled to less than 5 years of guaranteed payments.

Example. Bill Smith, age 65, began receiving retirement benefits in 2011, under a joint and survivor annuity. Bill's annuity starting date is January 1, 2011. The benefits are to be paid for the joint lives of Bill and his wife Kathy, age 65. Bill had contributed $31,000 to a qualified plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of $1,200 a month, and Kathy is to receive a monthly survivor benefit of $600 upon Bill's death.

Bill must use the Simplified Method to figure his taxable annuity because his payments are from a qualified plan and he is under age 75. Because his annuity is payable over the lives of more than one annuitant, he uses his and Kathy's combined ages and Table 2 at the bottom of the worksheet in completing line 3 of the worksheet. His completed worksheet is shown in Worksheet 10-A.

Bill's tax-free monthly amount is $100 ($31,000 / 310) as shown on line 4 of the worksheet. Upon Bill's death, if Bill has not recovered the full $31,000 investment, Kathy will also exclude $100 from her $600 monthly payment. The full amount of any annuity payments received after 310 payments are paid must be included in gross income.

If Bill and Kathy die before 310 payments are made, a miscellaneous itemized deduction will be allowed for the unrecovered cost on the final income tax return of the last to die. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

Worksheet 10-A. Simplified Method Worksheet for Bill Smith

1. Enter the total pension or annuity payments received this year. Also, add this amount to the total for Form 1040, line 16a, or Form 1040A, line 12a. **1.** 14,400

2. Enter your cost in the plan (contract) at the annuity starting date plus any death benefit exclusion*
Note: *If your annuity starting date was **before this year** and you completed this worksheet last year, skip line 3 and enter the amount from line 4 of last year's worksheet on line 4 below. Otherwise, go to line 3.* **2.** 31,000

3. Enter the appropriate number from Table 1 below. **But** if your annuity starting date was **after** 1997 **and** the payments are for your life and that of your beneficiary, enter the appropriate number from Table 2 below. **3.** 310

4. Divide line 2 by the number on line 3. **4.** 100

5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was ***before*** 1987, enter this amount on line 8 below and skip lines 6, 7, 10, and 11. Otherwise, go to line 6. **5.** 1,200

6. Enter any amounts previously recovered tax free in years after 1986. This is the amount shown on line 10 of your worksheet for the last year. **6.** -0-

7. Subtract line 6 from line 2. **7.** 31,000

8. Enter the ***smaller*** of line 5 or line 7. **8.** 1,200

9. Taxable amount for year. Subtract line 8 from line 1. Enter the result, but not less than zero. Also, add this amount to the total for Form 1040, line 16b, or Form1040A, line 12b.
Note: *If your Form 1099-R shows a larger taxable amount, use the amount on line 9 instead. If you are a retired public safety officer, see* Insurance Premiums for Retired Public Safety Officers *in Publication 575 before entering an amount on your tax return.* **9.** 13,200

10. Was your annuity starting date before 1987?
☐ Yes. **STOP**. Do not complete the rest of this worksheet.
☑ No. Add lines 6 and 8. This is the amount you have recovered tax free through 2011. You will need this number if you need to fill out this worksheet next year. **10.** 1,200

11. Balance of cost to be recovered. Subtract line 10 from line 2. If zero, you will not have to complete this worksheet next year. The payments you receive next year will generally be fully taxable. **11.** 29,800

TABLE 1 FOR LINE 3 ABOVE

IF the age at annuity starting date was…	AND your annuity starting date was Before November 19, 1996, enter on line 3…	AND your annuity starting date was After November 18, 1996, enter on line 3…
55 or under	300	360
56-60	260	310
61-65	240	260
66-70	170	210
71 or older	120	160

TABLE 2 FOR LINE 3 ABOVE

IF the combined ages at annuity starting date were…	THEN enter on line 3…
110 or under	410
111-120	360
121-130	310
131-140	260
141 or older	210

*A death benefit exclusion (up to $5,000) applied to certain benefits received by employees who died before August 21, 1996.

V. Taxation of Nonperiodic Payments

Nonperiodic distributions are also known as amounts not received as an annuity. They include all payments other than periodic payments and corrective distributions.

Corrective distributions of excess plan contributions. Generally, if the contributions made for you during the year to certain retirement plans exceed certain limits, the excess is taxable to you. To correct any excess, your plan may distribute it to you (along with any income earned on the excess).

Figuring the taxable amount of nonperiodic payments. How you figure the taxable amount of a nonperiodic distribution depends on whether it is made before the annuity starting date or on or after the annuity starting date. The annuity starting date is either the first day of the first period for which you receive an annuity payment under the contract or the date on which the obligation under the contract becomes fixed, whichever is later. If it is made before the annuity starting date, its tax treatment also depends on whether it is made under a qualified or nonqualified plan and, if it is made under a nonqualified plan, whether it fully discharges the contract or is allocable to an investment you made before August 14, 1982.

If you receive a nonperiodic payment from your annuity contract on or after the annuity starting date, you generally must include all of the payment in gross income.

If you receive a nonperiodic distribution before the annuity starting date from a qualified retirement plan, you generally can allocate only part of it to the cost of the contract. You exclude from your gross income the part that you allocate to the cost. You include the remainder in your gross income.

If you receive a nonperiodic distribution before the annuity starting date from a plan other than a qualified retirement plan, it is generally allocated first to earnings (the taxable part) and then to the cost of the contract (the tax-free part). This allocation rule applies, for example, to a commercial annuity contract you bought directly from the issuer.

LUMP-SUM DISTRIBUTIONS

If you receive a lump-sum distribution from a qualified employee plan or qualified employee annuity and the plan participant was born before January 2, 1936, you may be able to elect optional methods of figuring the tax on the distribution. The part from active participation in the plan before 1974 may qualify as capital gain subject to a 20% tax rate. The part from participation after 1973 (and any part from participation before 1974 that you do not report as capital gain) is ordinary income. You may be able to use the 10-year tax option, discussed later, to figure tax on the ordinary income part.

Use Form 4972 to figure the separate tax on a lump-sum distribution using the optional methods. The tax figured on Form 4972 is added to the regular tax figured on your other income. This may result in a smaller tax than you would pay by including the taxable amount of the distribution as ordinary income in figuring your regular tax.

Lump-sum distribution defined. A lump-sum distribution is the distribution or payment in 1 tax year of a plan participant's entire balance from all of the employer's qualified plans of one kind (for example, pension, profit-sharing, or stock bonus plans). A distribution from a nonqualified plan (such as a privately purchased commercial annuity or a section 457 deferred compensation plan of a state or local government or tax-exempt organization) cannot qualify as a lump-sum distribution.

The participant's entire balance from a plan does not include certain forfeited amounts. It also does not include any deductible voluntary employee contributions allowed by the plan after 1981 and before 1987.

How to treat the distribution. If you receive a lump-sum distribution, you may have the following options for how you treat the taxable part.

- Report the part of the distribution from participation before 1974 as a capital gain (if you qualify) and the part from participation after 1973 as ordinary income.
- Report the part of the distribution from participation before 1974 as a capital gain (if you qualify) and use the 10-year tax option to figure the tax on the part from participation after 1973 (if you qualify).
- Use the 10-year tax option to figure the tax on the total taxable amount (if you qualify).
- Roll over all or part of the distribution. See *Rollovers,* later. No tax is currently due on the part rolled over. Report any part not rolled over as ordinary income.
- Report the entire taxable part of the distribution as ordinary income on your tax return.

The first three options are explained in the following discussions.

Electing optional lump-sum treatment. You can choose to use the 10-year tax option or capital gain treatment only once after 1986 for any plan participant. If you make this choice, you cannot use either of these optional treatments for any future distributions for the participant.

Taxable and tax-free parts of the distribution. The taxable part of a lump-sum distribution is the employer's contributions and income earned on your account. You may recover your ***cost*** in the lump sum and any ***net unrealized appreciation (NUA)*** in employer securities tax free.

Cost. In general, your cost is the total of:

1) The plan participant's nondeductible contributions to the plan,
2) The plan participant's taxable costs of any life insurance contract distributed,
3) Any employer contributions that were taxable to the plan participant, and
4) Repayments of any loans that were taxable to the plan participant.

You must reduce this cost by amounts previously distributed tax free.

Capital Gain Treatment

Capital gain treatment applies only to the taxable part of a lump-sum distribution resulting from participation in the plan before 1974. The amount treated as capital gain is taxed at a 20% rate. You can elect this treatment only once for any plan participant, and only if the plan participant was born before January 2, 1936. Complete Part II of Form 4972 to choose the 20% capital gain election.

10-Year Tax Option

The 10-year tax option is a special formula used to figure a separate tax on the ordinary income part of a lump-sum distribution. You pay the tax only once, for the year in which you receive the distribution, not over the next 10 years. You can elect this treatment only once for any plan participant, and only if the plan participant was born before January 2, 1936.

The ordinary income part of the distribution is the amount shown in box 2a of the Form 1099-R given to you by the payer, minus the amount, if any, shown in box 3. You also can treat the capital gain part of the distribution (box 3 of Form 1099-R) as ordinary income for the 10-year tax option if you do ***not*** choose capital gain treatment for that part.

Complete Part III of Form 4972 to choose the 10-year tax option. You must use the special tax rates shown in the instructions for Part III to figure the tax. Publication 575 illustrates how to complete Form 4972 to figure the separate tax.

VI. Rollovers

If you withdraw cash or other assets from a qualified retirement plan in an eligible rollover distribution, you can defer tax on the distribution by rolling it over to another qualified retirement plan or a traditional IRA.

For this purpose, the following plans are qualified retirement plans.

- A qualified employee plan.
- A qualified employee annuity.
- A tax sheltered annuity plan (403(b) plan).
- An eligible state or local government section 457 deferred compensation plan.

Eligible rollover distributions. Generally, you can roll over any part of most nonperiodic distributions from a qualified retirement plan.

Rollover of nontaxable amounts. You may be able to roll over the nontaxable part of a distribution (such as your after-tax contributions) made to another qualified retirement plan that is a qualified employee plan or a 403(b) plan, or to a traditional or Roth IRA. The transfer must be made either through a direct rollover to a qualified plan or 403(b) that separately accounts for the taxable and nontaxable parts of the rollover or through a rollover to a traditional or Roth IRA.

If you roll over only part of a distribution that includes both taxable and nontaxable amounts, the amount you roll over is treated as coming first from the taxable part of the distribution.

Time for making rollover. You generally must complete the rollover of an eligible distribution paid to you by the 60th day following the day on which you receive the distribution from your employer's plan. (If an amount distributed to you becomes a frozen deposit in a financial institution during the 60-day period after you receive it, the rollover period is extended for the period during which the distribution is in a frozen deposit in a financial institution.)

Tip. *The IRS may waive the 60-day requirement where the failure to do so would be against equity or good conscience, such as in the event of a casualty, disaster, or other event beyond your reasonable control.*

Direct rollover option. You can choose to have any part or all of an eligible rollover distribution paid directly to another qualified retirement plan that accepts rollover distributions or to a traditional or Roth IRA. If you choose the direct rollover option, or have an automatic rollover, no tax will be withheld from any part of the distribution that is directly paid to the trustee of the other plan.

Payment to you option. If an eligible rollover distribution is paid to you, 20% generally will be withheld for income tax. However, the full amount is treated as distributed to you even though you actually receive only 80%. You generally must include in income any part (including the part withheld) that you do not rollover within 60 days to another qualified retirement plan or to a traditional or Roth IRA. (See *Pensions and Annuities* under *Withholding* in chapter 4.)

Caution. *If you decide to roll over an amount equal to the distribution before withholding, your contribution to the new plan or IRA must include other money (for example, from savings or amounts borrowed) to replace the amount withheld.*

The administrator must give you a written explanation of your distribution options within a reasonable period of time before making an eligible rollover distribution.

Rollover by surviving spouse. You may be able to roll over tax free all or part of a distribution from a qualified retirement plan you receive as the surviving spouse of a deceased employee. The rollover rules apply to you as if you were the employee. You can roll over a distribution into a qualified retirement plan or a traditional IRA.

A distribution paid to a beneficiary other than the employee's surviving spouse is generally not an eligible rollover distribution. However, see *Rollovers by nonspouse beneficiary*, next.

Rollovers by nonspouse beneficiary. If you are a designated beneficiary (other than a surviving spouse) of a deceased employee, you may be able to roll over tax free all or a portion of a distribution you receive from an eligible retirement plan of a deceased employee. The distribution must be a direct trustee-to-trustee transfer to your traditional or Roth IRA that was set up to receive the distribution. The transfer will be treated as an eligible rollover distribution and the receiving plan will be treated as an inherited IRA.

Qualified domestic relations order. You may be able to roll over all or any part of a distribution from a qualified retirement plan that you receive under a qualified domestic relations order (QDRO). If you receive the distribution as an employee's spouse or former spouse (not as a nonspousal beneficiary), the rollover rules apply to you as if you were the employee. You can roll over the distribution from the plan into a traditional IRA or to another eligible retirement plan. See Publication 575 for more information on benefits received under a QDRO.

Designated Roth accounts. You can roll over an eligible distribution from a designated Roth account only into another designated Roth account or a Roth IRA. If you want to roll over the part of the distribution that is not included in income, you must make a direct rollover of the entire distribution or you can roll over the entire amount (or any portion) to a Roth IRA.

In-plan rollovers to designated Roth accounts. After September 27, 2010, if you are a participant in a 401(k) or 403(b) plan, your plan may permit you to roll over amounts in those plans to a designated Roth account within the same plan. The rollover of any untaxed money must be included in income. You must report in-plan Roth rollovers on Form 8606. See Publication 575 for more information.

Rollovers to Roth IRAs. You can roll over distributions directly from a qualified retirement plan (other than a designated Roth account) to a Roth IRA.

You must include in your gross income distributions from a qualified retirement plan that you would have had to include in income if you had not rolled them over into a Roth IRA. You do not include in gross income any part of a distribution from a qualified retirement plan that is a return of contributions to the plan that were taxable to you when paid. In addition, the 10% tax on early distributions does not apply.

Form 8606. You must file Form 8606 with your tax return to report 2011 rollovers from qualified retirement plans (other than designated Roth accounts) to Roth IRAs (unless you recharacterized the entire amount), and to figure the amount to include in income. See the Instructions for Form 8606 for more information.

VII. Special Additional Taxes

To discourage the use of pension funds for purposes other than normal retirement, the law imposes additional taxes on early distributions of those funds and on failures to withdraw the funds timely. Ordinarily, you will not be subject to these taxes if you roll over all early distributions you receive, as explained earlier, and begin drawing out the funds at a normal retirement age, in reasonable amounts over your life expectancy. These special additional taxes are the taxes on:

- Early distributions, and
- Excess accumulation (not receiving minimum distributions).

These taxes are discussed in the following sections.

If you must pay either of these taxes, report them on Form 5329. However, you do not have to file Form 5329 if you owe only the tax on early distributions and your Form 1099-R shows a "1" in box 7. Instead, enter 10% of the taxable part of the distribution on line 58 of Form 1040 and write "No" on the dotted line next to line 58.

Even if you do not owe any of these taxes, you may have to complete Form 5329 and attach it to your Form 1040. This applies if you meet an exception to the tax on early distributions but box 7 of your Form 1099-R does not indicate an exception.

Tax on Early Distributions

Most distributions (both periodic and nonperiodic) from qualified retirement plans and nonqualified annuity contracts made to you before you reach age 59½ are subject to an additional tax of 10%. This tax applies to the part of the distribution that you must include in gross income.

For this purpose, a ***qualified retirement plan*** is:

- A qualified employee plan,
- A qualified employee annuity plan,
- A tax-sheltered annuity plan, or
- An eligible state or local government section 457 deferred compensation plan (to the extent that any distribution is attributable to amounts the plan received in a direct transfer or rollover from one of the other plans listed here).

5% rate on certain early distributions from deferred annuity contracts. If an early withdrawal from a deferred annuity is otherwise subject to the 10% additional tax, a 5% rate may apply instead. A 5% rate applies to distributions under a written election providing a specific schedule for the distribution of your interest in the contract if, as of March 1, 1986, you had begun receiving payments under the election. On line 4 of Form 5329, multiply the line 3 amount by 5% instead of 10%. Attach an explanation to your return.

Exceptions to tax. Certain early distributions are excepted from the early distribution tax. If the payer knows that an exception applies to your early distribution, distribution code "2," "3," or "4" should be shown in box 7 of your Form 1099-R and you do not have to report the distribution on Form 5329. If an exception applies but distribution code "1" (early distribution, no known exception) is shown in box 7, you must file Form 5329. Enter the taxable amount of the distribution shown in box 2a of your Form 1099-R on line 1 of Form 5329. On line 2, enter the amount that can be excluded and the exception number shown in the Form 5329 instructions.

General exceptions. The tax does not apply to distributions that are:

- Made as part of a series of substantially equal periodic payments (made at least annually) for your life (or life expectancy) or the joint lives (or joint life expectancies) of you and your designated beneficiary (if from a qualified retirement plan, the payments must begin after your separation from service),
- Made because you are totally and permanently disabled, or
- Made on or after the death of the plan participant or contract holder.

Additional exceptions for qualified retirement plans. The tax does not apply to distributions that are:

- From a qualified retirement plan after your separation from service in or after the year you reached age 55 (age 50 for qualified public safety employees),
- From a qualified retirement plan to an alternate payee under a qualified domestic relations order,
- From a qualified retirement plan to the extent you have deductible medical expenses (medical expenses that exceed 7.5% of your adjusted gross income), whether or not you itemize your deductions for the year,
- From an employer plan under a written election that provides a specific schedule for distribution of your entire interest if, as of March 1, 1986, you had separated from service and had begun receiving payments under the election,
- From an employee stock ownership plan for dividends on employer securities held by the plan,
- From a qualified retirement plan due to an IRS levy of the plan, or
- From elective deferral accounts under 401(k) or 403(b) plans or similar arrangements that are qualified reservist distributions.

Qualified reservist distributions. A qualified reservist distribution is not subject to the additional tax on early distributions. A qualified reservist distribution is a distribution: (a) from elective deferrals under a section 401(k) or 403(b) plan, (b) to an individual ordered or called to active duty (because he or she is a member of a reserve component) for a period of more than 179 days or for an indefinite period, and (c) made during the period beginning on the date of the order or call and ending at the close of the active duty period. You must be ordered or called to active duty after September 11, 2001.

Additional exceptions for nonqualified annuity contracts. The tax does not apply to distributions that are:

- From a deferred annuity contract to the extent allocable to investment in the contract before August 14, 1982,
- From a deferred annuity contract under a qualified personal injury settlement,
- From a deferred annuity contract purchased by your employer upon termination of a qualified employee plan or qualified employee annuity plan and held by your employer until your separation from service, or
- From an immediate annuity contract (a single premium contract providing substantially equal annuity payments that start within one year from the date of purchase and are paid at least annually).

Tax on Excess Accumulation

To make sure that most of your retirement benefits are paid to you during your lifetime, rather than to your beneficiaries after your death, the payments that you receive from qualified retirement plans must begin no later than on your ***required beginning date*** (defined later). The payments each year cannot be less than the required minimum distribution.

Required distributions not made. If the actual distributions to you in any year are less than the minimum required distribution for that year, you are subject to an additional tax. The tax equals 50% of the part of the required minimum distribution that was not distributed.

For this purpose, a ***qualified retirement plan*** includes a:

1) Qualified employee plan,
2) Qualified employee annuity plan,
3) Section 457 deferred compensation plan, or
4) Tax-sheltered annuity plan (for benefits accruing after 1986).

Required beginning date. Unless the rule for 5% owners applies, ***you must begin*** to receive distributions from your qualified retirement plan by April 1 of the year that follows the ***later*** of:

1) The calendar year in which you reach age 70½, or
2) The calendar year in which you retire from employment with the employer maintaining the plan.

However, your plan may require you to begin to receive distributions by April 1 of the year that follows the year in which you reach age 70½ even if you have not retired.

Age 70½. You reach age 70½ on the date that is 6 calendar months after the date of your 70th birthday.

For example, if you are retired and your 70th birthday was on June 30, 2011, you were age 70½ on December 30, 2011. If your 70th birthday was on July 1, 2011, you reached age 70½ on January 1, 2012.

5% owners. If you are a 5% owner of the company maintaining your qualified retirement plan, you must begin to receive distributions by April 1 of the calendar year that follows the year in which you reach age 70½.

Required distributions. By the required beginning date, as explained above, you must either:

- Receive your entire interest in the plan (for a tax-sheltered annuity, your entire benefit accruing after 1986), or
- Begin receiving periodic distributions in annual amounts calculated to distribute your entire interest (for a tax-sheltered annuity, your entire benefit accruing after 1986) over your life or life expectancy or over the joint lives or joint life expectancies of you and a designated beneficiary (or over a shorter period).

Form 5329. You must file a Form 5329 if you owe a tax because you did not receive a minimum required distribution from your qualified retirement plan.

VIII. <u>Survivors</u>

Generally, a survivor or beneficiary reports pension or annuity income in the same way the plan participant would have. However, some special rules apply.

Survivors of retirees. If you receive benefits as a survivor under a joint and survivor annuity, include those benefits in income in the same way the retiree would have included them in income. If you receive a survivor annuity because of the death of a retiree who had reported the annuity under the Three-Year Rule and recovered all of the cost tax free, your survivor payments are fully taxable.

If the retiree was reporting the annuity payments under the ***General Rule,*** apply the same exclusion percentage the retiree used to your initial payment called for in the contract. The resulting tax-free amount will then remain fixed. Any increases in the survivor annuity are fully taxable.

If the retiree was reporting the annuity payments under the ***Simplified Method,*** the part of each payment that is tax free is the same as the tax-free amount figured by the retiree at the annuity starting date. This amount remains fixed even if the annuity payments are increased or decreased. See *Simplified Method,* earlier.

In any case, if the annuity starting date is after 1986, the total exclusion over the years cannot be more than the cost.

Survivors of employees. If you are entitled to receive a survivor annuity on the death of an employee, who died before becoming entitled to any annuity payments, you can exclude part of each annuity payment as a tax-free recovery of the employee’s investment in the contract. You must figure the taxable and tax-free parts of your annuity payments using the method that applied as if you were the employee.

Estate tax deduction. If your annuity was a joint and survivor annuity that was included in the decedent's estate, an estate tax may have been paid on it. You can deduct the part of the total estate tax that was based on the annuity. The deceased annuitant must have died after the annuity starting date. (For details, see section 1.691(d)-1 of the regulations.) This amount cannot be deducted in one year. It must be deducted in equal amounts over your remaining life expectancy.

If the decedent died before the annuity starting date of a deferred annuity contract and you receive a death benefit under that contract, the amount you receive (either in a lump sum or as periodic payments) in excess of the decedent's cost is included in your gross income as income in respect of a decedent for which you may be able to claim an estate tax deduction.

You can take the estate tax deduction as an itemized deduction on Schedule A, Form 1040. This deduction is not subject to the 2%-of-adjusted-gross-income limit on miscellaneous deductions.

CHAPTER 10 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Generally, if you do not pay any part of the cost of your employee pension or annuity and your employer did not withhold part of the cost from your pay while you worked, the amounts you receive each year are fully taxable.

   a) true
   b) false

2. After receiving cash from a qualified retirement plan in an eligible rollover distribution, generally how long do you have to reinvest the funds into another qualified plan before incurring taxes and possible penalties:

   a) 30 days
   b) 45 days
   c) 60 days
   d) 90 days

3. Generally, at what age would most distributions made to you from a qualified retirement plan no longer be subject to an early distribution tax of 10%:

   a) 50 years
   b) 55 years
   c) 59½ years
   d) 65 years

CHAPTER 10 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** You must report them on your income tax return.

   B: False is incorrect. If you paid part of the cost, you are not taxed on that part of the annuity you receive that represents a return of your cost.

2. A: Incorrect. The selection option of 30 days is too short for a tax-free rollover reinvestment time limit.

   B: Incorrect. The selection option of 45 days is too short for a tax-free rollover reinvestment time limit.

   C: Correct. You generally must complete the rollover by the 60th day following the day on which you receive the distribution from your prior plan to retain a tax-free transfer.

   D: Incorrect. You must reinvest the funds in a period shorter than 90 days.

3. Incorrect. Avoiding an early distribution tax at age 50 is not generally available. However certain qualified public safety employees, after a separation in service, may qualify.

   B: Incorrect. An exception rule for distributions at age 55 after separation from service can apply to payments made from a qualified retirement plan, but this is not the age in general.

   C: Correct. Early distribution taxes no longer apply to individuals receiving qualified retirement plan payments upon reaching the age of 59½.

   D: Incorrect. Age 65 has no significance with regard to determining an early distribution tax liability.

Chapter 11: Social Security and Equivalent Railroad Retirement Benefits

I. <u>Introduction</u>

This chapter explains the federal income tax rules for social security benefits and equivalent tier 1 railroad retirement benefits. It explains:

- How to figure whether your benefits are taxable,
- How to use the social security benefits worksheet (with examples),
- How to report your taxable benefits, and
- How to treat repayments that are more than the benefits you received during the year.

Social security benefits include monthly survivor and disability benefits. They do not include supplemental security income (SSI) payments, which are not taxable.

Equivalent tier 1 railroad retirement benefits are the part of tier 1 benefits that a railroad employee or beneficiary would have been entitled to receive under the social security system. They are commonly called the social security equivalent benefit (SSEB) portion of tier 1 benefits.

If you received these benefits during 2011, you should have received a Form SSA-1099 or Form RRB-1099 (Form SSA-1042S or Form RRB-1042S if you are a nonresident alien). These forms show the amounts received and repaid, and taxes withheld for the year. You may receive more than one of these forms for the same year. You should add the amounts shown on all forms you receive for the year to determine the "total" amounts received and repaid, and taxes withheld for that year.

Note. *When the term "benefits" is used in this chapter, it applies to both social security benefits and the SSEB portion of tier 1 railroad retirement benefits*.

What is not covered in this chapter. This chapter does not cover the tax rules for the following railroad retirement benefits:

- Non-social security equivalent benefit (NSSEB) portion of tier 1 benefits,
- Tier 2 benefits,
- Vested dual benefits, and
- Supplemental annuity benefits.

II. <u>Are Any of Your Benefits Taxable?</u>

To find out whether any of your benefits are taxable, compare the ***base amount*** for your filing status with the total of:

1) One-half of your benefits, plus
2) All your other income, including tax-exempt interest.

When making this comparison, do not reduce your other income by any ***exclusions*** for:

- Interest from qualified U.S. savings bonds,
- Employer-provided adoption benefits,
- Foreign earned income or foreign housing, or
- Income earned in American Samoa or Puerto Rico by bona fide residents.

Figuring total income. To figure the total of one-half of your benefits plus your other income, use the worksheet later in this discussion. If the total is more than your base amount, part of your benefits may be taxable.

If you are married and file a joint return for 2011, you and your spouse must combine your incomes and your benefits to figure whether any of your combined benefits are taxable. Even if your spouse did not receive any benefits, you must add your spouse's income to yours to figure whether any of your benefits are taxable.

Base amount. Your base amount is:

- $25,000 if you are single, head of household, or qualifying widow(er),
- $25,000 if you are married filing separately and ***lived apart*** from your spouse for ***all*** of 2011,
- $32,000 if you are married filing jointly, or
- $-0- if you are married filing separately and ***lived with*** your spouse at any time during 2011.

Worksheet. You can use the following worksheet and example to figure the amount of income to compare with your base amount. This is a quick way to check whether some of your benefits may be taxable.

Example. You and your spouse (both over 65) are filing a joint return for 2011, and you both received social security benefits during the year. In January 2012, you received a Form SSA-1099 showing net benefits of $7,500 in box 5. Your spouse received a Form SSA-1099 showing net benefits of $3,500 in box 5. You also received a taxable pension of $22,000 and interest income of $500. You did not have any tax-exempt interest income. Your benefits are ***not*** taxable for 2011 because your income, as figured in the following worksheet, is not more than your base amount ($32,000) for married filing jointly.

Even though none of your benefits are taxable, you must file a return for 2011 because your taxable gross income ($22,500) exceeds the minimum filing requirement amount for your filing status.

Filled-in Worksheet – A Quick Way to Check If Your Benefits May Be Taxable

A. Write in the amount from ***box 5*** of all your Forms SSA-1099 and RRB-1099. Include the full amount of any lump-sum benefit payments received in 2011, for 2011 and earlier years. (If you received more than one form, combine the amounts from box 5 and enter in the total.)	A.	$11,000
Note. *If the amount on line A is zero or less, stop here; none of your benefits are taxable this year.*		
B. Enter one-half of the amount on line A	B.	5,500
C. Enter your taxable pensions, wages, interest, dividends, and other taxable income	C.	22,500
D. Enter any tax-exempt interest income (such as interest on municipal bonds) plus any exclusions from income (listed earlier).	D.	-0-
E. Add lines B, C, and D	E.	$28,000

Note. *Compare the amount on line E to your* **base amount** *for your filing status. If the amount on line E equals or is less than the* **base amount** *for your filing status, none of your benefits are taxable this year. If the amount on line E is more than your base amount, some of your benefits may be taxable. You then need to complete Worksheet 1 in Publication 915 (or the Social Security Benefits Worksheet in your tax form instruction booklet).*

Tax withholding and estimated tax. You can choose to have federal income tax withheld from your social security benefits and/or the SSEB portion of your tier 1 railroad retirement benefits. If you choose to do this, you must complete a Form W-4V. You can choose withholding at 7%, 10%, 15%, or 25% of your total benefit payment.

If you do not choose to have income tax withheld, you may have to request additional withholding from other income or pay estimated tax during the year.

III. How To Report Your Benefits

If part of your benefits are taxable, you must use Form 1040 or Form 1040A. You cannot use Form 1040EZ.

Reporting on Form 1040. Report your net benefits (the amount in box 5 of your Form SSA-1099 or Form RRB-1099) on line 20a and the taxable part on line 20b. If you are married filing separately and you lived apart from your spouse for all of 2011, also enter "D" to the right of the word "benefits" on line 20a.

Reporting on Form 1040A. Report your net benefits (the amount in box 5 of your Form SSA-1099 or Form RRB-1099) on line 14a and the taxable part on line 14b. If you are married filing separately and you lived apart from your spouse for all of 2011, also enter "D" to the right of the word "benefits" on line 14a.

Benefits not taxable. If you are filing Form 1040EZ, do not report any benefits on your tax return. If you are filing Form 1040 or Form 1040A, report your net benefits (the amount in box 5 of your Form SSA-1099 or Form RRB-1099) on Form 1040, line 20a, or Form 1040A, line 14a. Enter -0- on Form 1040, line 20b, or Form 1040A, line 14b. If you are married filing separately and you lived apart from your spouse for all of 2011, also enter “D” to the right of the word “benefits” on Form 1040, line 20a, or Form 1040A, line 14a.

HOW MUCH IS TAXABLE?

If part of your benefits are taxable, how much is taxable depends on the total amount of your benefits and other income. Generally, the higher that total amount, the greater the taxable part of your benefits.

Maximum taxable part. Generally, up to 50% of your benefits will be taxable. However, up to 85% of your benefits can be taxable if either of the following situations applies to you.

1) The total of one-half of your benefits and all your other income is more than $34,000 ($44,000 if you are married filing jointly).
2) You are married filing separately and ***lived with your spouse*** at any time during 2011.

Lump-sum election. You must include the taxable part of a lump-sum (retroactive) payment of benefits received in 2011 in your 2011 income, even if the payment includes benefits for an earlier year.

> ***Tip.*** *This type of lump-sum benefit payment should not be confused with the lump-sum death benefit that both the SSA and RRB pay to many of their beneficiaries. No part of the lump-sum death benefit is subject to tax.*

Generally, you use your 2011 income to figure the taxable part of the total benefits received in 2011. However, you may be able to figure the taxable part of a lump-sum payment for an earlier year separately, using your income for the earlier year. You can elect this method if it lowers your taxable benefits.

Making the election. If you received a lump-sum benefit payment in 2011 that includes benefits for one or more earlier years, follow the instructions in Publication 915 under *Lump-Sum Election* to see whether making the election will lower your taxable benefits. That discussion also explains how to make the election.

Caution. *Since the earlier year's taxable benefits are included in your 2011 income, no adjustment is made to the earlier year's return.* ***Do not*** *file an amended return for the earlier year.*

IV. Examples

The following are a few examples you can use as a guide to figure the taxable part of your benefits.

Example 1. George White is single and files Form 1040 for 2011. He received the following income in 2011:

Fully taxable pension	$18,600
Wages from part-time job	9,400
Taxable interest income	990
Total	**$28,990**

George also received social security benefits during 2011. The Form SSA-1099 he received in January 2012 shows $5,980 in box 5. To figure his taxable benefits, George completes the worksheet shown here.

Example 1 – Worksheet 1. Figuring Your Taxable Benefits

1. Enter the total amount from **box 5** of **ALL** your Forms SSA-1099 and RRB-1099. Also enter this amount on Form 1040, line 20a, or Form 1040A, line 14a	$5,980
2. Enter one-half of line 1	2,990
3. Enter the total of the amounts from: **Form 1040**: Lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21. **Form 1040A:** Lines 7, 8a, 9a, 10, 11b, 12b, and 13	28,990
4. Enter the amount, if any, from Form 1040 or 1040A, line 8b	-0-
5. **Form 1040 filers:** Enter the total of any exclusions/adjustments for: • Adoption benefits (Form 8839, line 26), • Foreign earned income or housing (Form 2555, lines 45 and 50, or Form 2555-EZ, line 18), and • Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico **Form 1040A filers:** Enter the total of any exclusions for qualified U.S. savings bond interest (Form 8815, line 14) or for adoption benefits (Form 8839, line 30)	-0-
6. Add lines 2, 3, 4 and 5	31,980
7. **Form 1040 filers:** Enter the amount from Form 1040, lines 23 through 32, and any write-in adjustments you entered on the line next to line 36 **Form 1040A filers:** Enter the amount from Form 1040A, lines 16 and 17	-0-
8. Is the amount on line 7 less than the amount on line 6? **No. STOP!** None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b, or Form 1040A, line 14b. **Yes.** Subtract line 7 from line 6	31,980
9. If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2011, enter $25,000 **Note.** If you are married filing separately and you lived with your spouse at any time in 2011, skip lines 9 through 16; multiply line 8 by 85% (.85) and enter the result on line 17. Then go to line 18.	25,000
10. Is the amount on line 9 less than the amount on line 8? **No. STOP!** None of your benefits are taxable. Enter -0- on Form 1040, line 20b, or on Form 1040A, line 14b. If you are married filing separately and you **lived apart** from your spouse for all of 2011, be sure you entered "D" to the right of the word "benefits" on Form 1040, line 20a, or on Form 1040A, line 14a. **Yes.** Subtract line 9 from line 8	6,980
11. Enter $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2011.	9,000
12. Subtract line 11 from line 10. If zero or less, enter –0-	-0-
13. Enter the **smaller** of line 10 or line 11	6,980
14. Enter one-half of line 13	3,490
15. Enter the **smaller** of line 2 or line 14	2,990
16. Multiply line 12 by 85% (.85). If line 12 is zero, enter -0-	-0-
17. Add lines 15 and 16	2,990
18. Multiple line 1 by 85% (.85)	5,083
19. **Taxable benefits.** Enter the **smaller** of line 17 or line 18. Also enter this amount on Form 1040, line 20b, or Form 1040A, line 14b	$2,990

The amount on line 19 of George's worksheet shows that $2,990 of his social security benefits is taxable. On line 20a of his Form 1040, George enters his net benefits of $5,980. On line 20b, he enters his taxable part of $2,990.

Example 2. Ray and Alice Hopkins file a joint return on Form 1040A for 2011. Ray is retired and received a fully taxable pension of $15,500. He also received social security benefits, and his Form SSA-1099 for 2011 shows net benefits of $5,600 in box 5. Alice worked during the year and had wages of $14,000. She made a deductible payment to her IRA account of $1,000. Ray and Alice have two savings accounts with a total of $250 in interest income. They complete Worksheet 1 and find that none of Ray's social security benefits are taxable. On line 3 of the worksheet, they enter $29,750 ($15,500 + $14,000 + $250). On Form 1040A, they enter $5,600 on line 14a and -0- on line 14b.

Example 2 – Worksheet 1. Figuring Your Taxable Benefits

1. Enter the total amount from **box 5** of **ALL** your Forms SSA-1099 and RRB-1099. Also enter this amount on Form 1040, line 20a, or Form 1040A, line 14a	$5,600
2. Enter one-half of line 1	2,800
3. Enter the total of the amounts from: **Form 1040**: Lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21. **Form 1040A:** Lines 7, 8a, 9a, 10, 11b, 12b, and 13	29,750
4. Enter the amount, if any, from Form 1040 or 1040A, line 8b	-0-
5. **Form 1040 filers:** Enter the total of any exclusions/adjustments for: • Adoption benefits (Form 8839, line 26), • Foreign earned income or housing (Form 2555, lines 45 and 50, or Form 2555-EZ, line 18), and • Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico **Form 1040A filers:** Enter the total of any exclusions for qualified U.S. savings bond interest (Form 8815, line 14) or for adoption benefits (Form 8839, line 30)	-0-
6. Add lines 2, 3, 4 and 5	32,550
7. **Form 1040 filers:** Enter the amount from Form 1040, lines 23 through 32, and any write-in adjustments you entered on the line next to line 36 **Form 1040A filers:** Enter the amount from Form 1040A, lines 16 and 17	1,000
8. Is the amount on line 7 less than the amount on line 6? **No. STOP!** None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b, or Form 1040A, line 14b. **Yes.** Subtract line 7 from line 6	31,550
9. If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2011, enter $25,000 **Note.** If you are married filing separately and you lived with your spouse at any time in 2011, skip lines 9 through 16; multiply line 8 by 85% (.85) and enter the result on line 17. Then go to line 18.	32,000
10. Is the amount on line 9 less than the amount on line 8? **No. STOP!** None of your benefits are taxable. Enter -0- on Form 1040, line 20b, or on Form 1040A, line 14b. If you are married filing separately and you **lived apart** from your spouse for all of 2011, be sure you entered "D" to the right of the word "benefits" on Form 1040, line 20a, or on Form 1040A, line 14a. **Yes.** Subtract line 9 from line 8	
11. Enter $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2011	
12. Subtract line 11 from line 10. If zero or less, enter –0-	
13. Enter the **smaller** of line 10 or line 11	
14. Enter one-half of line 13	
15. Enter the **smaller** of line 2 or line 14	
16. Multiply line 12 by 85% (.85). If line 12 is zero, enter -0-	
17. Add lines 15 and 16	
18. Multiple line 1 by 85% (.85)	
19. **Taxable benefits.** Enter the **smaller** of line 17 or line 18. Also enter this amount on Form 1040, line 20b, or Form 1040A, line 14b	

Example 3. Joe and Betty Johnson file a joint return on Form 1040 for 2011. Joe is a retired railroad worker and in 2011 received the social security equivalent benefit (SSEB) portion of tier 1 railroad retirement benefits. Joe's Form RRB-1099 shows $10,000 in box 5. Betty is a retired government worker and receives a fully taxable pension of $38,000. They had $2,300 in interest income plus interest of $200 on a qualified U.S. savings bond. The savings bond interest qualified for the exclusion. Thus, they have a total income of $40,300 ($38,000 + $2,300). They figure their taxable benefits by completing Worksheet 1. On line 3 of the worksheet, they enter $40,300 ($38,000 + $2,300).

Example 3 – Worksheet 1. Figuring Your Taxable Benefits

1. Enter the total amount from **box 5** of **ALL** your Forms SSA-1099 and RRB-1099. Also enter this amount on Form 1040, line 20a, or Form 1040A, line 14a	$10,000
2. Enter one-half of line 1	5,000
3. Enter the total of the amounts from: **Form 1040**: Lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21. **Form 1040A:** Lines 7, 8a, 9a, 10, 11b, 12b, and 13	40,300
4. Enter the amount, if any, from Form 1040 or 1040A, line 8b	-0-
5. **Form 1040 filers:** Enter the total of any exclusions/adjustments for: • Adoption benefits (Form 8839, line 30), • Foreign earned income or housing (Form 2555, lines 45 and 50, or Form 2555-EZ, line 18), and • Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico **Form 1040A filers:** Enter the total of any exclusions for qualified U.S. savings bond interest (Form 8815, line 14) or for adoption benefits (Form 8839, line 30)	200
6. Add lines 2, 3, 4 and 5	45,500
7. **Form 1040 filers:** Enter the amount from Form 1040, lines 23 through 32, and any write-in adjustments you entered on the line next to line 36 **Form 1040A filers:** Enter the amount from Form 1040A, lines 16 and 17	-0-
8. Is the amount on line 7 less than the amount on line 6? **No. STOP!** None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b, or Form 1040A, line 14b. **Yes.** Subtract line 7 from line 6	45,500
9. If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2011, enter $25,000 **Note.** If you are married filing separately and you lived with your spouse at any time in 2011, skip lines 9 through 16; multiply line 8 by 85% (.85) and enter the result on line 17. Then go to line 18.	32,000
10. Is the amount on line 9 less than the amount on line 8? **No. STOP!** None of your benefits are taxable. Enter -0- on Form 1040, line 20b, or on Form 1040A, line 14b. If you are married filing separately and you **lived apart** from your spouse for all of 2011, be sure you entered "D" to the right of the word "benefits" on Form 1040, line 20a, or on Form 1040A, line 14a. **Yes.** Subtract line 9 from line 8	13,500
11. Enter $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2011	12,000
12. Subtract line 11 from line 10. If zero or less, enter –0-	1,500
13. Enter the **smaller** of line 10 or line 11	12,000
14. Enter one-half of line 13	6,000
15. Enter the **smaller** of line 2 or line 14	5,000
16. Multiply line 12 by 85% (.85). If line 12 is zero, enter -0-	1,275
17. Add lines 15 and 16	6,275
18. Multiple line 1 by 85% (.85)	8,500
19. **Taxable benefits.** Enter the **smaller** of line 17 or line 18. Also enter this amount on Form 1040, line 20b, or Form 1040A, line 14b	$6,275

More than 50% of Joe's net benefits are taxable because the income on line 8 of the worksheet ($45,500) is more than $44,000. Joe and Betty enter $10,000 on line 20a, Form 1040, and $6,275 on line 20b, Form 1040.

V. Deductions Related to Your Benefits

You may be entitled to deduct certain amounts related to the benefits you receive.

Disability payments. You may have received disability payments from your employer or an insurance company that you included as income on your tax return in an earlier year. If you received a lump-sum payment from SSA or RRB, and you had to repay the employer or insurance company for the disability payments, you can take an itemized deduction for the part of the payments you included in gross income in the earlier year. If the amount you repay is more than $3,000, you may be able to claim a tax credit instead.

Legal expenses. You can usually deduct legal expenses that you pay or incur to produce or collect taxable income or in connection with the determination, collection, or refund of any tax.

Legal expenses for collecting the ***taxable*** part of your benefits are deductible as a miscellaneous itemized deduction on line 23, Schedule A (Form 1040).

REPAYMENTS MORE THAN GROSS BENEFITS

In some situations, your Form SSA-1099 or Form RRB-1099 will show that the total benefits you repaid (box 4) are more than the gross benefits (box 3) you received. If this occurred, your net benefits in box 5 will be a negative figure (a figure in parentheses) and none of your benefits will be taxable. If you receive more than one form, a negative figure in box 5 of one form is used to offset a positive figure in box 5 of another form for that same year.

If you have any questions about this negative figure, contact your local SSA office or your local U.S. RRB field office.

Joint return. If you and your spouse file a joint return, and your Form SSA-1099 or RRB-1099 has a negative figure in box 5, but your spouse's does not, subtract the amount in box 5 of your form from the amount in box 5 of your spouse's form. You do this to get your net benefits when figuring if your combined benefits are taxable.

Example. John and Mary file a joint return for 2011. John received Form SSA-1099 showing $3,000 in box 5. Mary also received Form SSA-1099 and the amount in box 5 was ($500). John and Mary will use $2,500 ($3,000 minus $500) as the amount of their net benefits when figuring if any of their combined benefits are taxable.

Repayment of benefits received in an earlier year. If the total amount shown in box 5 of all of your Forms SSA-1099 and RRB-1099 is a negative figure, you can take an itemized deduction for the part of this negative figure that represents benefits you included in gross income in an earlier year.

Deduction $3,000 or less. If this deduction is $3,000 or less, it is subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions. Claim it on line 23, Schedule A (Form 1040).

Deduction more than $3,000. If this deduction is more than $3,000, you should figure your tax two ways:

1) Figure your tax for 2011 with the itemized deduction included on line 28 of Schedule A.
2) Figure your tax for 2011 in the following steps.
   a) Figure the tax without the itemized deduction included on line 28 of Schedule A.
   b) For each year after 1983 for which part of the negative figure represents a repayment of benefits, refigure your taxable benefits as if your total benefits for the year were reduced by that part of the negative figure. Then refigure the tax for that year.
   c) Subtract the total of the refigured tax amounts in (b) from the total of your actual tax amounts.
   d) Subtract the result in (c) from the result in (a).

Compare the tax figured in methods (1) and (2). Your tax for 2011 is the smaller of the two amounts. If method (1) results in less tax, take the itemized deduction on line 28, Schedule A (Form 1040). If method (2) results in less tax, claim a credit for the amount from step 2(c) above on line 71 of Form 1040 and write "I.R.C. 1341" in the margin to the left of line 71. If both methods produce the same tax, deduct the repayment on line 28, Schedule A (Form 1040).

CHAPTER 11 - REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Social security benefits are never taxable.

   a) true
   b) false

CHAPTER 11 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. To find out whether any of your benefits are taxable, you compare the base amount for your filing status with the total of one-half of your benefits plus all your other income, including tax-exempt interest.

   B: False is correct. If the total amount of one-half of your benefits plus your other income is greater than your base amount, part of your benefits may be taxable.

Chapter 12: Other Income

I. Introduction

This chapter discusses many kinds of income and explains whether they are taxable or nontaxable.

- Income that is taxable must be reported on your tax return and is subject to tax.
- Income that is nontaxable may have to be shown on your tax return but is not taxable.

This chapter begins with discussions of the following income items.

- Bartering.
- Canceled debts.
- Sales parties at which you are the host or hostess.
- Life insurance proceeds.
- Partnership income.
- S Corporation income.
- Recoveries (including state income tax refunds).
- Rents from personal property.
- Repayments.
- Royalties.
- Unemployment benefits.
- Welfare and other public assistance benefits.

These discussions are followed by brief discussions of many income items arranged in alphabetical order.

II. Bartering

Bartering is an exchange of property or services. You must include in your income, at the time received, the fair market value of property or services you receive in bartering. If you exchange services with another person and you both have agreed ahead of time as to the value of the services, that value will be accepted as fair market value unless the value can be shown to be otherwise.

Generally, you report this income on Schedule C, *Profit or Loss From Business,* or Schedule C-EZ, *Net Profit From Business* (Form 1040). But if the barter involves an exchange of something other than services, such as in *Example 3* below, you may have to use another form or schedule instead.

Example 1. You are a self-employed attorney who performs legal services for a client, a small corporation. The corporation gives you shares of its stock as payment for your services. You must include the fair market value of the shares in your income on Schedule C or Schedule C-EZ (Form 1040) in the year you receive them.

Example 2. You are self-employed and a member of a barter club. The club uses "credit units" as a means of exchange. It adds credit units to your account for goods or services you provide to members, which you can use to purchase goods and services offered by other members of the barter club. The club subtracts credit units from your account when you receive goods or services from other members. You must include in your income the value of the credit units that are added to your account, even though you may not actually receive goods or services from other members until a later tax year.

Example 3. You own a small apartment building. In return for 6 months rent-free use of an apartment, an artist gives you a work of art she created. You must report as rental income on Schedule E, *Supplemental Income and Loss* (Form 1040), the fair market value of the artwork, and the artist must report as income on Schedule C or Schedule C-EZ (Form 1040) the fair rental value of the apartment.

Form 1099-B from barter exchange. If you exchanged property or services through a barter exchange, you should receive Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions,* or a similar statement from the barter exchange by February 15, 2012. It should show the value of cash, property, services, credits, or scrip you received from exchanges during 2011. The IRS will also receive a copy of Form 1099-B.

III. Canceled Debts

Generally, if a debt you owe is canceled or forgiven, other than as a gift or bequest, you must include the canceled amount in your income. You have no income from the canceled debt if it is intended as a gift to you. A debt includes any indebtedness for which you are liable or which attaches to property you hold.

If the debt is a nonbusiness debt, report the canceled amount on line 21 of Form 1040. If it is a business debt, report the amount on Schedule C or Schedule C-EZ (Form 1040) (or on Schedule F, *Profit or Loss From Farming* (Form 1040), if you are a farmer).

Form 1099-C. If a federal government agency, financial institution, or credit union cancels or forgives a debt you owe of $600 or more, you will receive a Form 1099-C, *Cancellation of Debt.* The amount of the canceled debt is shown in box 2.

Interest included in canceled debt. If any interest is forgiven and included in the amount of canceled debt in box 2, the amount of interest will also be shown in box 3. Whether or not you must include the interest portion of the canceled debt in your income depends on whether the interest would be deductible if you paid it. See *Deductible debt,* under *Exceptions,* later.

If the interest would not be deductible (such as interest on a personal loan), include in your income the amount from box 2 of Form 1099-C. If the interest would be deductible (such as on a business loan), include in your income the net amount of the canceled debt (the amount shown in box 2 less the interest amount shown in box 3).

Discounted mortgage loan. If your financial institution offers a discount for the early payment of your mortgage loan, the amount of the discount is canceled debt. You must include the canceled amount in your income.

Mortgage relief upon sale or other disposition. If you are personally liable for a mortgage (recourse debt), and you are relieved of the mortgage when you dispose of the property, you may realize gain or loss up to the fair market value of the property. To the extent the mortgage discharge exceeds the fair market value of the property, it is income from discharge of indebtedness unless it qualifies for exclusion under *Excluded debt*, later. Report any income from discharge of indebtedness on nonbusiness debt that does not qualify for exclusion as other income on Form 1040, line 21.

If you are not personally liable for a mortgage (nonrecourse debt), and you are relieved of the mortgage when you dispose of the property (such as through foreclosure or repossession), that relief is included in the amount you realize. You may have a taxable gain if the amount you realize exceeds your adjusted basis in the property. Report any gain on nonbusiness property as a capital gain.

Stockholder debt. If you are a stockholder in a corporation and the corporation cancels or forgives your debt to it, the canceled debt is a constructive distribution that is generally dividend income to you.

If you are a stockholder in a corporation and you cancel a debt owed to you by the corporation, you generally do not realize income. This is because the canceled debt is considered as a contribution to the capital of the corporation equal to the amount of debt principal that you canceled.

Repayment of canceled debt. If you included a canceled amount in your income and later pay the debt, you may be able to file a claim for refund for the year the amount was included in income. You can file a claim on Form 1040X if the statute of limitations for filing a claim is still open. The statute of limitations generally does not end until 3 years after the due date of your original return.

EXCEPTIONS

There are several exceptions to the inclusion of canceled debt in income. These are explained next.

Student loans. Certain student loans contain a provision that all or part of the debt incurred to attend the qualified educational institution will be canceled if you work for a certain period of time in certain professions for any of a broad class of employers.

You do not have income if your student loan is canceled after you agreed to this provision and then performed the services required. To qualify, the loan must have been made by:

1) The federal government, a state or local government, or an instrumentality, agency, or subdivision thereof,
2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or
3) An educational institution:
    a) Under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan, or
    b) As part of a program of the institution designed to encourage students to serve in occupations or areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization.

A loan to refinance a qualified student loan will also qualify if it was made by an educational institution or a tax-exempt 501(a) organization under its program designed as described in (3)(b) above.

Education loan repayment assistance. Education loan repayments made to you by the National Health Service Corps Loan Repayment Program (NHSC Loan Repayment Program), a state education loan repayment program eligible for funds under the Public Health Service Act, or any other state loan repayment or loan forgiveness program that is intended to provide for the increased availability of health services in underserved or health professional shortage areas are not taxable.

> ***Tip.*** *The provision relating to the “other state loan repayment or loan forgiveness program” was added to this exclusion for amounts received in tax years beginning after December 31, 2008.*

Deductible debt. You do not have income from the cancellation of a debt if your payment of the debt would be deductible. This exception applies only if you use the cash method of accounting.

Price reduced after purchase. Generally, if the seller reduces the amount of debt you owe for property you purchased, you do not have income from the reduction. The reduction of the debt is treated as a purchase price adjustment and reduces your basis in the property.

Excluded debt. Do not include a canceled debt in your gross income in the following situations.

- The debt is canceled in a bankruptcy case under title 11 of the U.S. Code. See Publication 908, Bankruptcy Tax Guide.
- The debt is canceled when you are insolvent. However, you cannot exclude any amount of canceled debt that is more than the amount by which you are insolvent.
- The debt is qualified farm debt and is canceled by a qualified person.
- The debt is qualified real property business debt.
- The cancellation is intended as a gift.
- The debt is qualified principal residence indebtedness.

IV. Host or Hostess

If you host a party at which sales are made, any gift you receive for giving the party is a payment for helping a direct seller make sales. You must report it as income at its fair market value.

Your out-of-pocket party expenses are subject to the 50% limit for meal and entertainment expenses. These expenses are deductible as miscellaneous itemized deductions subject to the 2% of AGI limit on Schedule A (Form 1040), but only up to the amount of income you receive for giving the party.

V. Life Insurance Proceeds

Life insurance proceeds paid to you because of the death of the insured person are not taxable unless the policy was turned over to you for a price. This is true even if the proceeds were paid under an accident or health insurance policy or an endowment contract. However, interest income received as a result of life insurance proceeds may be taxable.

Proceeds not received in installments. If death benefits are paid to you in a lump sum or other than at regular intervals, include in your income only the benefits that are more than the amount payable to you at the time of the insured person's death. If the benefit payable at death is not specified, you include in your income the benefit payments that are more than the present value of the payments at the time of death.

Proceeds received in installments. If you receive life insurance proceeds in installments, you can exclude part of each installment from your income.

To determine the excluded part, divide the amount held by the insurance company (generally the total lump sum payable at the death of the insured person) by the number of installments to be paid. Include anything over this excluded part in your income as interest.

Surviving spouse. If your spouse died before October 23, 1986, and insurance proceeds paid to you because of the death of your spouse are received in installments, you can exclude up to $1,000 a year of the interest included in the installments. If you remarry, you can continue to take the exclusion.

Surrender of policy for cash. If you surrender a life insurance policy for cash, you must include in income any proceeds that are more than the cost of the life insurance policy. In general, your cost (or investment in the contract) is the total of premiums that you paid for the life insurance policy, less any refunded premiums, rebates, dividends, or unrepaid loans that were not included in your income.

You should receive a Form 1099-R showing the total proceeds and the taxable part. Report these amounts on lines 16a and 16b of Form 1040, or lines 12a and 12b of Form 1040A.

ENDOWMENT CONTRACT PROCEEDS

Endowment proceeds paid in a lump sum to you at maturity are taxable only if the proceeds are more than the cost of the policy. To determine your cost, add the aggregate amount of premiums (or other consideration) paid for the contract and subtract any amount that you previously received under the contract and excluded from your income. Include the part of the lump sum payment that is more than your cost in your income.

ACCELERATED DEATH BENEFITS

Certain amounts paid as accelerated death benefits under a life insurance contract or viatical settlement before the insured's death are excluded from income if the insured is terminally or chronically ill.

Viatical settlement. This is the sale or assignment of any part of the death benefit under a life insurance contract to a viatical settlement provider. A viatical settlement provider is a person who regularly engages in the business of buying or taking assignment of life insurance contracts on the lives of insured individuals who are terminally or chronically ill and who meets the requirements of section 101(g)(2)(B) of the Internal Revenue Code.

Exclusion for terminal illness. Accelerated death benefits are fully excludable if the insured is a terminally ill individual. This is a person who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months from the date of the certification.

Exclusion for chronic illness. If the insured is a chronically ill individual who is not terminally ill, accelerated death benefits paid on the basis of costs incurred for qualified long-term care services are fully excludable. Accelerated death benefits paid on a per diem or other periodic basis are excludable up to a limit. This limit applies to the total of the accelerated death benefits and any periodic payments received from long-term care insurance contracts.

Exception. The exclusion does not apply to any amount paid to a person (other than the insured) who has an insurable interest in the life of the insured because the insured:

- Is a director, officer, or employee of the other person, or
- Has a financial interest in the person's business.

VI. Partnership Income

A partnership generally is not a taxable entity. The income, gains, losses, deductions, and credits of a partnership are ***passed through*** to the partners based on each partner's distributive share of these items.

Schedule K-1 (Form 1065). Although a partnership generally pays no tax, it must file an information return on Form 1065, *U.S. Return of Partnership Income,* and send Schedule K-1 (Form 1065) to each partner. In addition, the partnership will send each partner a copy of the *Partner's Instructions for Schedule K-1 (Form 1065)* to help each partner report his or her share of the partnership's income, deductions, credits, and tax preference items.

Records. Keep Schedule K-1 (Form 1065) for your records. Do not attach it to your Form 1040.

VII. S Corporation Income

In general, an S corporation does not pay tax on its income. Instead, the income, losses, deductions, and credits of the corporation are ***passed through*** to the shareholders based on each shareholder’s pro rata share.

Schedule K-1 (Form 1120S). An S corporation must file a return on Form 1120S, *U.S. Income Tax Return for an S Corporation,* and send Schedule K-1 (Form 1120S) to each shareholder. In addition, the S corporation will send each shareholder a copy of the *Shareholder's Instructions for Schedule K-1 (Form 1120S)* to help each shareholder report his or her share of the S corporation's income, losses, credits, and deductions.

Records. Keep Schedule K-1 (Form 1120S) for your records. Do not attach it to your Form 1040.

For more information on S corporations and their shareholders, see the instructions for Form 1120S.

VIII. Recoveries

A recovery is a return of an amount you deducted or took a credit for in an earlier year. The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A (Form 1040). You may also have recoveries of non-itemized deductions (such as payments on previously deducted bad debts) and recoveries of items for which you previously claimed a tax credit.

Tax benefit rule. You must include a recovery in your income in the year you receive it up to the amount by which the deduction or credit you took for the recovered amount reduced your tax in the earlier year. For this purpose, any increase to an amount carried over to the current year that resulted from the deduction or credit is considered to have reduced your tax in the earlier year.

Federal income tax refund. Refunds of federal income taxes are not included in your income because they are never allowed as a deduction from income.

State income tax refund. If you received a state or local income tax refund (or credit or offset) in 2011, you must include it in income if you deducted the tax in an earlier year. You should receive Form 1099-G, *Certain Government Payments,* from the payer by January 31, 2012. The IRS will also receive a copy of the Form 1099-G. Use the worksheet in the 2011 Form 1040 Instructions for line 10 to figure the amount (if any) to include in your income.

If you could choose to deduct for a tax year either:

- State and local income taxes, or
- State and local general sales taxes, then

the maximum refund that you may have to include in income is limited to the excess of the tax you chose to deduct for that year over the tax you did not choose to deduct for that year.

Mortgage interest refund. If you received a refund or credit in 2011 of mortgage interest paid in an earlier year, the amount should be shown in box 3 of your Form 1098, *Mortgage Interest Statement.* Do not subtract the refund amount from the interest you paid in 2011. You may have to include it in your income under the rules explained in the following discussions.

Interest on recovery. Interest on any of the amounts you recover must be reported as interest income in the year received. For example, report any interest you received on state or local income tax refunds on line 8a of Form 1040.

Recovery and expense in same year. If the refund or other recovery and the expense occur in the same year, the recovery reduces the deduction or credit and is not reported as income.

Recovery for 2 or more years. If you receive a refund or other recovery that is for amounts you paid in 2 or more separate years, you must allocate, on a pro rata basis, the recovered amount between the years in which you paid it. This allocation is necessary to determine the amount of recovery from any earlier years and to determine the amount, if any, of your allowable deduction for this item for the current year.

ITEMIZED DEDUCTION RECOVERIES

If you recover any amount that you deducted in an earlier year on Schedule A (Form 1040), you generally must include the full amount of the recovery in your income in the year you receive it.

Where to report. Enter your state or local income tax refund on line 10 of Form 1040, and the total of all other recoveries as other income on line 21 of Form 1040. You cannot use Form 1040A or Form 1040EZ.

Standard deduction limit. You generally are allowed to claim the standard deduction if you do not itemize your deductions. Only your itemized deductions that are more than your standard deduction are subject to the recovery rule (unless you are required to itemize your deductions). If your total deductions on the earlier year return were not more than your income for that year, include in your income this year the lesser of:

- Your recoveries, or
- The amount by which your itemized deductions exceeded the standard deduction.

Example. For 2010, you filed a joint return. Your taxable income was $60,000 and you were not entitled to any tax credits. Your standard deduction was $11,400, and you had itemized deductions of $13,000. In 2011, you received the following recoveries for amounts deducted on your 2010 return:

Medical expenses	$200
State and local income tax refund	400
Refund of mortgage interest	325
Total recoveries	**$925**

None of the recoveries were more than the deductions taken for 2010. The difference between the state and local income tax you deducted and your local general sales tax was more than $400.

Your total recoveries are less than the amount by which your itemized deductions exceeded the standard deduction ($13,000 – 11,400 = $1,600), so you must include your total recoveries in your income for 2011. Report the state and local income tax refund of $400 on line 10 of Form 1040, and the balance of your recoveries, $525, on line 21 of Form 1040.

Standard deduction for earlier years. To determine if amounts recovered in 2011 must be included in your income, you must know the standard deduction for your filing status for the year the deduction was claimed.

Example. You filed a joint return for 2010 with taxable income of $45,000. Your itemized deductions were $12,050. The standard deduction that you could have claimed was $11,400. In 2011 you recovered $2,100 of your 2010 itemized deductions. None of the recoveries were more than the actual deductions for 2010. Include $650 of the recoveries in your 2011 income. This is the smaller of your recoveries ($2,100) or the amount by which your itemized deductions were more than the standard deduction ($12,050 – 11,400 = $650).

Recovery limited to deduction. You do not include in your income any amount of your recovery that is more than the amount you deducted in the earlier year. The amount you include in your income is limited to the smaller of:

- The amount deducted on Schedule A (Form 1040), or
- The amount recovered.

Example. During 2010 you paid $1,700 for medical expenses. From this amount you subtracted $1,500, which was 7.5% of your adjusted gross income. Your actual medical expense deduction was $200. In 2011, you received a $500 reimbursement from your medical insurance for your 2010 expenses. The only amount of the $500 reimbursement that must be included in your income for 2011 is $200 – the amount actually deducted.

IX. Rents from Personal Property

If you rent out personal property, such as equipment or vehicles, how you report your income and expenses is generally determined by:

1) Whether or not the rental activity is a business, and
2) Whether or not the rental activity is conducted for profit.

Generally, if your primary purpose is income or profit and you are involved in the rental activity with continuity and regularity, your rental activity is a business. See Publication 535 for details on deducting expenses for both business and not-for-profit activities.

Reporting business income and expenses. If you are in the business of renting personal property, report your income and expenses on Schedule C or Schedule C-EZ (Form 1040). The form instructions have information on how to complete them.

Reporting nonbusiness income. If you are not in the business of renting personal property, report your rental income on line 21 of Form 1040. List the type and amount of the income on the dotted line to the left of the amount you report on line 21.

Reporting nonbusiness expenses. If you rent personal property for profit, include your rental expenses in the total amount you enter on line 36 of Form 1040. Also enter the amount and "PPR" on the dotted line to the left of line 36.

If you do not rent personal property for profit, your deductions are limited and you cannot report a loss to offset other income.

X. <u>Repayments</u>

If you had to repay an amount that you included in your income in an earlier year, you may be able to deduct the amount repaid from your income for the year in which you repaid it. Or, if the amount you repaid is more than $3,000, you may be able to take a credit against your tax for the year in which you repaid it. Generally, you can claim a deduction or credit only if the repayment qualifies as an expense or loss incurred in your trade or business or in a for-profit transaction.

Type of deduction. The type of deduction you are allowed in the year of repayment depends on the type of income you included in the earlier year. You generally deduct the repayment on the same form or schedule on which you previously reported it as income. For example, if you reported it as self-employment income, deduct it as a business expense on Schedule C or Schedule C-EZ (Form 1040) or Schedule F (Form 1040). If you reported it as a capital gain, deduct it as a capital loss on Schedule D (Form 1040). If you reported it as wages, unemployment compensation, or other nonbusiness income, deduct it as a miscellaneous itemized deduction on Schedule A (Form 1040).

Repayment – $3,000 or less. If the amount you repaid was $3,000 or less, deduct it from your income in the year you repaid it. If you must deduct it as a miscellaneous itemized deduction, enter it on line 23 of Schedule A (Form 1040).

Repayment – over $3,000. If the amount you repaid was more than $3,000, you can deduct the repayment, as described earlier. However, you can instead choose to take a tax credit for the year of repayment if you included the income under a ***claim of right***. This means that at the time you included the income, it appeared that you had an unrestricted right to it. If you qualify for this choice, figure your tax under both methods and compare the results. Use the method (deduction or credit) that results in less tax.

Method 1. Figure your tax for 2011 claiming a deduction for the repaid amount. If you must deduct it as a miscellaneous itemized deduction, enter it on line 28 of Schedule A (Form 1040).

Method 2. Figure your tax for 2011 claiming a credit for the repaid amount. Follow these steps.

1) Figure your tax for 2011 ***without*** deducting the repaid amount.
2) Refigure your tax from the earlier year without including in income the amount you repaid in 2011.
3) Subtract the tax in (2) from the tax shown on your return for the earlier year. This is the credit.
4) Subtract the answer in (3) from the tax for 2011 figured without the deduction (Step 1).

If method 1 results in less tax, deduct the amount repaid. If method 2 results in less tax, claim a credit for the amount repaid on line 71 of Form 1040, and write "I.R.C. 1341" next to line 71.

XI. <u>Royalties</u>

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income.

You generally report royalties in Part I of Schedule E (Form 1040). However, if you hold an operating oil, gas, or mineral interest or are in business as a self-employed writer, inventor, artist, etc., report your income and expenses on Schedule C or Schedule C-EZ (Form 1040).

Copyrights and patents. Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

Oil, gas, and minerals. Royalty income from oil, gas, and mineral properties is the amount you receive when natural resources are extracted from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

Depletion. If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance.

Coal and iron ore. Under certain circumstances, you can treat amounts you receive from the disposal of coal and iron ore as payments from the sale of a capital asset, rather than as royalty income.

Sale of property interest. If you sell your complete interest in oil, gas, or mineral rights, the amount you receive is considered payment for the sale of section 1231 property, not royalty income. Under certain circumstances, the sale is subject to capital gain or loss treatment on Schedule D (Form 1040). For more information on selling section 1231 property, see chapter 3 of Publication 544. If you retain a royalty, an overriding royalty, or a net profit interest in a mineral property for the life of the property, you have made a lease or a sublease, and any cash you receive for the assignment of other interests in the property is ordinary income subject to a depletion allowance.

Part of future production sold. If you own mineral property but sell part of the future production, you generally treat the money you receive from the buyer at the time of the sale as a loan from the buyer. Do not include it in your income or take depletion based on it.

When production begins, you include all the proceeds in your income, deduct all the production expenses, and deduct depletion from that amount to arrive at your taxable income from the property.

XII. Unemployment Benefits

The tax treatment of unemployment benefits you receive depends on the type of program paying the benefits.

Unemployment compensation. You must include in your income all unemployment compensation you received. You should receive a Form 1099-G, *Certain Government Payments,* showing the amount paid to you. The amount must be reported on line 19 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ. If married filing jointly, include any unemployment compensation received by your spouse.

Types of unemployment compensation. Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or of a state. It includes the following benefits.

- Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
- State unemployment insurance benefits.
- Railroad unemployment compensation benefits.
- Disability payments from a government program paid as a ***substitute*** for unemployment compensation. (Amounts received as workers' compensation for injuries or illness are ***not*** unemployment compensation. See chapter 5 for more information.)
- Trade readjustment allowances under the Trade Act of 1974.
- Unemployment assistance under the Disaster Relief and Emergency Assistance Act.

Governmental program. If you contribute to a governmental unemployment compensation program and your contributions are not deductible, amounts you receive under the program are not included as unemployment compensation until you recover your contributions. If you deducted all of your contributions to the program, the entire amount you receive under the program is included in your income.

Repayment of unemployment compensation, If you repaid in 2011 unemployment compensation you received in 2011, subtract the amount you repaid from the total amount you received and enter the difference on line 19 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ. On the dotted line next to your entry enter "Repaid" and the amount you repaid. If you repaid unemployment compensation in 2011 that you included in income in an earlier year, you can deduct the amount repaid on Schedule A (Form 1040), line 23, if you itemize deductions. If the amount is more than $3,000, see *Repayments*, earlier.

Tax withholding. You can choose to have federal income tax withheld from your unemployment compensation. To make this choice, complete Form W-4V, *Voluntary Withholding Request,* and give it to the paying office. Tax will be withheld at 10% of your payment.

Supplemental unemployment benefits. Benefits received from an employer-financed fund (to which the employees did not contribute) are not unemployment compensation. They are taxable as wages and are subject to withholding for income tax. They may be subject to social security and Medicare taxes. For more information, see *Supplemental Unemployment Benefits* in section

5 of Publication 15-A, *Employer's Supplemental Tax Guide*. Report these payments on line 7 of Form 1040 or Form 1040A or on line 1 of Form 1040EZ.

Repayment of benefits. You may have to repay some of your supplemental unemployment benefits to qualify for trade readjustment allowances under the Trade Act of 1974. If you repay supplemental unemployment benefits in the same year you receive them, reduce the total benefits by the amount you repay. If you repay the benefits in a later year, you must include the full amount of the benefits received in your income for the year you received them.

Deduct the repayment in the later year as an adjustment to gross income on Form 1040. (You cannot use Form 1040A or Form 1040EZ.) Include the repayment on line 36 of Form 1040, and write "Sub-Pay TRA" and the amount on the dotted line next to line 36. If the amount you repay in a later year is more than $3,000, you may be able to take a credit against your tax for the later year instead of deducting the amount repaid. For more information on this, see *Repayments,* earlier.

Private unemployment fund. Unemployment benefit payments from a private fund to which you voluntarily contribute are taxable only if the amounts you receive are more than your total payments into the fund. Report the taxable amount on line 21 of Form 1040.

Payments by a union. Benefits paid to you as an unemployed member of a union from regular union dues are included in your gross income on line 21 of Form 1040. However, if you contribute to a special union fund and your payments to the fund are not deductible, the unemployment benefits you receive from the fund are includible in your income only to the extent they are more than your contributions.

Guaranteed annual wage. Payments you receive from your employer during periods of unemployment, under a union agreement that guarantees you full pay during the year, are taxable as wages. Include them on line 7 of Form 1040 or Form 1040A or on line 1 of Form 1040EZ.

State employees. Payments similar to a state's unemployment compensation may be made by the state to its employees who are not covered by the state's unemployment compensation law. Although the payments are fully taxable, do not report them as unemployment compensation. Report these payments on line 21 of Form 1040.

XIII. <u>Welfare and Other Public Assistance Benefits</u>

Do not include in your income benefit payments from a public welfare fund, such as payments due to blindness. Payments from a state fund for the victims of crime should not be included in the victims' incomes if they are in the nature of welfare payments. Do not deduct medical expenses that are reimbursed by such a fund. You must include in your income any welfare payments obtained fraudulently.

Persons with disabilities. If you have a disability, you must include in income compensation you receive for services you perform unless the compensation is otherwise excluded. However, you do not include in income the value of goods, services, and cash that you receive, not in return for your services, but for your training and rehabilitation because you have a disability. Excludable amounts include payments for transportation and attendant care, such as interpreter services for the deaf, reader services for the blind, and services to help mentally retarded persons do their work.

Disaster relief grants. Do not include post-disaster grants received under the Disaster Relief and Emergency Assistance Act in your income if the grant payments are made to help you meet necessary expenses or serious needs for medical, dental, housing, personal property, transportation, or funeral expenses. Do not deduct casualty losses or medical expenses that are specifically reimbursed by these disaster relief grants. If you have deducted a casualty loss for the loss of your personal residence and you later receive a disaster relief grant for the loss of the same residence, you may have to include part or all of the grant in your taxable income. See *Recoveries*, earlier. Unemployment assistance payments under the Act are taxable unemployment compensation. See *Unemployment compensation* under *Unemployment Benefits*, earlier.

Mortgage assistance payments. Payments made under section 235 of the National Housing Act for mortgage assistance are not included in the homeowner's income. Interest paid for the homeowner under the mortgage assistance program cannot be deducted.

Nutrition Program for the Elderly. Food benefits you receive under the Nutrition Program for the Elderly are not taxable. If you prepare and serve free meals for the program, include in your income as wages the cash pay you receive, even if you are also eligible for food benefits.

Payments to reduce cost of winter energy. Payments made by a state to qualified people to reduce their cost of winter energy use are not taxable.

XIV. Other Income

The following brief discussions are arranged in alphabetical order. Income items that are discussed in greater detail in another publication include a reference to that publication.

Activity not for profit. You must include on your return income from an activity from which you do not expect to make a profit. An example of this type of activity is a hobby or a farm you operate mostly for recreation and pleasure. Enter this income on line 21 of Form 1040. Deductions for expenses related to the activity are limited. They cannot total more than the income you report and can be taken only if you itemize deductions on Schedule A (Form 1040).

Alaska Permanent Fund dividend income. If you received a payment from Alaska's mineral income fund (Alaska Permanent Fund dividend), report it as income on line 21 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ. The state of Alaska sends each recipient a document that shows the amount of the payment with the check. The amount is also reported to IRS.

Alimony. Include in your income on line 11 of Form 1040 any alimony payments you receive. Amounts you receive for child support are not income to you. Alimony and child support payments are discussed in chapter 18.

Campaign contributions. These contributions are not income to a candidate unless they are diverted to his or her personal use. To be exempt from tax, the contributions must be spent for campaign purposes or kept in a fund for use in future campaigns. However, interest earned on bank deposits, dividends received on contributed securities, and net gains realized on sales of contributed securities are taxable and must be reported on Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations.* Excess campaign funds transferred to an office account must be included in the officeholder's income on line 21 of Form 1040 in the year transferred.

Cash rebates. A cash rebate you receive from a dealer or manufacturer of an item you buy is not income, but you must reduce your basis by the amount of the rebate.

Example. You buy a new car for $24,000 cash and receive a $2,000 rebate check from the manufacturer. The $2,000 is not income to you. Your cost is $22,000. This is your basis on which you figure gain or loss if you sell the car, and depreciation if you use it for business.

Court awards and damages. To determine if settlement amounts you receive by compromise or judgment must be included in your income, you must consider the item that the settlement replaces. The character of the income as ordinary income or capital gain depends on the nature of the underlying claim. Include the following as ordinary income.

1) Interest on any award.
2) Compensation for lost wages or lost profits in most cases.
3) Punitive damages. It does not matter if they relate to a physical injury or physical sickness.
4) Amounts received in settlement of pension rights (if you did not contribute to the plan).
5) Damages for:
   a) Patent or copyright infringement,
   b) Breach of contract, or
   c) Interference with business operations.
6) Back pay and damages for emotional distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.
7) Attorney fees and costs (including contingent fees) where the underlying recovery is included in gross income.

Do not include in your income compensatory damages for personal physical injury or physical sickness (whether received in a lump sum or installments).

Emotional distress. Damages you receive for emotional distress due to a physical injury or sickness are treated as received for the physical injury or sickness. Do not include them in your income. If the emotional distress is due to a personal injury that is unrelated to a physical injury or sickness (for example, employment discrimination or injury to reputation), you must include the damages in your income, except for any damages you receive for medical care due to that emotional distress. Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

Credit card insurance. Generally, if you receive benefits under a credit card disability or unemployment insurance plan, the benefits are taxable to you. These plans make the minimum monthly payment on your credit card account if you cannot make the payment due to injury, illness, disability, or unemployment. Report on line 21 of Form 1040 the amount of benefits you received during the year that is more than the amount of the premiums you paid during the year.

Energy conservation subsidies. You can exclude from gross income any subsidy provided, either directly or indirectly, by public utilities for the purchase or installation of an energy conservation measure for a dwelling unit.

Energy conservation measure. This includes installations or modifications that are primarily designed to reduce consumption of electricity or natural gas, or improve the management of energy demand.

Dwelling unit. This includes a house, apartment, condominium, mobile home, boat, or similar property. If a building or structure contains both dwelling and other units, any subsidy must be properly allocated.

Estate and trust income. An estate or trust, unlike a partnership, may have to pay federal income tax. If you are a beneficiary of an estate or trust, you may be taxed on your share of its income distributed or required to be distributed to you. However, there is never a double tax.

Estates and trusts file their returns on Form 1041, *U.S. Income Tax Return for Estates and Trusts,* and your share of the income is reported to you on Schedule K-1 of Form 1041.

Current income required to be distributed. If you are the beneficiary of a trust that must distribute all of its current income, you must report your share of the distributable net income, whether or not you actually received it.

Current income not required to be distributed. If you are the beneficiary of an estate or trust and the fiduciary has the choice of whether to distribute all or part of the current income, you must report:

- All income that is required to be distributed to you, whether or not it is actually distributed, plus
- All other amounts actually paid or credited to you, up to the amount of your share of distributable net income.

How to report. Treat each item of income the same way that the estate or trust would treat it. For example, if a trust's dividend income is distributed to you, you report the distribution as dividend income on your return. The same rule applies to distributions of tax-exempt interest and capital gains. The fiduciary of the estate or trust must tell you the type of items making up your share of the estate or trust income and any credits you are allowed on your individual income tax return.

Losses. Losses of estates and trusts generally are not deductible by the beneficiaries.

Grantor trust. Income earned by a grantor trust is taxable to the grantor, not the beneficiary, if the grantor keeps certain control over the trust. (The grantor is the one who transferred property to the trust.) This rule applies if the property (or income from the property) put into the trust will or may revert (be returned) to the grantor or the grantor's spouse.

Generally, a trust is a grantor trust if the grantor has a reversionary interest valued (at the date of transfer) at more than 5% of the value of the transferred property.

Fees for services. Include all fees for your services in your income. Examples of these fees are amounts you receive for services you perform as:

- A corporate director,
- An executor, administrator, or personal representative of an estate,
- A manager of a trade or business you operated before declaring Chapter 11 bankruptcy,
- A notary public, or
- An election precinct official.

Nonemployee compensation. If you are ***not an employee*** and the fees for your services from the same payer total $600 or more for the year, you may receive a Form 1099-MISC. You may need to report your fees as self-employment income.

Corporate director. Corporate director fees are self-employment income. Report these payments on Schedule C or Schedule C-EZ (Form 1040).

Personal representatives. All personal representatives must include in their gross income fees paid to them from an estate. If you are not in the trade or business of being an executor (for instance, you are the executor of a friend's or relative's estate), report these fees on line 21 of Form 1040. If you provide the services as a trade or business, report them as self-employment income on Schedule C or Schedule C-EZ (Form 1040). The fee is not includible in income if it is waived.

Foster-care providers. Payments you receive from a state, political subdivision, or a qualified foster care placement agency for providing care to qualified foster individuals in your home generally are not included in your income. However, you must include in your income payments received for the care of more than 5 individuals age 19 or older and certain difficulty-of-care payments.

A qualified foster individual is a person who:

1) Is living in a foster family home, and
2) Was placed there by:
   a) An agency of a state or one of its political subdivisions, or
   b) A qualified foster care placement agency.

Difficulty-of-care payments. These are additional payments that are designated by the payer as compensation for providing the additional care that is required for physically, mentally, or emotionally handicapped qualified foster individuals. A state must determine that the additional compensation is needed, and the care for which the payments are made must be provided in your home. You must include in your income difficulty-of-care payments received for more than:

- 10 qualified foster individuals under age 19, or
- 5 qualified foster individuals age 19 or older.

Maintaining space in home. If you are paid to maintain space in your home for emergency foster care, you must include the payment in your income.

Free tour. If you received a free tour from a travel agency for organizing a group of tourists, you must include its value in your income. Report the fair market value of the tour on line 21 of Form 1040 if you are not in the trade or business of organizing tours. You cannot deduct your expenses in serving as the voluntary leader of the group at the group's request. If you organize tours as a trade or business, report the tour's value on Schedule C or Schedule C-EZ (Form 1040).

Gambling winnings. You must include your gambling winnings in income on line 21 of Form 1040. If you itemize your deductions on Schedule A (Form 1040), you can deduct gambling losses you had during the year, but only up to the amount of your winnings. See chapter 28 for information on recordkeeping.

Lotteries and raffles. Winnings from lotteries and raffles are gambling winnings. In addition to cash winnings, you must include in your income the fair market value of bonds, cars, houses, and other noncash prizes.

Form W-2G. You may have received a Form W-2G, *Certain Gambling Winnings,* showing the amount of your gambling winnings and any tax taken out of them. Include the amount from box 1 on the "Other Income" line of Form 1040. Include the amount shown in box 2 on your Form 1040 as federal income tax withheld.

Gifts and inheritances. Generally, property you receive as a gift, bequest, or inheritance is not included in your income. However, if property you receive this way later produces income such as interest, dividends, or rents, that income is taxable to you. If property is given to a trust and the income from it is paid, credited, or distributed to you, that income is also taxable to you. If the gift, bequest, or inheritance is the income from the property, that income is taxable to you.

Inherited pension or IRA. If you inherited a pension or an individual retirement arrangement (IRA), you may have to include part of the inherited amount in your income. See chapter 10 if you inherited a pension. See chapter 17 if you inherited an IRA.

Hobby losses. Losses from a hobby are not deductible from other income. A hobby is an activity from which you do not expect to make a profit. See *Activity not for profit,* earlier.

Indian fishing rights. If you are a member of a qualified Indian tribe that has fishing rights secured by treaty, executive order, or an Act of Congress as of March 17, 1988, do not include in your income amounts you receive from activities related to those fishing rights. The income is not subject to income tax, self-employment tax, or employment taxes.

Interest on frozen deposits. In general, you exclude from your income the amount of interest earned on a frozen deposit. See *Interest income on frozen deposits* in chapter 7.

Interest on qualified savings bonds. You may be able to exclude from income the interest from qualified U.S. savings bonds you redeem if you pay qualified higher educational expenses in the same year. For more information on this exclusion, see *Education Savings Bond Program* under *U.S. Savings Bonds* in chapter 7.

Job interview expenses. If a prospective employer asks you to appear for an interview and either pays you an allowance or reimburses you for your transportation and other travel expenses, the amount you receive is generally not taxable. You include in income only the amount you receive that is more than your actual expenses.

Jury duty. Jury duty pay you receive must be included in your income on line 21 of Form 1040. If you must give the pay to your employer because your employer continues to pay your salary while you serve on the jury, you can deduct the amount turned over to your employer as an adjustment to your income. Include the amount you repay your employer on line 36 of Form 1040.

Kickbacks. You must include kickbacks, side commissions, push money, or similar payments you receive in your income on line 21 of Form 1040, or on Schedule C or Schedule C-EZ (Form 1040), if from your self-employment activity.

Example. You sell cars and help arrange car insurance for buyers. Insurance brokers pay back part of their commissions to you for referring customers to them. You must include the kickbacks in your income.

Medical savings accounts (MSAs). You generally do not include in income amounts you withdraw from your Archer MSA or Medicare Advantage MSA if you use the money to pay for qualified medical expenses. Generally, qualified medical expenses are those you can deduct on Schedule A (Form 1040), *Itemized Deductions.* For more information about qualified medical expenses, see chapter 21. For more information about Archer MSAs or Medicare Advantage MSAs, see Publication 969, *Health Savings Accounts and Other Tax-Favored Health Plans*.

Prizes and awards. If you win a prize in a lucky number drawing, television or radio quiz program, beauty contest, or other event, you must include it in your income. For example, if you win a $50 prize in a photography contest, you must report this income on line 21 of Form 1040. If you refuse to accept a prize, do not include its value in your income.

Prizes and awards in goods or services must be included in your income at their fair market value.

Employee awards or bonuses. Cash awards or bonuses given to you by your employer for good work or suggestions generally must be included in your income as wages. However, certain noncash employee achievement awards can be excluded from income.

Pulitzer, Nobel, and similar prizes. If you were awarded a prize in recognition of past accomplishments in religious, charitable, scientific, artistic, educational, literary, or civic fields, you generally must include the value of the prize in your income. However, you do not include this prize in your income if you meet ***all*** of the following requirements.

- You were selected without any action on your part to enter the contest or proceeding.
- You are not required to perform substantial future services as a condition to receiving the prize or award.
- The prize or award is transferred by the payer directly to a governmental unit or tax-exempt charitable organization as designated by you.

Qualified tuition programs. A qualified tuition program (also known as a 529 plan or program) is a program set up to allow you to either prepay, or contribute to an account established for paying, a student's ***qualified higher education expenses*** at an ***eligible educational institution***.

The part of a distribution representing the amount paid or contributed to a QTP is not included in income. This is a return of the investment in the program.

The beneficiary generally does not include in income any earnings distributed from a QTP established and maintained by a state (or an agency or instrumentality of the state) if the total distribution is less than or equal to adjusted qualified higher education expenses.

Railroad retirement annuities. The following types of payments are treated as pension or annuity income and are taxable under the rules explained in chapter 11.

- Tier 1 railroad retirement benefits that are more than the ***social security equivalent benefit.***
- Tier 2 benefits.
- Vested dual benefits.

Sale of home. You may be able to exclude from income all or part of any gain from the sale or exchange of a personal residence. See chapter 15.

Sale of personal items. If you sold an item you owned for personal use, such as a car, refrigerator, furniture, stereo, jewelry, or silverware, your gain is taxable as a capital gain. Report it on Schedule D (Form 1040). You cannot deduct a loss.

However, if you sold an item you held for investment, such as gold or silver bullion, coins, or gems, any gain is taxable as a capital gain and any loss is deductible as a capital loss.

Scholarships and fellowships. A candidate for a degree can exclude amounts received as a qualified scholarship or fellowship. A qualified scholarship or fellowship is any amount you receive that is for:

- Tuition and fees to enroll at or attend an educational institution, or
- Fees, books, supplies, and equipment required for courses at the educational institution.

Amounts used for room and board ***do not*** qualify for the exclusion.

VA payments. Allowances paid by the Department of Veterans Affairs are not included in your income. These allowances are not considered scholarship or fellowship grants.

Prizes. Scholarship prizes won in a contest are not scholarships or fellowships if you do not have to use the prizes for educational purposes. You must include these amounts in your income on line 21 of Form 1040, whether or not you use the amounts for educational purposes.

Transporting school children. Do not include in your income a school board mileage allowance for taking children to and from school if you are not in the business of taking children to school. You cannot deduct expenses for providing this transportation.

Union benefits and dues. Amounts deducted from your pay for union dues, assessments, contributions, or other payments to a union cannot be excluded from your income.

You may be able to deduct some of these payments as a miscellaneous deduction subject to the 2% limit if they are related to your job and if you itemize your deductions on Schedule A (Form 1040). For more information, see *Union Dues and Expenses* in chapter 28.

Strike and lockout benefits. Benefits paid to you by a union as strike or lockout benefits, including both cash and the fair market value of other property, are usually included in your income as compensation. You can exclude these benefits from your income only when the facts clearly show that the union intended them as gifts to you.

Utility rebates. If you are a customer of an electric utility company and you participate in the utility's energy conservation program, you may receive on your monthly electric bill either:

- A reduction in the purchase price of electricity furnished to you (rate reduction), or
- A nonrefundable credit against the purchase price of the electricity.

The amount of the rate reduction or nonrefundable credit is not included in your income.

CHAPTER 12 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Since there is not an exchange for cash, bartering is not considered income for tax purposes.

   a) true
   b) false

2. Which of the following recoveries would generally not be added to other income on a taxpayer's federal income tax return:

   a) federal income tax refunds
   b) state income tax refunds
   c) previously deducted bad debts
   d) any recovery amount previously claimed as a tax credit item

3. You must include in your income unemployment compensation (subject to exclusions) that you receive. Which of the following payments is not a type of unemployment compensation:

   a) benefits paid from the Federal Unemployment Trust Fund
   b) benefits paid from state unemployment insurance benefits
   c) trade readjustment allowances under the Trade Act of 1974
   d) payments from a worker's compensation fund for a work-related injury

4. Benefits paid to you by a union as strike or lockout benefits are always included in your income as compensation.

   a) true
   b) false

CHAPTER 12 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. You must include in your income, at the time received, the fair market value of property or services you receive in bartering.

   B: False is correct. Generally, you report barter income on Schedule C, Form 1040. If the barter involves an exchange of something other than services, you may have to use another form or schedule instead.

2. **A: Correct**. Refunds of federal income taxes paid are not included in income because they are never allowed as a deduction from income.

   B: Incorrect. Generally, if a taxpayer receives a state income tax refund in which he deducted the tax in an earlier year, then the recovery must be included as income for the year received.

   C: Incorrect. Recoveries of non-itemized deductions, such as payments received on previously deducted bad debts, are generally income for the taxpayer in the year of receipt.

   D: Incorrect. A later recovery of items previously taken as a tax credit become income in the year of receipt.

3. A: Incorrect. Benefits paid from the Federal Unemployment Trust Fund are categorized as unemployment benefits and must be reported as taxable income, subject to exclusions.

   B: Incorrect. Benefits paid by state unemployment insurance funds are categorized as unemployment benefits and must be reported as taxable income, subject to any exclusions.

   C: Incorrect. Payments made under the 1974 Trade Act are considered unemployment compensation within this context.

   D: Correct. Disability payments paid as worker's compensation for injury or illness is not unemployment compensation.

4. A: True is incorrect. Usually, benefits paid to you by a union as strike or lockout benefits, including both cash and the fair market value of other property, are included in your income as compensation.

   B: False is correct. You can exclude these benefits from your income only when the facts clearly show that the union intended them as gifts to you.

PART THREE. GAINS AND LOSSES

The four chapters in this part discuss investment gains and losses, including how to figure your basis in property. A gain from selling or trading stocks, bonds, or other investment property may be taxed or it may be tax free, at least in part. A loss may or may not be deductible. These chapters also discuss gains from selling property you personally use -- including the special rules for selling your home. Nonbusiness casualty and theft losses are discussed in chapter 25 in Part Five.

Chapter 13: Basis of Property

I. Introduction

This chapter discusses how to figure your basis in property. It is divided into the following sections.

- Cost basis.
- Adjusted basis.
- Basis other than cost.

Basis is the amount of your investment in property for tax purposes. Use the basis of property to figure gain or loss on the sale, exchange, or other disposition of property. Also use it to figure deductions for depreciation, amortization, depletion, and casualty losses.

If you use property for both business and personal purposes, you must allocate the basis based on the use. Only the basis allocated to the business use of the property can be depreciated.

Your original basis in property is adjusted (increased or decreased) by certain events. If you make improvements to the property, increase your basis. If you take deductions for depreciation or casualty losses, reduce your basis.

II. Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay in cash, debt obligations, other property, or services. Your cost also includes amounts you pay for the following items.

- Sales tax.
- Freight.
- Installation and testing.
- Excise taxes.
- Legal and accounting fees (when they must be capitalized).
- Revenue stamps.
- Recording fees.
- Real estate taxes (if assumed for the seller).

In addition, the basis of real estate and business assets may include other items.

Loans with low or no interest. If you buy property on a time-payment plan that charges little or no interest, the basis of your property is your stated purchase price minus any amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the applicable federal rate.

REAL PROPERTY

Real property, also called real estate, is land and generally anything built on, growing on, or attached to land.

If you buy real property, certain fees and other expenses you pay are part of your cost basis in the property.

Lump sum purchase. If you buy buildings and the land on which they stand for a lump sum, allocate the basis among the land and the buildings so you can figure the allowable depreciation on the buildings. Land is not depreciable. Allocate the cost according to the fair market values of the land and buildings at the time of purchase. Figure the basis of each asset by multiplying the lump sum by a fraction. The numerator is the FMV of that asset and the denominator is the FMV of the whole property at the time of purchase.

Fair market value (FMV) is the price at which the property would change hands between a willing buyer and a willing seller, neither having to buy or sell, who both have reasonable knowledge of all the necessary facts. Sales of similar property on or about the same date may be helpful in figuring the FMV of the property.

Assumption of mortgage. If you buy property and assume (or buy subject to) an existing mortgage on the property, your basis includes the amount you pay for the property plus the amount to be paid on the mortgage.

Settlement costs. You can include in the basis of property you buy the settlement fees and closing costs for buying the property. (A fee for buying property is a cost that must be paid even if you buy the property for cash.) You cannot include fees and costs for getting a loan on the property in your basis.

The following are some of the settlement fees or closing costs you can include in the basis of your property.

- Abstract fees (abstract of title fees).
- Charges for installing utility services.
- Legal fees (including title search and preparation of the sales contract and deed).
- Recording fees.
- Survey fees.
- Transfer taxes.
- Owner's title insurance.
- Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Settlement costs ***do not include*** amounts placed in escrow for the future payment of items such as taxes and insurance.

The following are some of the settlement fees and closing costs you ***cannot*** include in the basis of property.

1) Casualty insurance premiums.
2) Rent for occupancy of the property before closing.
3) Charges for utilities or other services related to occupancy of the property before closing.
4) Charges connected with getting a loan. The following are examples of these charges.
   a) Points (discount points, loan origination fees).
   b) Mortgage insurance premiums.
   c) Loan assumption fees.
   d) Cost of a credit report.
   e) Fees for an appraisal required by a lender.
5) Fees for refinancing a mortgage.

Real estate taxes. If you pay real estate taxes the seller owed on real property you bought, and the seller did not reimburse you, treat those taxes as part of your basis. You cannot deduct them as an expense.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct that amount as an expense in the year of purchase. Do not include that amount in the basis of your property. If you did not reimburse the seller, you must reduce your basis by the amount of those taxes.

Points. If you pay points to get a loan (including a mortgage, second mortgage, line of credit, or a home equity loan), do not add the points to the basis of the related property. Generally, you deduct the points over the term of the loan. For more information, see *Points* in chapter 23.

Points on home mortgage. Special rules may apply to points you and the seller pay when you get a mortgage to buy your main home. If certain requirements are met, you can deduct the points in full for the year in which they are paid. Reduce the basis of your home by any seller-paid points.

III. Adjusted Basis

Before figuring gain or loss on a sale, exchange, or other disposition of property or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the cost of the property. The result is the adjusted basis.

Table 13-1. Examples of Adjustments to Basis

Increases to Basis	Decreases to Basis
• Capital improvements: Putting an addition on your home Replacing an entire roof Paving your driveway Installing central air conditioning Rewiring your home • Assessments for local improvements: Water connections Extending utility service lines to the property Sidewalks Roads • Casualty losses: Restoring damaged property • Legal fees: Cost of defending and perfecting a title Fees for getting a reduction of an assessment • Zoning costs	• Exclusion from income of subsidies for energy conservation measures • Casualty or theft loss deductions and insurance reimbursements • Postponed gain from the sale of a home • Alternative motor vehicle credit • Alternative fuel vehicle refueling property credit • Residential energy credits • Depreciation and section 179 deduction • Nontaxable corporate distributions • Certain canceled debt excluded from income • Easements • Adoption tax benefits

INCREASES TO BASIS

Increase the basis of any property by all items properly added to a capital account. Examples of items that increase basis are shown in Table 13-1.

Improvements. Add the cost of improvements to your basis in the property if they increase the value of the property, lengthen its life, or adapt it to a different use. For example, improvements include putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, installing a new roof, or paving your driveway.

Assessments for local improvements. Add assessments for improvements such as streets and sidewalks to the basis of the property if they increase the value of the property assessed. Do not deduct them as taxes. However, you can deduct as taxes assessments for maintenance, repairs, or interest charges on the improvements.

Example. Your city changes the street in front of your store into an enclosed pedestrian mall and assesses you and other affected property owners for the cost of the conversion. Add the assessment to your property's basis. In this example, the assessment is a depreciable asset.

DECREASES TO BASIS

Decrease the basis of any property by all items that represent a return of capital for the period during which you held the property. Examples of items that decrease basis are shown in Table 13-1.

Casualty and theft losses. If you have a casualty or theft loss, decrease the basis in your property by any insurance proceeds or other reimbursement and by any deductible loss not covered by insurance.

You must increase your basis in the property by the amount you spend on repairs that restore the property to its pre-casualty condition.

Depreciation and section 179 deduction. Decrease the basis of your qualifying business property by any section 179 deduction you take and the depreciation you deducted, or could have deducted, on your tax returns under the method of depreciation you selected.

Example. You owned a duplex used as rental property that cost you $40,000, of which $35,000 was allocated to the building and $5,000 to the land. You added an improvement to the duplex that cost $10,000. In February last year the duplex was damaged by fire. Up to that time you had been allowed depreciation of $23,000. You sold some salvaged material for $1,300 and collected $19,700 from your insurance company. You deducted a casualty loss of $1,000 on your income tax return for last year. You spent $19,000 of the insurance proceeds for restoration of the duplex, which was completed this year. You must use the duplex's adjusted basis after the restoration to determine depreciation for the rest of the property's recovery period. Figure the adjusted basis of the duplex as follows:

Original cost of duplex		$35,000
Addition to duplex		10,000
Total cost of duplex		$45,000
Minus: Depreciation		23,000
Adjusted basis before casualty		$22,000
Minus: Insurance proceeds	$19,700	
Deducted casualty loss	1,000	
Salvage proceeds	1,300	22,000
Adjusted basis after casualty		-0-
Add: Cost of restoring duplex		$19,000
Adjusted basis after restoration		**$19,000**

Your basis in the land is its original cost of $5,000.

Easements. The amount you receive for granting an easement is generally considered to be from the sale of an interest in real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis in that part to zero and treat the excess as a recognized gain.

Exclusion of subsidies for energy conservation measures. You can exclude from gross income any subsidy you received from a public utility company for the purchase or installation of an energy conservation measure for a dwelling unit. Reduce the basis of the property for which you received the subsidy by the excluded amount. For more information about this subsidy, see chapter 12.

Postponed gain from sale of home. If you postponed gain from the sale of your main home under rules in effect before May 7, 1997, you must reduce the basis of the home you acquired as a replacement by the amount of the postponed gain.

IV. Basis Other Than Cost

There are many times when you cannot use cost as basis. In these cases, the fair market value or the adjusted basis of the property can be used. Fair market value (FMV) and adjusted basis were discussed earlier.

PROPERTY RECEIVED FOR SERVICES

If you receive property for your services, include its FMV in income. The amount you include in income becomes your basis. If the services were performed for a price agreed on beforehand, it will be accepted as the FMV of the property if there is no evidence to the contrary.

Restricted property. If you receive property for your services and the property is subject to certain restrictions, your basis in the property is its FMV when it becomes substantially vested. However, this rule does not apply if you make an election to include in income the FMV of the property at the time it is transferred to you, less any amount you paid for it. Property becomes substantially vested when your rights in the property or the rights of any person to whom you transfer the property are not subject to a substantial risk of forfeiture.

Bargain purchases. A bargain purchase is a purchase of an item for less than its FMV. If, as compensation for services, you buy goods or other property at less than FMV, include the difference between the purchase price and the property's FMV in your income. Your basis in the property is its FMV (your purchase price plus the amount you include in income).

If the difference between your purchase price and the FMV is a qualified employee discount, do not include the difference in income. However, your basis in the property is still its FMV.

TAXABLE EXCHANGES

A taxable exchange is one in which the gain is taxable or the loss is deductible. A taxable gain or deductible loss also is known as a recognized gain or loss. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its FMV at the time of the exchange.

INVOLUNTARY CONVERSIONS

If you receive property as a result of an involuntary conversion, such as a casualty, theft, or condemnation, you can figure the basis of the replacement property using the basis of the converted property.

Similar or related property. If you receive property similar or related in service or use to the converted property, the replacement property's basis is the same as the converted property's basis on the date of the conversion, with the following adjustments.

1) Decrease the basis by the following.
    a) Any loss you recognize on the involuntary conversion.
    b) Any money you receive that you do not spend on similar property.
2) Increase the basis by the following.
    a) Any gain you recognize on the involuntary conversion.
    b) Any cost of acquiring the replacement property.

Money or property not similar or related. If you receive money or property not similar or related in service or use to the converted property, and you buy replacement property similar or related in service or use to the converted property, the basis of the replacement property is its cost decreased by the gain not recognized on the conversion.

Example. The state condemned your property. The adjusted basis of the property was $26,000 and the state paid you $31,000 for it. You realized a gain of $5,000 ($31,000 - $26,000). You bought replacement property similar in use to the converted property for $29,000. You recognize a gain of $2,000 ($31,000 - $29,000), the unspent part of the payment from the state. Your unrecognized gain is $3,000, the difference between the $5,000 realized gain and the $2,000 recognized gain. The basis of the replacement property is figured as follows:

Cost of replacement property	$29,000
Minus: Gain not recognized	3,000
Basis of replacement property	**$26,000**

Allocating the basis. If you buy more than one piece of replacement property, allocate your basis among the properties based on their respective costs.

NONTAXABLE EXCHANGES

A nontaxable exchange is an exchange in which you are not taxed on any gain and you cannot deduct any loss. If you receive property in a nontaxable exchange, its basis is generally the same as the basis of the property you transferred.

Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To qualify as a like-kind exchange, the property traded and the property received must be both of the following.

- Qualifying property.
- Like-kind property.

The basis of the property you receive is generally the same as the basis of the property you gave up. If you trade property in a like-kind exchange and also pay money, the basis of the property received is the basis of the property you gave up increased by the money you paid.

Qualifying property. In a like-kind exchange, you must hold for investment or for productive use in your trade or business both the property you give up and the property you receive.

Like-kind property. There must be an exchange of like property. The exchange of real estate for real estate or personal property for similar personal property are exchanges of like property.

Example. You trade in an old truck used in your business with an adjusted basis of $1,700 for a new one costing $6,800. The dealer allows you $2,000 on the old truck, and you pay $4,800. This is a like-kind exchange. The basis of the new truck is $6,500 (the adjusted basis of the old one, $1,700, plus the amount you paid, $4,800).

If you sell your old truck to a third party for $2,000 instead of trading it in and then buy a new one from the dealer, you have a taxable gain of $300 on the sale ($2,000 sale price minus $1,700 basis). The basis of the new truck is the price you pay the dealer.

Partially nontaxable exchange. A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the total adjusted basis of the property you gave up, with the following adjustments.

1) Decrease the basis by the following amounts.
   a) Any money you receive.
   b) Any loss you recognize on the exchange.
2) Increase the basis by the following amounts.
   a) Any additional costs you incur.
   b) Any gain you recognize on the exchange.

If the other party to the exchange assumes your liabilities, treat the debt assumption as money you received in the exchange.

Allocation of basis. Allocate the basis first to the unlike property, other than money, up to its FMV on the date of the exchange. The rest is the basis of the like-kind property.

PROPERTY TRANSFERRED FROM A SPOUSE

The basis of property transferred to you or transferred in trust for your benefit by your spouse is the same as your spouse's adjusted basis. The same rule applies to a transfer by your former spouse that is incident to divorce. However, adjust your basis for any gain recognized by your spouse or former spouse on property transferred in trust. This rule applies only to a transfer of property in trust in which the liabilities assumed, plus the liabilities to which the property is subject, are more than the adjusted basis of the property transferred.

If the property transferred to you is a series E, series EE, or series I U.S. savings bond, the transferor must include in income the interest accrued to the date of transfer. Your basis in the bond immediately after the transfer is equal to the transferor's basis increased by the interest income includible in the transferor's income. For more information on these bonds, see chapter 7.

At the time of the transfer, the transferor must give you the records needed to determine the adjusted basis and holding period of the property as of the date of the transfer.

PROPERTY RECEIVED AS A GIFT

To figure the basis of property you receive as a gift, you must know its adjusted basis to the donor just before it was given to you, its FMV at the time it was given to you, and any gift tax paid on it.

FMV less than donor's adjusted basis. If the FMV of the property at the time of the gift is less than the donor's adjusted basis, your basis depends on whether you have a gain or a loss when you dispose of the property. Your basis for figuring gain is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you held the property. Your basis for figuring loss is its FMV when you received the gift plus or minus any required adjustments to basis while you held the property. See *Adjusted Basis,* earlier.

Example. You received an acre of land as a gift. At the time of the gift, the land had a FMV of $8,000. The donor's adjusted basis was $10,000. After you received the property, no events occurred to increase or decrease your basis. If you later sell the property for $12,000, you will have a $2,000 gain because you must use the donor's adjusted basis at the time of the gift ($10,000) as your basis to figure gain. If you sell the property for $7,000, you will have a $1,000 loss because you must use the FMV at the time of the gift ($8,000) as your basis to figure loss. If the sales price is between $8,000 and $10,000, you have neither gain nor loss.

Business property. If you hold the gift as business property, your basis for figuring any depreciation, depletion, or amortization deduction is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you hold the property.

FMV equal to or greater than donor's adjusted basis. If the FMV of the property is equal to or greater than the donor's adjusted basis, your basis is the donor's adjusted basis at the time you received the gift. Increase your basis by all or part of any gift tax paid, depending on the date of the gift, explained later.

Also, for figuring gain or loss from a sale or other disposition or for figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis by any required adjustments to basis while you held the property. See *Adjusted Basis,* earlier.

If you received a gift during the tax year, increase your basis in the gift (the donor's adjusted basis) by the part of the gift tax paid on it due to the net increase in value of the gift. Figure the increase by multiplying the gift tax paid by a fraction. The numerator of the fraction is the net increase in value of the gift and the denominator is the amount of the gift.

The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis. The amount of the gift is its value for gift tax purposes after reduction by any annual exclusion and marital or charitable deduction that applies to the gift.

Example. In 2011, you received a gift of property from your mother that had an FMV of $50,000. Her adjusted basis was $20,000. The amount of the gift for gift tax purposes was $37,000 ($50,000 minus the $13,000 annual exclusion). She paid a gift tax of $7,540 on the property. Your basis is $26,107 figured as follows:

Fair market value	$50,000
Minus: adjusted basis	-20,000
Net increase in value	$30,000
Gift tax paid	$ 7,540
Multiplied by ($30,000 ÷ $37,000)	X .81
Gift tax due to net increase in value	$ 6,107
Adjusted basis of property to your mother	+20,000
Your basis in property	$26,107

Note. If you received a gift before 1977, your basis in the gift (the donor's adjusted basis) includes any gift tax paid on it. However, your basis cannot exceed the FMV of the gift at the time it was given to you.

INHERITED PROPERTY

Your basis in property you inherit from a decedent is generally one of the following.

- The FMV of the property at the date of the decedent's death.
- The FMV on the alternate valuation date if the personal representative for the estate elects to use alternate valuation.
- The value under the special-use valuation method for real property used in farming or a closely held business if elected for estate tax purposes.
- The decedent's adjusted basis in land to the extent of the value excluded from the decedent's taxable estate as a qualified conservation easement.

If a federal estate tax return does not have to be filed, your basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

PROPERTY CHANGED TO BUSINESS OR RENTAL USE

If you hold property for personal use and then change it to business use or use it to produce rent, you must figure its basis for depreciation. An example of changing property held for personal use to business use would be renting out your former personal residence.

Basis for depreciation. The basis for depreciation is the lesser of the following amounts.

- The FMV of the property on the date of the change.
- Your adjusted basis on the date of the change.

Example. Several years ago, you paid $160,000 to have your house built on a lot that cost $25,000. You paid $20,000 for permanent improvements to the house and claimed a $2,000 casualty loss deduction for damage to the house before changing the property to rental use last year. Because land is not depreciable, you include only the cost of the house when figuring the basis for depreciation.

Your adjusted basis in the house when you changed its use was $178,000 ($160,000 + $20,000 - $2,000). On the same date, your property had an FMV of $180,000, of which $15,000 was for the land and $165,000 was for the house. The basis for figuring depreciation on the house is its FMV on the date of the change ($165,000) because it is less than your adjusted basis ($178,000).

Sale of property. If you later sell or dispose of property changed to business or rental use, the basis you use will depend on whether you are figuring gain or loss.

Gain. The basis for figuring a gain is your adjusted basis in the property when you sell the property.

Example. Assume the same facts as in the previous example except that you sell the property at a gain after being allowed depreciation deductions of $37,500. Your adjusted basis for figuring gain is $165,500 ($178,000 + $25,000 (land) - $37,500).

Loss. Figure the basis for a loss starting with the smaller of your adjusted basis or the FMV of the property at the time of the change to business or rental use. Then adjust this amount for the period after the change in the property's use, as discussed earlier under *Adjusted Basis*, to arrive at a basis for loss.

Example. Assume the same facts as in the previous example, except that you sell the property at a loss after being allowed depreciation deductions of $37,500. In this case, you would start with the FMV on the date of the change to rental use ($180,000), because it is less than the adjusted basis of $203,000 ($178,000 + $25,000) on that date. Reduce that amount ($180,000) by the depreciation deductions to arrive at a basis for loss of $142,500 ($180,000 - $37,500).

STOCKS AND BONDS

The basis of stocks or bonds you buy generally is the purchase price plus any costs of purchase, such as commissions and recording or transfer fees. If you get stocks or bonds other than by purchase, your basis is usually determined by the FMV or the previous owner's adjusted basis, as discussed earlier.

You must adjust the basis of stocks for certain events that occur after purchase. For example, if you receive additional stock from nontaxable stock dividends or stock splits, divide the adjusted basis of the old stock by the number of shares of old and new stock. This rule applies only when the additional stock received is identical to the stock held. Also reduce your basis when you receive nontaxable distributions. They are a return of capital.

Example. In 2009 you bought 100 shares of XYZ stock for $1,000 or $10 a share. In 2010 you bought 100 shares of XYZ stock for $1,600 or $16 a share. In 2011 XYZ declared a 2-for-1 stock split. You now have 200 shares of stock with a basis of $5 a share and 200 shares with a basis of $8 a share.

Other basis. There are other ways to figure the basis of stocks or bonds depending on how you acquired them.

Identifying stocks or bonds sold. If you can adequately identify the shares of stock or the bonds you sold, their basis is the cost or other basis of the particular shares of stocks or bonds. If you buy and sell securities at various times in varying quantities and you cannot adequately identify the shares you sell, the basis of the securities you sell is the basis of the securities you acquired first.

Mutual fund shares. If you sell mutual funds you acquired at various times and prices and left on deposit in an account kept by a custodian or agent, you can elect to use an average basis.

Bond premium. If you buy a taxable bond at a premium and choose to amortize the premium, reduce the basis of the bond by the amortized premium you deduct each year. See *Bond Premium Amortization* in chapter 3 of Publication 550 for more information. Although you cannot deduct the premium on a tax-exempt bond, you must amortize the premium each year and reduce your basis in the bond by the amortized amount.

Original issue discount (OID) on debt instruments. You must increase your basis in an OID debt instrument by the OID you include in income for that instrument. See *Original Issue Discount* in Chapter 7.

CHAPTER 13 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The cost basis of property you buy is usually the sum of its costs. Which of the following would not be a cost added to the cost basis:

   a) the amount you pay in cash
   b) the amount of debt obligations obtained
   c) other property or services provided
   d) charges connected with getting a loan to purchase the property

2. A nontaxable exchange requires which of the following to be true:

   a) there must be an exchange of some money
   b) one of the properties involved must be qualifying property
   c) both properties are like-kind property
   d) the cost basis of the old and new property must be the same

3. To figure the basis of property you receive as a gift, you only need to know its original basis to the donor.

   a) true
   b) false

4. Your basis in property you inherit from a decedent is always the FMV of the property at the date of the individual's death.

   a) true
   b) false

CHAPTER 13 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The amount of cash paid for a property is part of its cost basis.

   B: Incorrect. Any debt assumed or newly acquired in purchasing property is also a component of its cost basis.

   C: Incorrect. All other property or services provided to a seller to induce them into transferring property is also part of the property's cost basis.

   D: Correct. Fees and/or charges (for example, points, credit reporting, and loan assumption fees) associated with obtaining a loan used to purchase property are not usually added to the property's cost basis.

2. A: Incorrect. There is no requirement for the exchange of money.

   B: Incorrect. A nontaxable exchange requires that both of the properties involved be "qualifying property" as specified in the tax code, not just one of the properties.

   C: Correct. A nontaxable exchange requires that the property involved be "like-kind property" as specified in the tax code.

   D: Incorrect. This is not a condition required for a nontaxable exchange to occur.

3. A: True is incorrect. To figure the basis of property you receive as a gift, you must know its adjusted basis to the donor just before it was given to you, its FMV at the time it was given to you, and any gift tax paid on it.

   B: False is correct. If the FMV of the property at the time of the gift is less than the donor's adjusted basis, your basis depends on whether you have a gain or a loss when you dispose of the property. If the FMV of the property is equal to or greater than the donor's adjusted basis, your basis is the donor's adjusted basis at the time you received the gift.

4. A: True is incorrect. The basis can be the FMV of the property at the date of the individual's death, but it can also be the FMV on the alternate valuation date, the value under the special-use valuation method, or the decedent's adjusted basis in land to the extent of the value excluded from the decedent's taxable estate as a qualified conservation easement.

   B: False is correct. There are a variety of possibilities. If a federal estate tax return does not have to be filed, your basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

Chapter 14: Sale of Property

I. Introduction

This chapter discusses the tax consequences of selling or trading investment property. It explains:

- What is a sale or trade,
- Figuring gain or loss,
- Nontaxable trades,
- Related party transactions,
- Capital gains or losses,
- Capital assets and noncapital assets,
- Holding period, and
- Rollover of gain from publicly traded securities.

II. Sales and Trades

If you sold property such as stocks, bonds, or certain commodities through a broker during the year, you should receive, for each sale, a ***Form 1099-B,*** *Proceeds From Broker and Barter Exchange Transactions,* or an equivalent statement from the broker. You should receive the statement by March 1 of the next year. It will show the gross proceeds from the sale. The IRS will also get a copy of Form 1099-B from the broker.

Use Form 1099-B (or an equivalent statement received from your broker) to complete Schedule D of Form 1040.

Sale and purchase. Ordinarily, a transaction is not a trade when you voluntarily sell property for cash and immediately buy similar property to replace it. The sale and purchase are two separate transactions. But see *Like-kind exchanges* under *Nontaxable Trades,* later.

Redemption of stock. A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

Dividend versus sale or trade. Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

1) The redemption is not essentially equivalent to a dividend (see chapter 8),
2) There is a substantially disproportionate redemption of stock,
3) There is a complete redemption of all the stock of the corporation owned by the shareholder, or
4) The redemption is a distribution in partial liquidation of a corporation.

Redemption or retirement of bonds. A redemption or retirement of bonds or notes at their maturity is generally treated as a sale or trade.

Surrender of stock. A surrender of stock by a dominant shareholder who retains control of the corporation is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must reallocate his or her basis in the surrendered shares to the shares he or she retains.

Worthless securities. Stocks, stock rights, and bonds (other than those held for sale by a securities dealer) that became worthless during the tax year are treated as though they were sold on the last day of the tax year. This affects whether your capital loss is long-term or short-term. See *Holding Period,* later.

To abandon a security, you must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for it. All the facts and circumstances determine whether the transaction is properly characterized as an abandonment or other type of transaction, such as an actual sale or exchange, contribution to capital, dividend, or gift.

If you are a cash basis taxpayer and make payments on a negotiable promissory note that you issued for stock that became worthless, you can deduct these payments as losses in the years you actually make the payments. Do not deduct them in the year the stock became worthless.

How to report loss. Report worthless securities on line 1 or line 8 of Schedule D (Form 1040), whichever applies. In columns (c) and (d), write "Worthless." Enter the amount of your loss in parentheses in column (f).

Filing a claim for refund. If you do not claim a loss for a worthless security on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the loss. You must use Form 1040X, *Amended U.S. Individual Income Tax Return,* to amend your return for the year the security became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in chapter 1.

HOW TO FIGURE GAIN OR LOSS

You figure gain or loss on a sale or trade of property by comparing the amount you realize with the adjusted basis of the property.

Gain. If the amount you realize from a sale or trade is more than the adjusted basis of the property you transfer, the difference is a gain.

Loss. If the adjusted basis of the property you transfer is more than the amount you realize, the difference is a loss.

Adjusted basis. The adjusted basis of property is your original cost or other original basis properly adjusted (increased or decreased) for certain items. See chapter 13 for more information about determining the adjusted basis of property.

Amount realized. The amount you realize from a sale or trade of property is everything you receive for the property. This includes the money you receive plus the fair market value of any property or services you receive.

If you finance the buyer's purchase of your property and the debt instrument does not provide for adequate stated interest, the unstated interest that you must report as ordinary income will reduce the amount realized from the sale.

Fair market value. Fair market value is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts.

Example. You trade A Company stock with an adjusted basis of $7,000 for B Company stock with a fair market value of $10,000, which is your amount realized. Your gain is $3,000 ($10,000 minus $7,000).

Debt paid off. A debt against the property, or against you, that is paid off as a part of the transaction, or that is assumed by the buyer, must be included in the amount realized. This is true even if neither you nor the buyer is personally liable for the debt. For example, if you sell or trade property that is subject to a nonrecourse loan, the amount you realize generally includes the full amount of the note assumed by the buyer even if the amount of the note is more than the fair market value of the property.

Example. You sell stock that you had pledged as security for a bank loan of $8,000. Your basis in the stock is $6,000. The buyer pays off your bank loan and pays you $20,000 in cash. The amount realized is $28,000 ($20,000 plus $8,000). Your gain is $22,000 ($28,000 minus $6,000).

Payment of cash. If you trade property and cash for other property, the amount you realize is the fair market value of the property you receive. Determine your gain or loss by subtracting the cash you pay plus the adjusted basis of the property you traded in from the amount you realize. If the result is a positive number, it is a gain. If the result is a negative number, it is a loss.

No gain or loss. You may have to use a basis for figuring gain that is different from the basis used for figuring loss. In this case, you may have neither a gain nor a loss. See *Basis Other Than Cost* in chapter 13.

NONTAXABLE TRADES

Like-kind exchanges. If you trade business or investment property for other business or investment property of a like kind, you do not pay tax on any gain or deduct any loss until you sell or dispose of the property you receive. To be nontaxable, a trade must meet all six of the following conditions.

1) The property must be business or investment property. You must hold both the property you trade and the property you receive for productive use in your trade or business or for investment. Neither property may be property used for personal purposes, such as your home or family car.
2) The property must not be held primarily for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise.
3) The property must not be stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest, including partnership interests. However, you can have a nontaxable trade of corporate stocks under a different rule, as discussed later.
4) There must be a trade of like property. The trade of real estate for real estate, or personal property for similar personal property is a trade of like property. The trade of an apartment house for a store building, or a panel truck for a pickup truck, is a trade of like property. The trade of a piece of machinery for a store building is not a trade of like property. Real property located in the United States and real property located outside the United States are not like property. Also, personal property used predominantly within the United States and personal property used predominantly outside the United States are not like property.

5) The property to be received must be identified within 45 days after the date you transfer the property given up in the trade.
6) The property to be received must be received by the earlier of:
   a) The 180th day after the date on which you transfer the property given up in the trade, or
   b) The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

If you trade property with a related party in a like-kind exchange, a special rule may apply. See *Related Party Transactions,* later in this chapter.

Partly nontaxable exchange. If you receive cash or unlike property in addition to like property, and the above six conditions are met, you have a partially nontaxable trade. You are taxed on any gain you realize, but only up to the amount of the cash and the fair market value of the unlike property you receive. You cannot deduct a loss.

Like property and unlike property transferred. If you give up unlike property in addition to the like property, you must recognize gain or loss on the unlike property you give up. The gain or loss is the difference between the adjusted basis of the unlike property and its fair market value.

Like property and money transferred. If conditions (1) - (6) are met, you have a nontaxable trade even if you pay money in addition to the like property.

Basis of property received. To figure the basis of the property received, see *Nontaxable Exchanges* in chapter 13.

How to report. You must report the trade of like property on **Form 8824**. If you figure a recognized gain or loss on Form 8824, report it on Schedule D of Form 1040 or on **Form 4797,** *Sales of Business Property,* whichever applies.

Corporate stocks. The following trades of corporate stocks generally do not result in a taxable gain or a deductible loss.

Corporate reorganizations. In some instances, a company will give you common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation. If this is a result of a merger, recapitalization, transfer to a controlled corporation, bankruptcy, corporate division, corporate acquisition, or other corporate reorganization, you do not recognize gain or loss.

Stock for stock of the same corporation. You can exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two stockholders as well as a trade between a stockholder and the corporation.

Convertible stocks and bonds. You generally will not have a recognized gain or loss if you convert bonds into stock or preferred stock into common stock of the same corporation according to a conversion privilege in the terms of the bond or the preferred stock certificate.

Property for stock of a controlled corporation. If you transfer property to a corporation solely in exchange for stock in that corporation, and immediately after the trade you are in control of the corporation, you ordinarily will not recognize a gain or loss. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply if the corporation is an investment company.

For this purpose, to be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock of the corporation.

If this provision applies to you, you must attach to your return a complete statement of all facts pertinent to the exchange.

Insurance policies and annuities. You will not have a recognized gain or loss if you trade:

1) A life insurance contract for another life insurance contract or for an endowment or annuity contract,
2) An endowment contract for an annuity contract or for another endowment contract that provides for regular payments beginning at a date not later than the beginning date under the old contract, or
3) An annuity contract for another annuity contract.

You also may not have to recognize gain or loss on an exchange of a portion of an annuity contract for another annuity contract.

Exchanges of contracts not included in this list, such as an annuity contract for an endowment contract, or an annuity or endowment contract for a life insurance contract, are taxable.

Demutualization of life insurance companies. If you received stock in exchange for your equity interest as a policyholder or an annuitant, you generally will not have a recognized gain or loss.

U.S. Treasury notes or bonds. You can trade certain issues of U.S. Treasury obligations for other issues designated by the Secretary of the Treasury, with no gain or loss recognized on the trade.

TRANSFERS BETWEEN SPOUSES

Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or if incident to a divorce, a former spouse. This nonrecognition rule does not apply if the recipient spouse or former spouse is a nonresident alien. The rule also does not apply to a transfer in trust to the extent the adjusted basis of the property is less than the amount of the liabilities assumed plus any liabilities on the property.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the recipient as a gift and is not considered a sale or exchange. The recipient's basis in the property will be the same as the adjusted basis of the giver immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient. This rule applies for purposes of determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

A transfer of property is incident to a divorce if the transfer occurs within 1 year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage.

RELATED PARTY TRANSACTIONS

Special rules apply to the sale or trade of property between related parties.

Gain on sale or trade of depreciable property. Your gain from the sale or trade of property to a related party may be ordinary income, rather than capital gain, if the property can be depreciated by the party receiving it.

Like-kind exchanges. Generally, if you trade business or investment property for other business or investment property of a like kind, no gain or loss is recognized. See *Like-kind exchanges* earlier under *Nontaxable Trades.*

This rule also applies to trades of property between related parties, defined next under *Losses on sales or trades of property.* However, if either you or the related party disposes of the like property within 2 years after the trade, you both must report any gain or loss not recognized on the original trade on your return filed for the year in which the later disposition occurs.

Losses on sales or trades of property. You cannot deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between you and the following ***related parties.***

1) Members of your family. This includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
2) A partnership in which you directly or indirectly own more than 50% of the capital interest or the profits interest.
3) A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock. (See *Constructive ownership of stock,* later.)
4) A tax-exempt charitable or educational organization that is directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

In addition, a loss on the sale or trade of property is not deductible if the transaction is directly or indirectly between the following related parties.

1) A grantor and fiduciary, or the fiduciary and beneficiary, of any trust.
2) Fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
3) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned by or for the trust, or by or for the grantor of the trust.
4) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership.
5) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
6) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
7) An executor and a beneficiary of an estate (except in the case of a sale or trade to satisfy a pecuniary bequest).
8) Two corporations that are members of the same controlled group. (Under certain conditions, however, these losses are not disallowed but must be deferred.)
9) Two partnerships if the same persons own, directly or indirectly, more than 50% of the capital interests or the profit interests in both partnerships.

Multiple property sales or trades. If you sell or trade to a related party a number of blocks of stock or pieces of property in a lump sum, you must figure the gain or loss separately for each block of stock or piece of property. The gain on each item may be taxable. However, you cannot deduct the loss on any item. Also, you cannot reduce gains from the sales of any of these items by losses on the sales of any of the other items.

Indirect transactions. You cannot deduct your loss on the sale of stock through your broker if, under a prearranged plan, a related party buys the same stock you had owned. This does not apply to a trade between related parties through an exchange that is purely coincidental and is not prearranged.

Constructive ownership of stock. In determining whether a person directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply.

Rule 1. Stock directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

Rule 2. An individual is considered to own the stock that is directly or indirectly owned by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

Rule 3. An individual owning, other than by applying rule 2, any stock in a corporation is considered to own the stock that is directly or indirectly owned by or for his or her partner.

Rule 4. When applying rule 1, 2, or 3, stock constructively owned by a person under rule 1 is treated as actually owned by that person. But stock constructively owned by an individual under rule 2 or rule 3 is not treated as owned by that individual for again applying either rule 2 or rule 3 to make another person the constructive owner of the stock.

Property received from a related party. If you sell or trade at a gain property that you acquired from a related party, you recognize the gain only to the extent it is more than the loss previously disallowed to the related party. This rule applies only if you are the original transferee and you acquired the property by purchase or exchange. This rule does not apply if the related party's loss was disallowed because of the wash sale rules described in chapter 4 of Publication 550 under *Wash Sales.*

If you sell or trade at a loss property that you acquired from a related party, you cannot recognize the loss that was not allowed to the related party.

Example 1. Your brother sells you stock for $7,600. His cost basis is $10,000. Your brother cannot deduct the loss of $2,400. Later, you sell the same stock to an unrelated party for $10,500, realizing a gain of $2,900. Your reportable gain is $500 – the $2,900 gain minus the $2,400 loss not allowed to your brother.

Example 2. If, in *Example 1,* you sold the stock for $6,900 instead of $10,500, your recognized loss is only $700 (your $7,600 basis minus $6,900). You cannot deduct the loss that was not allowed to your brother.

III. <u>Capital Gains and Losses</u>

This section discusses the tax treatment of gains and losses from different types of investment transactions.

Character of gain or loss. You need to classify your gains and losses as either ordinary or capital gains or losses. You then need to classify your capital gains and losses as either short-term or long-term. If you have long-term gains and losses, you must identify your 28% rate gains and losses. If you have a net capital gain, you must also identify any unrecaptured section 1250 gain.

CAPITAL OR ORDINARY GAIN OR LOSS

If you have a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or loss, depending on the circumstances. Generally, a sale or trade of a capital asset (defined next) results in a capital gain or loss. A sale or trade of a noncapital asset generally results in ordinary gain or loss. Depending on the circumstances, a gain or loss on a sale or trade of property used in a trade or business may be treated as either capital or ordinary, as explained in Publication 544. In some situations, part of your gain or loss may be a capital gain or loss, and part may be an ordinary gain or loss.

CAPITAL ASSETS AND NONCAPITAL ASSETS

For the most part, everything you own and use for personal purposes, pleasure, or investment is a ***capital asset.*** Some examples are:

- Stocks or bonds held in your personal account,
- A house owned and used by you and your family,
- Household furnishings,
- A car used for pleasure or commuting,
- Coin or stamp collections,
- Gems and jewelry, and
- Gold, silver, or any other metal.

Any property you own is a capital asset, except the following ***noncapital assets.***

1) ***Property held mainly for sale to customers*** or property that will physically become a part of the merchandise that is for sale to customers.
2) ***Depreciable property*** used in your trade or business, even if fully depreciated.
3) ***Real property*** used in your trade or business.
4) ***A copyright, a literary, musical, or artistic composition, a letter or memorandum,*** or similar property:
   a) Created by your personal efforts,
   b) Prepared or produced for you as a letter, memorandum, or similar property, or
   c) Acquired under circumstances (for example, by gift) entitling you to the basis of the person who created the property or for whom it was prepared or produced.
5) ***Accounts or notes receivable*** acquired in the ordinary course of a trade or business for services rendered or from the sale of property described in (1).
6) ***U.S. Government publications*** that you received from the government free or for less than the normal sales price, or that you acquired under circumstances entitling you to the basis of someone who received the publications free or for less than the normal sales price.
7) ***Certain commodities derivative financial instruments*** held by commodities derivatives dealers.
8) ***Hedging transactions,*** but only if the transaction is clearly identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into.
9) ***Supplies*** of a type you regularly use or consume in the ordinary course of your trade or business.

Investment Property

Investment property is a capital asset. Any gain or loss from its sale or trade is generally a capital gain or loss.

Gold, silver, stamps, coins, gems, etc. These are capital assets except when they are held for sale by a dealer. Any gain or loss you have from their sale or trade generally is a capital gain or loss.

Stocks, stock rights, and bonds. All of these (including stock received as a dividend) are capital assets except when held for sale by a securities dealer. However, if you own small business stock, see *Losses on Section 1244 (Small Business) Stock* and *Losses on Small Business Investment Company Stock* in chapter 4 of Publication 550.

Personal Use Property

Property held for personal use only, rather than for investment, is a capital asset, and you must report a gain from its sale as a capital gain. However, you cannot deduct a loss from selling personal use property.

Discounted Debt Instruments

Treat your gain or loss on the sale, redemption, or retirement of a bond or other debt instrument originally issued at a discount or bought at a discount as capital gain or loss, except as explained in the following discussions.

Short-term government obligations. Treat gains on short-term federal, state, or local government obligations (other than tax-exempt obligations) as ordinary income up to your ratable share of the acquisition discount. This treatment applies to obligations that have a fixed maturity date not more than 1 year from the date of issue. ***Acquisition discount*** is the stated redemption price at maturity minus your basis in the obligation.

However, do not treat these gains as income to the extent you previously included the discount in income.

Short-term nongovernment obligations. Treat gains on short-term nongovernment obligations as ordinary income up to your ratable share of original issue discount (OID). This treatment applies to obligations that have a fixed maturity date of not more than 1 year from the date of issue. However, to the extent you previously included the discount in income, you do not have to include it in income again.

Tax-exempt state and local government bonds. If these bonds were originally issued at a discount before September 4, 1982, or you acquired them before March 2, 1984, treat your part of the OID as tax-exempt interest. To figure your gain or loss on the sale or trade of these bonds, reduce the amount realized by your part of the OID.

If the bonds were issued after September 3, 1982, and acquired after March 1, 1984, increase the adjusted basis by your part of the OID to figure gain or loss.

Any gain from market discount is usually taxable on disposition or redemption of tax-exempt bonds. If you bought the bonds before May 1, 1993, the gain from market discount is capital gain. If you bought the bonds after April 30, 1993, the gain is ordinary income.

You figure the market discount by subtracting the price you paid for the bond from the sum of the original issue price of the bond and the amount of accumulated OID from the date of issue that represented interest to any earlier holders.

A loss on the sale or other disposition of a tax-exempt state or local government bond is deductible as a capital loss.

Redeemed before maturity. If a state or local bond that was issued ***before June 9, 1980,*** is redeemed before it matures, the OID is not taxable to you.

If a state or local bond issued ***after June 8, 1980,*** is redeemed before it matures, the part of the OID that is earned while you hold the bond is not taxable to you. However, you must report the unearned part of the OID as a capital gain.

Example. On July 1, 2000, the date of issue, you bought a 20-year, 6% municipal bond for $800. The face amount of the bond was $1,000. The $200 discount was OID. At the time the bond was issued, the issuer had no intention of redeeming it before it matured. The bond was callable at its face amount beginning 10 years after the issue date.

The issuer redeemed the bond at the end of 11 years (July 1, 2011) for its face amount of $1,000 plus accrued annual interest of $60. The OID earned during the time you held the bond, $73, is not taxable. The $60 accrued annual interest also is not taxable. However, you must report the unearned part of the OID ($127) as a capital gain.

Market discount bonds. If the debt instrument has market discount and you chose to include the discount in income as it accrued, increase your basis in the debt instrument by the accrued discount to figure capital gain or loss on its disposition. If you did not choose to include the discount in income as it accrued, you must report gain as ordinary interest income up to the instrument's accrued market discount. The rest of the gain is capital gain.

Retirement of debt instrument. Any amount that you receive on the retirement of a debt instrument is treated in the same way as if you had sold or traded that instrument.

Notes of individuals. If you hold an obligation of an individual that was issued with OID after March 1, 1984, you generally must include the OID in your income currently, and your gain or loss on its sale or retirement is generally capital gain or loss. An exception to this treatment applies if the obligation is a loan between individuals and all of the following requirements are met.

1) The lender is not in the business of lending money.
2) The amount of the loan, plus the amount of any outstanding prior loans, is $10,000 or less.
3) Avoiding federal tax is not one of the principal purposes of the loan.

If the exception applies, or the obligation was issued before March 2, 1984, you do not include the OID in your income currently. When you sell or redeem the obligation, the part of your gain that is not more than your accrued share of the OID at that time is ordinary income. The rest of the gain, if any, is capital gain. Any loss on the sale or redemption is capital loss.

Deposit in Insolvent or Bankrupt Financial Institution

If you lose money you have on deposit in a qualified financial institution that becomes insolvent or bankrupt, you may be able to deduct your loss in one of three ways.

1) Ordinary loss,
2) Casualty loss, or
3) Nonbusiness bad debt (short-term capital loss).

Sale of Annuity

The part of any gain on the sale of an annuity contract before its maturity date that is based on interest accumulated on the contract is ordinary income.

NONBUSINESS BAD DEBTS

If someone owes you money that you cannot collect, you have a bad debt. You may be able to deduct the amount owed to you when you figure your tax for the year the debt becomes worthless. A debt must be genuine for you to deduct a loss. A debt is genuine if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed or determinable sum of money.

Generally, bad debts that you did not get in the course of operating your trade or business are nonbusiness bad debts and are deductible as short-term capital losses. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partly worthless nonbusiness debt.

Basis in bad debt required. To deduct a bad debt, you must have a basis in it -- that is, you must have already included the amount in your income or loaned out your cash. For example, you cannot claim a bad debt deduction for court-ordered child support not paid to you by your former spouse. If you are a cash method taxpayer (as most individuals are), you generally cannot take a bad debt deduction for unpaid salaries, wages, rents, fees, interest, dividends, and similar items.

How to report bad debts. Deduct nonbusiness bad debts as short-term capital losses on Schedule D (Form 1040).

In Part I, line 1 of Schedule D, enter the name of the debtor and "statement attached" in column (a). Enter the amount of the bad debt in parentheses in column (f). Use a separate line for each bad debt.

For each bad debt, attach a statement to your return that contains:

1) A description of the debt, including the amount, and the date it became due,
2) The name of the debtor, and any business or family relationship between you and the debtor,
3) The efforts you made to collect the debt, and
4) Why you decided the debt was worthless. For example, you could show that the borrower has declared bankruptcy, or that legal action to collect would probably not result in payment of any part of the debt.

Filing a claim for refund. If you do not deduct a bad debt on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the bad debt. To do this, use Form 1040X, *Amended U.S. Individual Income Tax Return,* to amend your return for the year the debt became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in chapter 1.

LOSSES ON SMALL BUSINESS STOCK

You can deduct as an ordinary loss, rather than as a capital loss, your loss on the sale, trade, or worthlessness of section 1244 stock. Report the loss on **Form 4797,** line 10. Any gain on this stock is capital gain and is reported on Schedule D (Form 1040) if the stock is a capital asset in your hands.

HOLDING PERIOD

If you sold or traded investment property, you must determine your holding period for the property. Your holding period determines whether any capital gain or loss was a short-term or long-term capital gain or loss.

Long term or short term. If you hold investment property ***more than 1 year,*** any capital gain or loss is a ***long-term*** capital gain or loss. If you hold the property ***1 year or less,*** any capital gain or loss is a ***short-term*** capital gain or loss.

To determine how long you held the investment property, begin counting on the date after the day you acquired the property. The day you disposed of the property is part of your holding period.

Example. If you bought investment property on February 5, 2010, and sold it on February 5, 2011, your holding period is not more than 1 year and you have a short-term capital gain or loss. If you sold it on February 6, 2011, your holding period is more than 1 year and you will have a long-term capital gain or loss.

Securities traded on established market. For securities traded on an established securities market, your holding period begins the day after the trade date you bought the securities, and ends on the trade date you sold them.

Example. You are a cash method, calendar year taxpayer. You sold stock at a gain on December 29, 2011. According to the rules of the stock exchange, the sale was closed by delivery of the stock three trading days after the sale, on January 4, 2012. You received payment of the sales price on that same day. Report your gain on your 2011 return, even though you received the payment in 2012. The gain is long term or short term depending on whether you held the stock more than 1 year. Your holding period ended on December 29. If you had sold the stock at a loss, you would also report it on your 2011 return.

Nontaxable trades. If you acquire investment property in a trade for other investment property and your basis for the new property is determined, in whole or in part, by your basis in the old property, your holding period for the new property begins on the day following the date you acquired the old property.

Property received as a gift. If you receive a gift of property and your basis is determined by the donor's adjusted basis, your holding period is considered to have started on the same day the donor's holding period started.

If your basis is determined by the fair market value of the property, your holding period starts on the day after the date of the gift.

Inherited property. If you inherit investment property, your capital gain or loss on any later disposition of that property is treated as a long-term capital gain or loss. This is true regardless of how long you actually held the property.

Real property bought. To figure how long you have held real property bought under an unconditional contract, begin counting on the day after you received title to it or on the day after you took possession of it and assumed the burdens and privileges of ownership, whichever happened first. However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Automatic investment service. In determining your holding period for shares bought by the bank or other agent, full shares are considered bought first and any fractional shares are considered bought last. Your holding period starts on the day after the bank's purchase date. If a share was bought over more than one purchase date, your holding period for that share is a split holding period. A part of the share is considered to have been bought on each date that stock was bought by the bank with the proceeds of available funds.

Stock dividends. The holding period for stock you received as a taxable stock dividend begins on the date of distribution.

The holding period for new stock you received as a nontaxable stock dividend begins on the same day as the holding period of the old stock. This rule also applies to stock acquired in a "spin-off," which is a distribution of stock or securities in a controlled corporation.

Nontaxable stock rights. Your holding period for nontaxable stock rights begins on the same day as the holding period of the underlying stock. The holding period for stock acquired through the exercise of stock rights begins on the date the right was exercised.

WASH SALES

You cannot deduct losses from sales or trades of stock or securities in a wash sale.

A wash sale occurs when you sell or trade stock or securities at a loss and within 30 days before or after the sale you:

- Buy substantially identical stock or securities,
- Acquire substantially identical stock or securities in a fully taxable trade,
- Acquire a contract or option to buy substantially identical stock or securities, or
- Acquire substantially identical stock for your individual retirement account (IRA) or Roth IRA.

If your loss was disallowed because of the wash sale rules, add the disallowed loss to the cost of the new stock or securities. The result is your basis in the new stock or securities. This adjustment postpones the loss deduction until the disposition of the new stock or securities.

ROLLOVER OF GAIN FROM PUBLICLY TRADED SECURITIES

You may qualify for a tax-free rollover of certain gains from the sale of publicly traded securities. This means that if you buy certain replacement property and make the choice described in this section, you postpone part or all of your gain.

You postpone the gain by adjusting the basis of the replacement property as described in *Basis of replacement property,* later. This postpones your gain until the year you dispose of the replacement property.

You qualify to make this choice if you meet all the following tests.

1) You sell publicly traded securities at a gain. Publicly traded securities are securities traded on an established securities market.
2) Your gain from the sale is a capital gain.
3) During the 60-day period beginning on the date of the sale, you buy replacement property. This replacement property must be either common stock or a partnership interest in a specialized small business investment company (SSBIC). This is any partnership or corporation licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958, as in effect on May 13, 1993.

Amount of gain recognized. If you make the choice described in this section, you must recognize gain only up to the following amount:

1) The amount realized on the sale, minus
2) The cost of any common stock or partnership interest in an SSBIC that you bought during the 60-day period beginning on the date of sale (and did not previously take into account on an earlier sale of publicly traded securities).

If this amount is less than the amount of your gain, you can postpone the rest of your gain, subject to the limit described next. If this amount is equal to or more than the amount of your gain, you must recognize the full amount of your gain.

Limit on gain postponed. The amount of gain you can postpone each year is limited to the smaller of:

1) $50,000 ($25,000 if you are married and file a separate return), or
2) $500,000 ($250,000 if you are married and file a separate return), minus the amount of gain you postponed for all earlier years.

Basis of replacement property. You must subtract the amount of postponed gain from the basis of your replacement property.

CHAPTER 14 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Stocks, stock rights, and bonds (other than those held for sale by a securities dealer) that became worthless during the tax year are treated as though they were sold on the last day of the tax year.

   a) true
   b) false

2. Generally, no gain or loss is recognized on the transfer of property from an individual to a spouse. In the case of divorce, such a transfer generally must occur within:

   a) 3 months of the final divorce date
   b) 1 year of the final divorce date
   c) 2 years of the final divorce date
   d) 3 years of the final divorce date

3. To be deductible, a nonbusiness bad debt must meet all of the following conditions <u>except</u>:

   a) it must be totally worthless
   b) the owner must have a cost basis in the debt
   c) the debt did not arise from running your trade or business
   d) it can retain some limited value

CHAPTER 14 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** This affects whether your capital loss is long-term or short-term.

   B: False is incorrect. If you are a cash basis taxpayer and make payments on a negotiable promissory note that you issued for stock that became worthless, you can deduct these payments as losses in the years you actually make the payments. Do not deduct them in the year the stock became worthless.

2. A: Incorrect. The suggested time period is not correct. However, this carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient.

   B: Correct. The transfer of property is incident to a divorce if the transfer occurs within 1 year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage.

   C: Incorrect. The suggested time period is not correct.

   D: Incorrect. The suggested time period is not correct.

3. A: Incorrect. To be deductible, a nonbusiness bad debt must be totally worthless in order to make a claim.

   B: Incorrect. A nonbusiness bad debt must originally have had a cost basis.

   C: Incorrect. To be a nonbusiness deduction, it cannot arise from the operation of a trade or business.

   D: Correct. This response is not a condition required for the deductibility of a nonbusiness bad debt. All nonbusiness bad debts must be totally worthless to qualify as a valid deduction.

Chapter 15: Selling Your Home

I. Important Information

Nonqualified use limits home sale exclusion. Gain from the sale of a principal residence is not excludable to the extent that it is allocable to nonqualified use after 2008. With certain exceptions, nonqualified use means any period after 2008 during which the home is not used as a principal residence.

Home sold with undeducted points. If you have not deducted all the points you paid to secure a mortgage on your old home, you may be able to deduct the remaining points in the year of the sale. See *Mortgage ending early* under *Points* in chapter 23.

II. Introduction

This chapter explains the tax rules that apply when you sell your main home. Generally, your main home is the one in which you live most of the time.

If you sold your main home in 2011, you may be able to exclude from income any gain up to a limit of $250,000 ($500,000 on a joint return in most cases). See *Excluding the Gain*, later. If you can exclude all of the gain, you do not need to report the sale on your tax return.

If you have gain that cannot be excluded, it is taxable. Report it on Schedule D (Form 1040). You may also have to include Form 4797, Sales of Business Property. See *Reporting the Sale*, later.

If you have a loss on the sale, you cannot deduct it on your return. However, you may need to report it.

The following are main topics in this chapter.

- Figuring gain or loss.
- Basis.
- Excluding the gain.
- Ownership and use tests.
- Reporting the sale.

Other topics include the following.

- Business use or rental of home.
- Recapturing a federal mortgage subsidy.

III. Main Home

Usually, the home you live in most of the time is your main home and can be a:

- House,
- Houseboat,
- Mobile home,
- Cooperative apartment, or
- Condominium.

To exclude gain under the rules of this chapter, you generally must have owned and lived in the property as your main home for at least 2 years during the 5-year period ending on the date of sale.

Land. If you sell the land on which your main home is located, but not the house itself, you cannot exclude any gain you have from the sale of the land.

Example. You buy a piece of land and move your main home to it. Then you sell the land on which your main home was located. This sale is not considered a sale of your main home, and you cannot exclude any gain on the sale of the land.

More than one home. If you have more than one home, you can exclude gain only from the sale of your main home. You must include in income the gain from the sale of any other home. If you have two homes and live in both of them, your main home is ordinarily the one you live in most of the time.

Example 1. You own and live in a house in the city. You also own a beach house, which you use during summer months. The house in the city is your main home.

Example 2. You own a house, but you live in another house that you rent. The rented house is your main home.

Property used partly as your main home. If you use only part of the property as your main home, the rules discussed in this chapter apply only to the gain or loss on the sale of that part of the property. For details, see *Property used partly as your home and partly for business or rental during the year of sale* under *Business Use or Rental of Home*, later.

IV. <u>Figuring Gain or Loss</u>

To figure the gain or loss on the sale of your main home, you must know the ***selling price,*** the ***amount realized,*** and the ***adjusted basis.***

<u>SELLING PRICE</u>

The selling price is the total amount you receive for your home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part of the sale, and the fair market value of any other property or any services you receive.

Payment by employer. You may have to sell your home because of a job transfer. If your employer pays you for a loss on the sale or for your selling expenses, do ***not*** include the payment as part of the selling price. Your employer will include it in box 1 of your Form W-2 and you will include it in your gross income as wages on line 7 of Form 1040.

Option to buy. If you grant an option to buy your home and the option is exercised, add the amount you receive for the option to the selling price of your home. If the option is not exercised, you must report the amount as ordinary income in the year the option expires. Report this amount on line 21 of Form 1040.

Form 1099-S. If you received Form 1099-S, *Proceeds From Real Estate Transactions,* box 2 (gross proceeds) should show the total amount you received for your home.

However, box 2 will not include the fair market value of any property other than cash or notes, or any services, you received or will receive. Instead, box 4 will be checked to indicate your receipt (or expected receipt) of these items.

If you can exclude the entire gain, the person responsible for closing the sale generally will not have to report it on Form 1099-S. If you do not receive Form 1099-S, use sale documents and other records to figure the total amount you received for your home.

AMOUNT REALIZED

The amount realized is the selling price minus selling expenses.

Selling expenses. Selling expenses include:

- Commissions,
- Advertising fees,
- Legal fees, and
- Loan charges paid by the seller, such as loan placement fees or “points.”

ADJUSTED BASIS

While you owned your home, you may have made adjustments (increases or decreases) to the basis. This adjusted basis must be determined before you can figure gain or loss on the sale of your home. For information on how to figure your home's adjusted basis, see *Determining Basis* later.

AMOUNT OF GAIN OR LOSS

To figure the amount of gain or loss, compare the amount realized to the adjusted basis.

Gain on sale. If the amount realized is more than the adjusted basis, the difference is a gain and, except for any part you can exclude, generally is taxable.

Loss on sale. If the amount realized is less than the adjusted basis, the difference is a loss. A loss on the sale of your main home cannot be deducted.

Jointly owned home. If you and your spouse sell your jointly owned home and file a joint return, you figure your gain or loss as one taxpayer.

Separate returns. If you file separate returns, each of you must figure your own gain or loss according to your ownership interest in the home. Your ownership interest is determined by state law.

Joint owners not married. If you and a joint owner other than your spouse sell your jointly owned home, each of you must figure your own gain or loss according to your ownership interest in the home. Each of you applies the rules discussed in this chapter on an individual basis.

OTHER DISPOSITIONS

Trading homes. If you trade your old home for another home, treat the trade as a sale and a purchase.

Example. You owned and lived in a home that had an adjusted basis of $41,000. A real estate dealer accepted your old home as a trade-in and allowed you $50,000 toward a new home priced at $80,000. This is treated as a sale of your old home for $50,000 with a gain of $9,000 ($50,000 - $41,000).

If the dealer had allowed you $27,000 and assumed your unpaid mortgage of $23,000 on your old home, your sales price would still be $50,000 (the $27,000 trade-in allowed plus the $23,000 mortgage assumed).

Foreclosure or repossession. If your home was foreclosed on or repossessed, you have a sale.

You figure the gain or loss from the sale in generally the same way as gain or loss from any sale. But the amount of your gain or loss depends, in part, on whether you were personally liable for repaying the debt secured by the home and whether the debt is qualified principal residence indebtedness.

Form 1099-A and Form 1099-C. If your debt is canceled, you may receive Form 1099-C, *Cancellation of Debt*. Generally, you will receive Form 1099-A, *Acquisition or Abandonment of Secured Property,* from your lender. This form will have the information you need to determine the amount of your gain or loss and any ordinary income from cancellation of debt that is not a discharge of qualified principal residence indebtedness.

Discharges of qualified principal residence indebtedness. You may be able to exclude from gross income a discharge of qualified principal residence indebtedness. This exclusion applies to discharges made after 2006 and before 2013. If you choose to exclude this income, you must reduce (but not below zero) the basis of the principal residence by the amount excluded from your gross income.

File Form 982 with your tax return. See the form's instructions for detailed information.

Principal residence. Your principal residence is the home where you ordinarily live most of the time. You can have only one principal residence at any one time. See *Main Home*, earlier.

Qualified principal residence indebtedness. This indebtedness is a mortgage you took out to buy, build, or substantially improve your principal residence. It also must be secured by your principal residence.

Amount eligible for the exclusion. The exclusion applies only to debt discharged after 2006 and before 2013. The maximum amount you can treat as qualified principal residence indebtedness is $2 million ($1 million if married filing separately). You cannot exclude from gross income discharge of qualified principal residence indebtedness if the discharge was for services performed for the lender or on account of any other factor not directly related to a decline in the value of your residence or to your financial condition.

Abandonment. If you abandon your home, you may have ordinary income. If the abandoned home secures a debt for which you are personally liable and the debt is canceled, you have ordinary income equal to the amount of the canceled debt.

Transfer to spouse. If you transfer your home to your spouse, or to your former spouse incident to your divorce, you generally have no gain or loss. This is true even if you receive cash or other consideration for the home. Therefore, the rules in this chapter do not apply.

DETERMINING BASIS

You need to know your basis in your home to determine any gain or loss when you sell it. Your basis in your home is determined by how you got the home. Your basis is its cost if you bought it or built it. If you got it in some other way (inheritance, gift, etc.), its basis is either its fair market value when you got it or the adjusted basis of the person you got it from.

While you owned your home, you may have made adjustments (increases or decreases) to your home's basis. The result of these adjustments is your home's ***adjusted basis,*** which is used to figure gain or loss on the sale of your home. See *Adjusted Basis*, later.

Cost as Basis

The cost of property is the amount you pay for it in cash, debt obligations, other property, or services.

Purchase. If you buy your home, your basis is its cost to you. This includes the purchase price and certain settlement or closing costs. Generally, your purchase price includes your down payment and any debt, such as a first or second mortgage or notes you gave the seller in payment for the home.

Settlement fees or closing costs. When you bought your home, you may have paid settlement fees or closing costs in addition to the contract price of the property. You can include in your basis the settlement fees and closing costs you paid for buying the home. You cannot include in your basis the fees and costs for getting a mortgage loan. Therefore, a fee paid for buying the home is any fee you would have had to pay even if you paid cash for the home (that is without the need for financing).

Adjusted Basis

Adjusted basis is your basis ***increased*** or ***decreased*** by certain amounts.

Increases to basis. These include any:

- Additions and other improvements that have a useful life of more than 1 year,
- Special assessments for local improvements, and
- Amounts you spent after a casualty to restore damaged property.

Decreases to basis. These include any:

- Discharge of qualified principal indebtedness (but do not reduce basis below zero),
- Gain you postponed from the sale of a previous home before May 7, 1997,
- General sales taxes claimed as an itemized deduction on Schedule A from 2004 through 2009 that were imposed on the purchase of a houseboat or mobile home,
- Deductible casualty losses,
- Insurance payments you received or expect to receive for casualty losses,
- Payments you received for granting an easement or right-of-way,
- Depreciation allowed or allowable if you used your home for business or rental purposes,
- Residential energy credit (generally allowed from 1977 through 1987) claimed for the cost of energy improvements that you added to the basis of your home,
- Nonbusiness energy property credit (allowed beginning in 2006 but not for 2008) claimed for making certain energy saving improvements that you added to the basis of your home,

- Residential energy efficient property credit (allowed beginning in 2006) claimed for making certain energy saving improvements that you added to the basis of your home,
- Adoption credit you claimed for improvements added to the basis of your home,
- Nontaxable payments from an adoption assistance program of your employer that you used for improvements you added to the basis of your home,
- Energy conservation subsidy excluded from your gross income because you received it (directly or indirectly) from a public utility after 1992 to buy or install any energy conservation measure. An energy conservation measure is an installation or modification that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home, and
- Carryforward of the District of Columbia first-time homebuyer credit (allowed on the purchase of a principal resident in the District of Columbia beginning on August 5, 1997 and ending on December 31, 2009).

Improvements. These add to the value of your home, prolong its useful life, or adapt it to new uses. You add the cost of additions and other improvements to the basis of your property.

Examples. Putting a recreation room or another bathroom in your unfinished basement, putting up a new fence, putting in new plumbing or wiring, putting on a new roof, or paving your unpaved driveway are improvements. An addition to your house, such as a new deck, a sunroom, or a garage, is also an improvement.

Repairs. These maintain your home in good condition but do not add to its value or prolong its life. You do not add their cost to the basis of your property.

Examples. Repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken window panes are examples of repairs.

V. <u>Excluding the Gain</u>

You may qualify to exclude from your income all or part of any gain from the sale of your main home. This means that, if you qualify, you will not have to pay tax on the gain up to the limit described under *Maximum Amount of Exclusion,* next. To qualify, you must meet the ownership and use tests described later.

You can choose not to take the exclusion. In that case, you must include in gross income your entire gain in the year of sale.

<u>MAXIMUM EXCLUSION</u>

You can exclude the entire gain on the sale of your main home up to $250,000 if all of the following are true.

1) You meet the ownership test.
2) You meet the use test.
3) During the 2-year period ending on the date of the sale, you did not exclude gain from the sale of another home.

You may be able to exclude the entire gain on the sale of your main home up to $500,000 if all of the following are true.

1) You are married and file a joint return for the year.
2) Either you or your spouse meets the ownership test.

3) Both you and your spouse meet the use test.
4) During the 2-year period ending on the date of the sale, neither you nor your spouse excluded gain from the sale of another home.

REDUCED MAXIMUM EXCLUSION

If you fail to meet the requirements to qualify for the $250,000 or $500,000 exclusion, you may still qualify for a reduced exclusion. This applies to those who:

- Fail to meet the ownership and use tests, or
- Have used the exclusion within 2 years of selling their current home.

In both cases, to qualify for a reduced exclusion, the sale of your main home must be due to one of the following reasons.

- A change in place of employment.
- Health.
- Unforeseen circumstances.

Unforeseen circumstances. The sale of your main home is because of an unforeseen circumstance if your primary reason for the sale is the occurrence of an event that you could not reasonably have anticipated before buying and occupying your main home.

OWNERSHIP AND USE TESTS

To claim the exclusion, you must meet the ownership and use tests. This means that during the ***5-year period*** ending on the date of the sale, you must have:

1) ***Owned*** the home for at least ***2 years*** (the ownership test), ***and***
2) ***Lived in*** the home as your main home for at least ***2 years*** (the use test).

Exception. If you owned and lived in the property as your main home for less than 2 years, you can still claim an exclusion in some cases. The maximum amount you can claim will be reduced. See *Reduced Maximum Exclusion*, earlier.

Period of Ownership and Use

The required 2 years of ownership and use during the 5-year period ending on the date of the sale do not have to be continuous, nor do they have to occur at the same time.

You meet the tests if you can show that you owned and lived in the property as your main home for either 24 full months or 730 days (365 X 2) during the 5-year period ending on the date of sale.

Temporary absence. Short temporary absences for vacations or other seasonal absences, even if you rent the property during the absences, are counted as periods of use.

Example. Professor Paul Beard, who is single, bought and moved into a house on August 28, 2008. He lived in it as his main home continuously until January 5, 2010, when he went abroad for a 1-year sabbatical leave. During part of the period of leave, the house was unoccupied, and during the rest of the period, he rented it. On February 6, 2011, 1 month after returning from leave, he sold the house at a gain.

Because his leave was not a short temporary absence, he cannot include the period of leave to meet the 2-year use test. He cannot exclude any part of his gain, because he did not use the residence for the required 2 years.

Ownership and use tests met at different times. You can meet the ownership and use tests during different 2-year periods. However, you must meet both tests during the 5-year period ending on the date of the sale.

Example. In 2002, Helen Jones lived in a rented apartment. The apartment building was later converted to condominiums, and she bought her same apartment on December 3, 2008. In 2009, Helen became ill and on April 14 of that year she moved to her daughter's home. On July 12, 2011, while still living in her daughter's home, she sold her condominium.

Helen can exclude gain on the sale of her condominium because she met the ownership and use tests. Her 5-year period is from July 13, 2006, to July 12, 2011, the date she sold the condominium. She owned her condominium from December 3, 2008, to July 12, 2011 (over 2 years). She lived in the property from July 13, 2006 (the beginning of the 5-year period), to April 14, 2009 (over 2 years).

The time Helen lived in her daughter's home during the 5-year period can be counted toward her period of ownership, and the time she lived in her rented apartment during the 5-year period can be counted toward her period of use.

Cooperative apartment. If you sold stock in a cooperative housing corporation, the ownership and use tests are met if, during the 5-year period ending on the date of sale, you:

1) Owned the stock for at least 2 years, and
2) Lived in the house or apartment that the stock entitles you to occupy as your main home for at least 2 years.

Exception for individuals with a disability. There is an exception to the use test if during the 5-year period before the sale of your home:

1) You become physically or mentally unable to care for yourself, and
2) You owned and lived in your home as your main home for a total of at least 1 year.

Under this exception, you are considered to live in your home during any time that you own the home and live in a facility (including a nursing home) that is licensed by a state or political subdivision to care for persons in your condition.

If you meet this exception to the use test, you still have to meet the 2-out-of-5-year ownership test to claim the exclusion.

Previous home destroyed or condemned. For the ownership and use tests, you add the time you owned and lived in a previous home that was destroyed or condemned to the time you owned and lived in the home on which you wish to exclude gain. This rule applies if any part of the basis of the home you sold depended on the basis of the destroyed or condemned home. Otherwise, you must have owned and lived in the ***same*** home for 2 of the 5 years before the sale to qualify for the exclusion.

Married Persons

If you and your spouse file a joint return for the year of sale, you can exclude gain if either spouse meets the ownership and use tests. (But see *Maximum Amount of Exclusion,* earlier.)

Example 1 - one spouse sells a home. Emily sells her home in June 2011. She marries Jamie later in the year. She meets the ownership and use tests, but Jamie does not. She can exclude up to $250,000 of gain on a separate or joint return for 2011. The $500,000 maximum exclusion does not apply because Jamie does not jointly meet the use test.

Example 2 - each spouse sells a home. The facts are the same as in *Example 1* except that Jamie also sells a home in 2011 before he marries Emily. He meets the ownership and use tests on his home, but Emily does not. Emily and Jamie can each exclude up to $250,000 of gain. The $500,000 maximum exclusion for certain joint returns does not apply because Emily and Jamie do not jointly meet the use test for the same home.

Home transferred from spouse. If your home was transferred to you by your spouse (or former spouse if the transfer was incident to divorce), you are considered to have owned it during any period of time when your spouse owned it.

Use of home after divorce. You are considered to have used property as your main home during any period when:

1) You owned it, and
2) Your spouse or former spouse is allowed to live in it under a divorce or separation instrument and uses it as his or her main home.

VI. <u>Business Use or Rental of Home</u>

You may be able to exclude your gain from the sale of a home that you have used for business or to produce rental income. But you must meet the ownership and use tests.

Example 1. On May 29, 2005, Amy bought a house. She moved in on that date and lived in it until May 31, 2007, when she moved out of the house and put it up for rent. The house was rented from June 1, 2007, to March 31, 2009. Amy moved back into the house on April 1, 2009, and lived there until she sold it on January 30, 2011. During the 5-year period ending on the date of the sale (January 31, 2006 - January 30, 2011), Amy owned and lived in the house for more than 2 years as shown in the table below.

Five Year Period	**Used as Home**	**Used as Rental**
1/31/06 – 5/31/07	16 months	
6/1/07 – 3/31/09		22 months
4/1/09 – 1/30/11	22 months	
	38 months	22 months

Amy can exclude gain up to $250,000. But she cannot exclude the part of the gain equal to the depreciation she claimed, or should have claimed, for renting the house, as explained after *Example 2.*

Example 2. William owned and used a house as his main home from 2005 through 2008. On January 1, 2009, he moved to another state. He rented his house from that date until April 30, 2011, when he sold it. During the 5-year period ending on the date of sale (May 1, 2006 - April 30, 2011), William owned and lived in the house for 32 months (more than 2 years). He must report the sale on Form 4797. He can exclude gain up to $250,000. However, he cannot exclude the part of the gain equal to the depreciation he claimed, or should have claimed, for renting the house, as explained next.

Depreciation after May 6, 1997. If you were entitled to take depreciation deductions because you used your home for business purposes or as rental property, you cannot exclude the part of your gain equal to any depreciation allowed as a deduction for periods after May 6, 1997. If you cannot show by adequate records or other evidence that the depreciation deduction allowed was less than the amount allowable, the amount you cannot exclude is the amount allowed.

VII. Reporting the Sale

Do ***not*** report the 2011 sale of your main home on your tax return unless:

- You have a gain and you do not qualify to exclude all of it,
- You have a gain and you choose not to exclude it, or
- You have a loss and you received Form 1099-S.

If you have any taxable gain on the sale of your main home that cannot be excluded, report the entire gain realized on Schedule D (Form 1040). Report it on line 1 or line 8 of Schedule D, depending on how long you owned the home. If you qualify for an exclusion, show it on the line directly below the line on which you report the gain. Write "Section 121 exclusion" in column (a) of that line and show the amount of the exclusion in column (f) as a loss (in parentheses).

If you have a loss on the sale of your main home for which you received a Form 1099-S, you must report the loss on Schedule D even though the loss is not deductible. Report the transaction on line 1 or 8, as above. Complete columns (a) through (e). Enter -0- in column (f).

If you used the home for business or to produce rental income during the year of sale, you must use Form 4797 to report the sale of the business or rental part (or the sale of the entire property if used entirely for business or rental).

Installment sale. Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called "installment sales." If you finance the buyer's purchase of your home yourself, instead of having the buyer get a loan or mortgage from a bank, you probably have an installment sale. You may be able to report the part of the gain you cannot exclude on the installment basis.

Use Form 6252, *Installment Sale Income,* to report the sale. Enter your exclusion on line 15 of Form 6252.

VIII. Special Situations

The situations that follow may affect your exclusion.

Sale of home acquired in like-kind exchange. You cannot claim the exclusion if:

- You acquired your home in a like-kind exchange (also known as a section 1031 exchange); or your basis in your home is determined by reference to the basis of the home in the hands of the person who acquired the property in a like-kind exchange (for example, you received the home from that person as a gift), and
- You sold the home during the 5-year period beginning with the date your home was acquired in the like-kind exchange.

Gain from a like-kind exchange is not taxable. This means that gain will not be recognized until you sell the property you receive. To defer gain from a like-kind exchange, you must have exchanged business or investment property for business or investment property of a like kind.

Home relinquished in a like-kind exchange. If you use your main home partly for business or rental purposes and then exchange the home for another property.

Sale of remainder interest. Subject to the other rules in this chapter, you can choose to exclude gain from the sale of a remainder interest in your home. If you make this choice, you cannot choose to exclude gain from your sale of any other interest in the home that you sell separately.

Exception for sales to related persons. You cannot exclude gain from the sale of a remainder interest in your home to a related person. Related persons include your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.). Related persons also include certain corporations, partnerships, trusts, and exempt organizations.

IX. Recapture of Federal Mortgage Subsidy

If you financed your home under a federally subsidized program (loans from tax-exempt qualified mortgage bonds or loans with mortgage credit certificates), you may have to recapture all or part of the benefit you received from that program when you sell or otherwise dispose of your home. You recapture the benefit by increasing your federal income tax for the year of the sale. You may have to pay this recapture tax even if you can exclude your gain from income; that exclusion does not affect the recapture tax.

Loans subject to recapture rules. The recapture applies to loans that:

1) Came from the proceeds of qualified mortgage bonds, or
2) Were based on mortgage credit certificates.

The recapture also applies to assumptions of these loans.

When the recapture applies. The recapture of the federal mortgage subsidy applies only if you meet ***both*** of the following conditions.

- Within the first 9 years after the date you close your mortgage loan, you sell or otherwise dispose of your home at a gain.
- Your income for the year of disposition is more than that year's adjusted qualifying income for your family size for that year (related to the income requirements a person must meet to qualify for the federally subsidized program).

When recapture does not apply. The recapture does ***not*** apply if any of the following situations apply to you:

- Your mortgage loan was a qualified home improvement loan of not more than $15,000,
- The home is disposed of as a result of your death,
- You dispose of the home more than 9 years after the date you closed your mortgage loan,
- You transfer the home to your spouse, or to your former spouse incident to a divorce, where no gain is included in your income,
- You dispose of the home at a loss,
- Your home is destroyed by a casualty, and you repair it or replace it on its original site within 2 years after the end of the tax year when the destruction happened, or
- You refinance your mortgage loan (unless you later meet all of the conditions listed previously under *When the recapture applies*).

CHAPTER 15 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. If you have a gain from the sale of your main home, you may be able to exclude up to $500,000 of the gain from your income if you file a joint return.

   a) true
   b) false

2. To figure the gain or loss on the sale of your main home, you must know the selling price, the amount realized, and the adjusted basis.

   a) true
   b) false

3. To claim the maximum exclusion on the gain received from the sale of your primary residence, you must meet all of the following tests except:

   a) ownership test
   b) sales test
   c) use test
   d) both a and c above

CHAPTER 15 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** Any gain not excluded is taxable. You cannot deduct a loss from the sale of your main home.

   B: False is incorrect. If you file a single return, or married filing separately, you can exclude up to $250,000 of gain. You cannot deduct a loss from the sale of your main home.

2. **A: True is correct.** The selling price is the amount you received for your home. The amount realized is equal to the selling price less the selling expenses. The adjusted basis is your original basis (determined when you got the home) increased or decreased by certain amounts.

   B: False is incorrect. You cannot figure the gain or loss without knowing all three of the following: the selling price, the amount realized, and the adjusted basis.

3. A: Incorrect. To claim the maximum exclusion, the taxpayer is required to pass the ownership test. This is achieved by owning the home for a minimum of two years during a five year period.

   B: Correct. There is no sales test discussed in this course, nor a part of the exclusion qualifications.

   C: Incorrect. The taxpayer must past the use test in order to claim the maximum exclusion.

   D: Incorrect. Passing both the ownership and use test is necessary in order to claim the maximum exclusion.

Chapter 16: Reporting Gains and Losses

I. Important Information

Maximum tax rate on qualified dividends and net capital gain. For 2011 and 2012, the 5% maximum tax rate on qualified dividends and net capital gain (the excess of net long-term capital gain over net short-term capital loss) is reduced to 0 (zero)%. This reduction applies for both regular and alternative minimum tax. The 15% maximum tax rate on qualified dividends and net capital gain has not changed. See *Capital Gain Tax Rates* later.

Form 8949

Form 8949 is a new form for reporting 2011 sales (and other dispositions) of capital assets that is attached to Schedule D. After entering short-term transactions in Part I of Form 8949 and long-term transactions in Part II, the total sales price and basis amounts are transferred to Schedule D where net gain or loss is figured.

If you acquired stock in 2011 and sold it before the end of the year, the broker must report your cost basis for the securities in Box 3 of Form 1099-B. In Parts I and II of Form 8949, you must enter a code to indicate whether your basis for sold securities was reported to you by your broker in Box 3 of Form 1099-B.

II. Introduction

This chapter discusses how to report capital gains and losses from sales, exchanges, and other dispositions of investment property on Schedule D of Form 1040. The discussion includes:

- How to report short-term gains and losses,
- How to report long-term gains and losses,
- How to figure capital loss carryovers, and
- How to figure your tax using the lower tax rates on a net capital gain.

III. Reporting Capital Gains and Losses

Report capital gains and losses on Schedule D (Form 1040). Enter your sales and trades of stocks, bonds, etc., and real estate (if not required to be reported on another form) on lines 1-3 of Part I or lines 8-10 of Part II, from Form 8949 as appropriate. Include all these transactions even if you did not receive a Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions,* or Form 1099-S, *Proceeds From Real Estate Transactions* (or substitute statement).

Passive activity gains and losses. If you have gains or losses from a passive activity, you may also have to report them on **Form 8582.** In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its separate instructions for more information about reporting capital gains and losses from a passive activity.

Form 1099-S transactions. If you sold or traded reportable real estate, you generally should receive from the real estate reporting person a Form 1099-S showing the gross proceeds.

"Reportable real estate" is defined as any present or future ownership interest in any of the following:

1) Improved or unimproved land, including air space,
2) Inherently permanent structures, including any residential, commercial, or industrial building,
3) A condominium unit and its accessory fixtures and common elements, including land, and
4) Stock in a cooperative housing corporation (as defined in section 216 of the Internal Revenue Code).

A "real estate reporting person" could include the buyer's attorney, your attorney, the title or escrow company, a mortgage lender, your broker, the buyer's broker, or the person acquiring the biggest interest in the property.

Your Form 1099-S will show the gross proceeds from the sale or exchange in box 2. Follow the instructions for Schedule D to report these transactions and include them on lines 1-3 or 8-10 as appropriate. However, report like-kind exchanges on Form 8824 instead.

Sale of property bought at various times. If you sell a block of stock or other property that you bought at various times, report the short-term gain or loss from the sale on one line in Part I of Form 8949 and the long-term gain or loss on one line in Part II. Write "Various" in column (c) for the "Date acquired."

Sale expenses. Add to your cost or other basis any expense of sale such as brokers' fees, commissions, state and local transfer taxes, and option premiums. Enter this adjusted amount in column (f) of either Part I or Part II of Form 8949, whichever applies, unless you reported the net sales price amount in column (e).

For more information about adjustments to basis, see chapter 13.

Short-term gains and losses. Capital gain or loss on the sale or trade of investment property held 1 year or less is a short-term capital gain or loss. You report it in Part I of Schedule D. If the amount you report in column (f) is a loss, show it in parentheses.

You combine your share of short-term capital gains or losses from partnerships, S corporations, and fiduciaries, and any short-term capital loss carryover, with your other short-term capital gains and losses to figure your net short-term capital gain or loss on line 7 of Schedule D.

Long-term gains and losses. A capital gain or loss on the sale or trade of property held more than 1 year is a long-term capital gain or loss. You report it in Part II of Schedule D. If the amount in column (f) is a loss, show it in parentheses.

You also report the following in Part II of Schedule D:

1) Undistributed long-term capital gains from a regulated investment company (mutual fund) or real estate investment trust (REIT),
2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries,
3) All capital gain distributions from mutual funds and REITs not reported directly on line 10 of Form 1040A or line 13 of Form 1040, and
4) Long-term capital loss carryovers.

The result after combining these items with your other long-term capital gains and losses is your net long-term capital gain or loss (line 15 of Schedule D).

Total net gain or loss. To figure your total net gain or loss, combine your net short-term capital gain or loss (line 7) with your net long-term capital gain or loss (line 15). Enter the result on line 16, Part III of Schedule D. If your losses are more than your gains, see *Capital Losses,* next. If both lines 15 and 16 are gains and line 43 of Form 1040 is more than zero, see *Capital Gain Tax Rates*, later.

CAPITAL LOSSES

If your capital losses are more than your capital gains, you can claim a capital loss deduction. Report the deduction on line 13 of Form 1040, enclosed in parentheses.

Limit on deduction. Your allowable capital loss deduction, figured on Schedule D, is the lesser of:

1) $3,000 ($1,500 if you are married and file a separate return), or
2) Your total net loss as shown on line 16 of Schedule D.

You can use your total net loss to reduce your income dollar for dollar, up to the $3,000 limit.

Capital loss carryover. If you have a total net loss on line 16 of Schedule D that is more than the yearly limit on capital loss deductions, you can carry over the unused part to the next year and treat it as if you had incurred it in that next year. If part of the loss is still unused, you can carry it over to later years until it is completely used up.

When you figure the amount of any capital loss carryover to the next year, you must take the current year's allowable deduction into account, whether or not you claimed it, and whether or not you filed a return for the current year.

When you carry over a loss, it remains long term or short term. A long-term capital loss you carry over to the next tax year will reduce that year's long-term capital gains before it reduces that year's short-term capital gains.

Figuring your carryover. The amount of your capital loss carryover is the amount of your total net loss that is more than the lesser of:

1) Your allowable capital loss deduction for the year, or
2) Your taxable income increased by your allowable capital loss deduction for the year and your deduction for personal exemptions.

If your deductions are more than your gross income for the tax year, use your negative taxable income in computing the amount in item (2).

Complete the *Capital Loss Carryover Worksheet* in the Schedule D (Form 1040) instructions to determine the part of your capital loss for 2011 that you can carry over to 2012.

Example. Bob and Gloria sold securities in 2011. The sales resulted in a capital loss of $7,000. They had no other capital transactions. Their taxable income was $26,000. On their joint 2011 return, they can deduct $3,000. The unused part of the loss, $4,000 ($7,000 - $3,000), can be carried over to 2012.

If their capital loss had been $2,000, their capital loss deduction would have been $2,000. They would have no carryover.

Use short-term losses first. When you figure your capital loss carryover, use your short-term capital losses first, even if you incurred them after a long-term capital loss. If you have not reached the limit on the capital loss deduction after using short-term losses, use the long-term losses until you reach the limit.

Decedent's capital loss. A capital loss sustained by a decedent during his or her last tax year (or carried over to that year from an earlier year) can be deducted only on the final income tax return filed for the decedent. The capital loss limits discussed earlier still apply in this situation. The decedent's estate cannot deduct any of the loss or carry it over to following years.

Joint and separate returns. If you and your spouse once filed separate returns and are now filing a joint return, combine your separate capital loss carryovers. However, if you and your spouse once filed a joint return and are now filing separate returns, any capital loss carryover from the joint return can be deducted only on the return of the person who actually had the loss.

CAPITAL GAIN TAX RATES

The tax rates that apply to a net capital gain are generally lower than the tax rates that apply to other income. These lower rates are called the maximum capital gain rates.

The term "net capital gain" means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

For 2011, the maximum capital gain rates are 0%, 15%, 25%, or 28%.

Investment interest deducted. If you claim a deduction for investment interest, you may have to reduce the amount of your net capital gain that is eligible for the capital gain tax rates. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction. This is done on the Schedule D Tax Worksheet or the Qualified Dividends and Capital Gain Tax Worksheet.

Gain on qualified small business stock. If you realized a gain from qualified small business stock that you held more than 5 years, you generally can exclude up to 50% of your gain from income. The exclusion can be up to 75% for stock acquired after February 17, 2009, and before September 27, 2010. The exclusion can be up to 60% for certain empowerment zone business stock. The eligible gain minus your section 1202 exclusion is a 28% rate gain.

- The percentage exclusion for qualified small business stock acquired after September 27, 2010 through December 31, 2011 is increased to 100 percent, and the minimum tax preference does not apply. Thus, no regular tax or alternative minimum tax is imposed on the sale of this stock held at least five years.

Unrecaptured section 1250 gain. Generally, this is any part of your capital gain from selling section 1250 property (real property) that is due to depreciation (but not more than your net section 1231 gain), reduced by any net loss in the 28% group. Use the worksheet in the Schedule D instructions to figure your unrecaptured section 1250 gain.

Tax computation using maximum capital gains rates. Use the Qualified Dividends and Capital Gain Tax Worksheet or the Schedule D Tax Worksheet (whichever applies) to figure your tax if you have qualified dividends or net capital gain. You have net capital gain if Schedule D, lines 15 and 16, are both gains.

Schedule D Tax Worksheet. You must use the Schedule D Tax Worksheet in the Schedule D instructions to figure your tax if:

- You have to file Schedule D, and
- Schedule D, line 18 (28% rate gain) or line 19 (unrecaptured section 1250 gain), is more than zero.

Qualified Dividends and Capital Gain Tax Worksheet. If you do not have to use the Schedule D Tax Worksheet (as explained above) and any of the following apply, use the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040 or Form 1040A (whichever you file) to figure your tax.

- You received qualified dividends (See *Qualified Dividends* in chapter 8.)
- You do not have to file Schedule D and you received capital gain distributions. (See *Capital gain distributions only*, earlier.)
- Schedule D, lines 15 and 16, are both more than zero.

CHAPTER 16 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Reportable real estate includes any present or future ownership interest in a condominium unit and its accessory fixtures and common elements, including land.

   a) true
   b) false

2. The maximum amount of a capital loss, in excess of that year's capital gain, that a married couple (filing jointly) can claim is:

   a) $1,500
   b) $3,000
   c) $6,000
   d) unlimited

CHAPTER 16 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** If you sold or traded reportable real estate, you should receive from the real estate reporting person a Form 1099-S showing the gross proceeds.

   B: False is incorrect. Other reportable real estate includes improved or unimproved land, including air space, inherently permanent structures, including any residential, commercial, or industrial building, and stock in a cooperative housing corporation.

2. A: Incorrect. The maximum capital loss deduction is greater than this amount.

   B: Correct. The maximum capital loss deduction is $3,000 ($1,500 if married and file separate returns).

   C: Incorrect. Any amounts greater than $3,000 can be carried over to future tax years.

   D: Incorrect. The capital loss deduction is not unlimited in any one year.

PART FOUR. ADJUSTMENTS TO INCOME

The three chapters in this part discuss some of the adjustments to income that you can deduct in figuring your adjusted gross income. These chapters cover:

- Contributions you make to traditional individual retirement arrangements (IRAs) and moving expenses -- chapter 17,

- Alimony you pay -- chapter 18, and

- Educator expenses, student loan interest, and tuition and fees you pay -- chapter 19.

Chapter 17: Individual Retirement Arrangements (IRAs) and Moving Expenses

PART I: INDIVIDUAL RETIREMENT ARRANGEMENTS (IRAs)

I. 2011 Information

Traditional IRA contribution and deduction limit. The contribution limit to your traditional IRA for 2011 will be the smaller of the following amounts:

- $5,000, or
- Your taxable compensation for the year.

If you were age 50 or older before 2012, the most that can be contributed to your traditional IRA for 2011 will be the smaller of the following amounts:

- $6,000, or
- Your taxable compensation for the year.

Roth IRA contribution limit. If contributions on your behalf are made only to Roth IRAs, your contribution limit for 2011 will generally be the lesser of:

- $5,000, or
- Your taxable compensation for the year.

If you were age 50 or older before 2012 and contributions on your behalf were made only to Roth IRAs, your contribution limit for 2011 will generally be the lesser of:

- $6,000, or
- Your taxable compensation for the year.

However, if your modified adjusted gross income (AGI) is above a certain amount, your contribution limit may be reduced.

Modified AGI limit for traditional IRA contributions increased. For 2011, if you were covered by a retirement plan at work, your deduction for contributions to a traditional IRA is reduced (phased out) if your modified adjusted gross income (AGI) is:

- More than $90,000 but less than $110,000 for a married couple filing a joint return or a qualifying widow(er),
- More than $56,000 but less than $66,000 for a single individual or head of household, or
- Less than $10,000 for a married individual filing a separate return.

If you either lived with your spouse or file a joint return, and your spouse was covered by a retirement plan at work, but you were not, your deduction is phased out if your AGI is more than $169,000 but less than $179,000. If your AGI is $179,000 or more, you cannot take a deduction for contributions to a traditional IRA.

Modified AGI limit for Roth contributions. For 2011, your Roth IRA contribution limit is reduced (phased out) in the following situations.

- Your filing status is married filing jointly or qualifying widow(er) and your modified AGI is at least $169,000. You cannot make a Roth IRA contribution if your modified AGI is $179,000 or more.
- Your filing status is single, head of household, or married filing separately and you did not live with your spouse at any time in 2011, and your modified AGI is at least $107,000. You cannot make a Roth IRA contribution if your modified AGI is $122,000 or more.
- Your filing status is married filing separately, you lived with your spouse at any time during the year, and your modified AGI is more than -0-. You cannot make a Roth IRA contribution if your modified AGI is $10,000 or more.

II. Important Reminders

Statement of required minimum distribution. If a minimum distribution is required from your IRA, the trustee, custodian, or issuer that held the IRA at the end of the preceding year must either report the amount of the required minimum distribution to you, or offer to calculate it for you. The report or offer must include the date by which the amount must be distributed. The report is due January 31 of the year in which the minimum distribution is required. It can be provided with the year-end fair market value statement that you normally get each year. No report is required for IRAs of owners who have died.

IRA interest. Although interest earned from your IRA is generally not taxed in the year earned, it is not tax-exempt interest. Do not report this interest on your tax return as tax-exempt interest.

Form 8606. If you make nondeductible contributions to a traditional IRA and you do not file Form 8606, Nondeductible IRAs, with your tax return, you may have to pay a $50 penalty.

Tip. *The term "50 or older" is used several times in this chapter. It refers to an IRA owner who is age 50 or older by the end of the tax year.*

III. Introduction

An individual retirement arrangement (IRA) is a personal savings plan that offers you tax advantages to set aside money for your retirement.

This chapter discusses:

1) The rules for a ***traditional IRA*** (any IRA that is not a Roth or SIMPLE IRA), and
2) The ***Roth IRA,*** which features nondeductible contributions and tax-free distributions.

Simplified Employee Pensions (SEPs) and Savings Incentive Match Plans for Employees (SIMPLEs) are not discussed in this chapter.

IV. Traditional IRAs

In this chapter the original IRA (sometimes called an ordinary or regular IRA) is referred to as a "traditional IRA." Two advantages of a traditional IRA are:

1) You may be able to deduct some or all of your contributions to it, depending on your circumstances, and
2) Generally, amounts in your IRA, including earnings and gains, are not taxed until they are distributed.

WHAT IS A TRADITIONAL IRA?

A traditional IRA is any IRA that is not a Roth IRA or a SIMPLE IRA.

WHO CAN SET UP A TRADITIONAL IRA?

You can set up and make contributions to a traditional IRA if:

1) You (or, if you file a joint return, your spouse) received taxable compensation during the year, and
2) You were not age 70½ by the end of the year.

Self-employment income. If you are self-employed (a sole proprietor or a partner), compensation is the net earnings from your trade or business (provided your personal services are a material income-producing factor) reduced by the total of:

1) The deduction for contributions made on your behalf to retirement plans, and
2) The deduction allowed for one-half of your self-employment taxes.

Compensation includes earnings from self-employment even if they are not subject to self-employment tax because of your religious beliefs.

WHEN AND HOW CAN A TRADITIONAL IRA BE SET UP?

You can set up a traditional IRA at any time. However, the time for making contributions for any year is limited. See *When Can Contributions Be Made,* later.

You can set up different kinds of IRAs with a variety of organizations. You can set up an IRA at a bank or other financial institution or with a mutual fund or life insurance company. You can also set up an IRA through your stockbroker. Any IRA must meet Internal Revenue Code requirements.

Kinds of traditional IRAs. Your traditional IRA can be an individual retirement account or annuity. It can be part of either a simplified employee pension (SEP) or an employer or employee association trust account.

HOW MUCH CAN BE CONTRIBUTED?

There are limits and other rules that affect the amount that can be contributed and the amount you can deduct. These limits and other rules are explained below.

Community property laws. Except as discussed later under *Spousal IRA limit,* each spouse figures his or her limit separately, using his or her own compensation. This is the rule even in states with community property laws.

Brokers' commissions. Brokers' commissions paid in connection with your traditional IRA are subject to the contribution limit.

Trustees' fees. Trustees' administrative fees are not subject to the contribution limit.

General limit. For 2011, the most that can be contributed to your traditional IRA is ***the smaller of*** the following amounts:

1) Your taxable compensation (defined earlier) for the year, or
2) $5,000 ($6,000 if you are 50 or older in 2011).

This is the most that can be contributed regardless of whether the contributions are to one or more traditional IRAs or whether all or part of the contributions are nondeductible. (See *Nondeductible Contributions,* later.)

Example 1. Betty, who is 34 years old and single, earned $24,000 in 2011. Her IRA contributions for 2011 are limited to $5,000.

Example 2. John, an unmarried college student working part time, earned $3,500 in 2011. His IRA contributions for 2011 are limited to $3,500, the amount of his compensation.

Spousal IRA limit. For 2011, if you file a joint return and your taxable compensation is less than that of your spouse, the most that can be contributed for the year to your IRA is the smaller of the following amounts:

1) $5,000 ($6,000 if you are 50 or older).
2) The total compensation includible in the gross income of both you and your spouse for the year, reduced by the following two amounts.
   a) Your spouse's contribution for the year to a traditional IRA.
   b) Any contribution for the year to a Roth IRA on behalf of your spouse.

This means that the total combined contributions that can be made for the year to your IRA and your spouse's IRA can be as much as $10,000 ($11,000 if only one of you is 50 or older, or $12,000 if both of you are 50 or older).

WHEN CAN CONTRIBUTIONS BE MADE?

As soon as you set up your traditional IRA, contributions can be made to it through your chosen sponsor (trustee or other administrator). Contributions to a traditional IRA must be in the form of money (cash, check, or money order). Property cannot be contributed.

Contributions must be made by due date. Contributions can be made to your traditional IRA for a year at any time during the year or by the due date for filing your return for that year, ***not*** including extensions.

Age 70½ rule. Contributions cannot be made to your traditional IRA for the year in which you reach age 70½ or for any later year.

Designating year for which contribution is made. If an amount is contributed to your traditional IRA between January 1 and April 15, you should tell the sponsor which year (the current year or the previous year) the contribution is for. If you do not tell the sponsor which year it is for, the sponsor can assume, and report to the IRS, that the contribution is for the current year (the year the sponsor received it).

Filing before a contribution is made. You can file your return claiming a traditional IRA contribution before the contribution is actually made. Generally, the contribution must be made by the due date of your return, ***not*** including extensions.

Contributions not required. You do not have to contribute to your traditional IRA for every tax year, even if you can.

HOW MUCH CAN I DEDUCT?

Generally, you can deduct the lesser of:

- The contributions to your traditional IRA for the year, or
- The general limit (or the spousal IRA limit, if it applies).

However, if you or your spouse was covered by an employer retirement plan, you may not be able to deduct this amount. See *Limit If Covered by Employer Plan,* later.

Trustees' fees. Trustees' administrative fees that are billed separately and paid in connection with your traditional IRA are not deductible as IRA contributions. However, they may be deductible as a miscellaneous itemized deduction on Schedule A (Form 1040). See chapter 28.

Brokers' commissions. Brokers' commissions are part of your IRA contribution and, as such, are deductible subject to the limits.

Full deduction. If neither you nor your spouse was covered for any part of the year by an employer retirement plan, you can take a deduction for total contributions to one or more traditional IRAs of up to the lesser of:

1) $5,000 ($6,000 if you are 50 or older in 2011), or
2) 100% of your compensation.

This limit is reduced by any contributions made to a 501(c)(18) plan on your behalf.

Spousal IRA. In the case of a married couple with unequal compensation who file a joint return, the deduction for contributions to the traditional IRA of the spouse with less compensation is limited to the lesser of:

1) $5,000 ($6,000 if 50 or older in 2011), or
2) The total compensation includible in the gross income of both spouses for the year reduced by the following three amounts.
   a) The IRA deduction for the year of the spouse with the greater compensation.
   b) Any designated nondeductible contribution for the year made on behalf of the spouse with the greater compensation.
   c) Any contributions for the year to a Roth IRA on behalf of the spouse with the greater compensation.

This limit is reduced by any contributions to a 501(c)(18) plan on behalf of the spouse with the lesser compensation.

Covered by an employer retirement plan. If you or your spouse was covered by an employer retirement plan at any time during the year for which contributions were made, your deduction may be further limited. This is discussed later under *Limit If Covered by Employer Plan.* Limits on the amount you can deduct do not affect the amount that can be contributed. See *Nondeductible Contributions,* later.

Are You Covered By an Employer Plan?

The Form W-2 you receive from your employer has a box used to indicate whether you were covered for the year. The "Retirement plan" box should be checked if you were covered.

For Which Year(s) Are You Covered?

Special rules apply to determine the tax years for which you are covered by an employer plan. These rules differ depending on whether the plan is a defined contribution plan or a defined benefit plan.

Tax year. Your tax year is the annual accounting period you use to keep records and report income and expenses on your income tax return. For most people, the tax year is the calendar year.

Defined contribution plan. Generally, you are covered by a defined contribution plan for a tax year if amounts are contributed or allocated to your account for the plan year that ends with or within that tax year.

A defined contribution plan is a plan that provides for a separate account for each person covered by the plan. Types of defined contribution plans include profit-sharing plans, stock bonus plans, and money purchase pension plans.

Defined benefit plan. If you are eligible to participate in your employer's defined benefit plan for the plan year that ends within your tax year, you are covered by the plan. This rule applies even if you:

- Declined to participate in the plan,
- Did not make a required contribution, or
- Did not perform the minimum service required to accrue a benefit for the year.

A defined benefit plan is any plan that is not a defined contribution plan. Types of defined benefit plans include pension plans and annuity plans.

No vested interest. If you accrue a benefit for a plan year, you are covered by that plan even if you have no vested interest in (legal right to) the account or the accrual.

Situations in Which You Are Not Covered

Unless you are covered under another employer plan, you are not covered by an employer plan if you are in one of the situations described below.

Social security or railroad retirement. Coverage under social security or railroad retirement is not coverage under an employer retirement plan.

Benefits from a previous employer's plan. If you receive retirement benefits from a previous employer's plan, you are not covered by that plan.

Reservists. If the only reason you participate in a plan is because you are a member of a reserve unit of the armed forces, you may not be covered by the plan. You are not covered by the plan if ***both*** of the following conditions are met.

1) The plan you participate in is established for its employees by:
   a) The United States,
   b) A state or political subdivision of a state, or
   c) An instrumentality of either (a) or (b) above.
2) You did not serve more than 90 days on active duty during the year (not counting duty for training).

Volunteer firefighters. If the only reason you participate in a plan is because you are a volunteer firefighter, you may not be covered by the plan. You are not covered by the plan if ***both*** of the following conditions are met.

1) The plan you participate in is established for its employees by:
   a) The United States,
   b) A state or political subdivision of a state, or
   c) An instrumentality of either (a) or (b) above.
2) Your accrued retirement benefits at the beginning of the year will not provide more than $1,800 per year at retirement

Limit If Covered By Employer Plan

If either you or your spouse was covered by an employer retirement plan, you may be entitled to only a partial (reduced) deduction or no deduction at all, depending on your income and your filing status.

Your deduction begins to decrease (phase out) when your income rises above a certain amount and is eliminated altogether when it reaches a higher amount. These amounts vary depending on your filing status.

To determine if your deduction is subject to phaseout, you must determine your modified adjusted gross income (AGI) and your filing status. Then use *Table 17-1* or *17-2* to determine if the phaseout applies.

Table 17-1. Effect of Modified AGI[1] on Deduction if You Are Covered by Retirement Plan at Work

If you are covered by a retirement plan at work, use this table to determine if your modified AGI affects the amount of your deduction.

IF your filing status is…	AND your modified AGI is…	THEN you can take…
single or head of household	$56,000 or less	a full deduction.
	more than $56,000 but less than $66,000	a partial deduction.
	$66,000 or more	no deduction.
married filing jointly or qualifying widow(er)	$90,000 or less	a full deduction.
	more than $90,000 but less than $110,000	a partial deduction.
	$110,000 or more	no deduction.
married filing separately[2]	less than $10,000	a partial deduction.
	$10,000 or more	no deduction.

[1]Modified AGI (adjusted gross income). See *Modified adjusted gross income (AGI).*
[2]If you did not live with your spouse at any time during the year, your filing status is considered Single for this purpose (therefore, your IRA deduction is determined under the "Single" column).

Table 17-2. Effect of Modified AGI[1] on Deduction if You Are NOT Covered by Retirement Plan at Work

If you are not covered by a retirement plan at work, use this table to determine if your modified AGI affects the amount of your deduction.

IF your filing status is…	AND your modified AGI is…	THEN you can take…
single, head of household or qualifying widow(er)	any amount	a full deduction.
married filing jointly or separately with a spouse who **is not** covered by a plan at work	any amount	a full deduction.
married filing jointly with a spouse who **is** covered by a plan at work	$169,000 or less	a full deduction.
	more than $169,000 but less than $179,000	a partial deduction.
	$179,000 or more	no deduction.
married filing separately with a spouse who **is** covered by a plan at work[2]	less than $10,000	a partial deduction.
	$10,000 or more	no deduction.

[1]Modified AGI (adjusted gross income). See *Modified adjusted gross income (AGI).*
[2]You are entitled to the full deduction if you did not live with your spouse at any time during the year.

If your spouse is covered. If you are not covered by an employer retirement plan, but your spouse is, and you did not receive any social security benefits, your IRA deduction may be reduced or eliminated entirely depending on your filing status and modified AGI as shown in *Table 17-2.*

Filing status. Your filing status depends primarily on your marital status. For this purpose, you need to know if your filing status is single or head of household, married filing jointly or qualifying widow(er), or married filing separately. If you need more information on filing status, see chapter 2.

Lived apart from spouse. If you did not live with your spouse at any time during the year and you file a separate return, your filing status, for this purpose, is single.

Modified adjusted gross income (AGI). How you figure your modified AGI depends on whether you are filing Form 1040 or Form 1040A.

Form 1040. If you file Form 1040, refigure the amount on page 1 "adjusted gross income" line without taking into account any of the following amounts.

- IRA deduction.
- Student loan interest deduction.
- Tuition and fees deduction.
- Domestic production activities deduction.
- Foreign earned income exclusion.
- Foreign housing exclusion or deduction.
- Exclusion of qualified savings bond interest shown on Form 8815, *Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989 (For Filers With Qualified Higher Education Expenses).*
- Exclusion of employer-paid adoption expenses shown on Form 8839, *Qualified Adoption Expenses.*

This is your modified AGI.

Form 1040A. If you file Form 1040A, refigure the amount on page 1 "adjusted gross income" line without taking into account any of the following amounts.

- IRA deduction.
- Student loan interest deduction.
- Tuition and fees deduction.
- Exclusion of qualified savings bond interest shown on Form 8815.

This is your modified AGI.

Both contributions for 2011 and distributions in 2011. If ***all three*** of the following occurred, any IRA distributions you received in 2011 may be partly tax free and partly taxable.

1) You received distributions in 2011 from one or more traditional IRAs.
2) You made contributions to a traditional IRA for 2011.
3) Some of those contributions may be nondeductible contributions depending on whether your IRA deduction for 2011 is reduced.

If all three of the above occurred, you must figure the taxable part of the traditional IRA distribution before you can figure your modified AGI.

If at least one of the above did ***not*** occur, figure your modified AGI using *Worksheet 17-1* in this chapter.

Worksheet 17-1. Figuring Your Modified AGI

Use this worksheet to figure your modified adjusted gross income for traditional IRA purposes.

1. Enter your adjusted gross income (AGI) from Form 1040, line 38, or Form 1040A, line 22, figured without taking into account the amount from form 1040, line 32; or Form 1040A, line 17	1. ___________
2. Enter any student loan interest deduction from Form 1040, line 33, or Form 1040A, line 18	2. ___________
3. Enter any tuition and fees deduction from Form 1040, line 34, or Form 1040A, line 19	3. ___________
4. Enter any domestic production activities deduction from Form 1040, line 35	4. ___________
5. Enter any foreign earned income and/or housing exclusion from Form 2555, line 45, or Form 2555-EZ, line 18	5. ___________
6. Enter any foreign housing deduction from Form 2555, line 50	6. ___________
7. Enter any excludable savings bond interest from Form 8815, line 14	7. ___________
8. Enter any excluded employer-provided adoption benefits from Form 8839, line 30	8. ___________
9. Add lines 1 through 8. This is your **Modified AGI** for traditional IRA purposes	9. ___________

NONDEDUCTIBLE CONTRIBUTIONS

Although your deduction for IRA contributions may be reduced or eliminated, contributions can be made to your IRA up to the general limit or, if it applies, the spousal IRA limit. The difference between your total permitted contributions and your IRA deduction, if any, is your nondeductible contribution.

Example. Mike is 28 years old and single. In 2011, he was covered by a retirement plan at work. His salary was $57,312. His modified AGI was $68,000. Mike made a $5,000 IRA contribution for 2011. Because he was covered by a retirement plan and his modified AGI was over $66,000, he cannot deduct his $5,000 IRA contribution. He must designate this contribution as a nondeductible contribution, as explained next.

Form 8606. To designate contributions as nondeductible, you must file Form 8606.

You do not have to designate a contribution as nondeductible until you file your tax return. When you file, you can even designate otherwise deductible contributions as nondeductible.

You must file Form 8606 to report nondeductible contributions even if you do not have to file a tax return for the year.

Failure to report nondeductible contributions. If you do not report nondeductible contributions, all of the contributions to your traditional IRA will be treated as deductible. All distributions from your IRA will be taxed unless you can show, with satisfactory evidence, that nondeductible contributions were made.

Penalty for overstatement. If you overstate the amount of nondeductible contributions on your Form 8606 for any tax year, you must pay a penalty of $100 for each overstatement, unless it was due to reasonable cause.

Penalty for failure to file Form 8606. You will have to pay a $50 penalty if you do not file a required Form 8606, unless you can prove that the failure was due to reasonable cause.

Tax on earnings on nondeductible contributions. As long as contributions are within the contribution limits, none of the earnings or gains on those contributions (deductible or nondeductible) will be taxed until they are distributed.

Cost basis. You will have a cost basis in your IRA if there are nondeductible contributions. Your cost basis is the sum of the nondeductible contributions to your IRA minus any withdrawals or distributions of nondeductible contributions.

INHERITED IRAS

If you inherit a traditional IRA, you are called a beneficiary. A beneficiary can be any person or entity the owner chooses to receive the benefits of the IRA after he or she dies. Beneficiaries of a traditional IRA must include in their gross income any taxable distributions they receive.

Inherited from spouse. If you inherit a traditional IRA from your spouse, you generally have the following three choices. You can:

1) Treat it as your own IRA by designating yourself as the account owner.

2) Treat it as your own by rolling it over into your IRA, or to the extent it is taxable, into a:

    a) Qualified employer plan,
    b) Qualified employee annuity plan (section 403(a) plan),
    c) Tax-sheltered annuity plan (section 403(b) plan), or
    d) Deferred compensation plan of a state or local government (section 457 plan).

3) Treat yourself as the beneficiary rather than treating the IRA as your own.

Treating it as your own. You will be considered to have chosen to treat the IRA as your own if:

- Contributions (including rollover contributions) are made to the inherited IRA, or
- You do not take the required minimum distribution for a year as a beneficiary of the IRA.

You will only be considered to have chosen to treat the IRA as your own if:

- You are the sole beneficiary of the IRA, and
- You have an unlimited right to withdraw amounts from it.

However, if you receive a distribution from your deceased spouse's IRA, you can roll that distribution over into your own IRA within the 60-day time limit, as long as the distribution is not a required distribution, even if you are not the sole beneficiary of your deceased spouse's IRA.

Inherited from someone other than spouse. If you inherit a traditional IRA from anyone other than your deceased spouse, you cannot treat the inherited IRA as your own. This means that contributions (including rollover contributions) cannot be made to the IRA and you cannot roll over any amounts out of the inherited IRA. However, you can make a trustee-to-trustee transfer as long as the IRA into which amounts are being moved is set up and maintained in the name of the deceased IRA owner for the benefit of you as beneficiary.

CAN I MOVE RETIREMENT PLAN ASSETS?

Traditional IRA rules permit you to transfer, tax free, assets (money or property) from other retirement plans (including traditional IRAs) to a traditional IRA. The rules permit the following kinds of transfers.

- Transfers from one trustee to another.
- Rollovers.
- Transfers incident to a divorce.

Transfers to Roth IRAs. Under certain conditions, you can move assets from a traditional IRA to a Roth IRA. In 2011, you can also move assets from a qualified retirement plan to a Roth IRA. See *Can I Move Amounts Into a Roth IRA?* under *Roth IRAs,* later.

Trustee-to-Trustee Transfer

A transfer of funds in your traditional IRA from one trustee directly to another, either at your request or at the trustee's request, is ***not a rollover***. Because there is no distribution to you, the transfer is tax free. Because it is not a rollover, it is not affected by the 1-year waiting period required between rollovers, discussed later under *Rollover From One IRA Into Another*.

Rollovers

Generally, a rollover is a tax-free distribution to you of cash or other assets from one retirement plan that you contribute (roll over) to another retirement plan. The contribution to the second retirement plan is called a "rollover contribution."

Kinds of rollovers to a traditional IRA. You can roll over amounts from the following plans into a traditional IRA:

1) A traditional IRA,
2) An employer's qualified retirement plan for its employees,
3) A deferred compensation plan of a state or local government (section 457 plan), or
4) A tax-sheltered annuity plan (section 403 plan).

Treatment of rollovers. You cannot deduct a rollover contribution, but you must report the rollover distribution on your tax return as discussed later under *Reporting rollovers from IRAs* and under *Reporting rollovers from employee plans*.

Kinds of rollovers from a traditional IRA. You may be able to roll over, tax free, a distribution from your traditional IRA into a qualified plan, including the federal Thrift Savings Fund, a deferred compensation plan of a state or local government (section 457 plan), and a tax-sheltered annuity (section 403(b) plan). The part of the distribution that you can roll over is the part that would otherwise be taxable (includible in your income). Qualified plans may, but are not required to, accept such rollovers.

Time limit for making a rollover contribution. You generally must make the rollover contribution by the 60th day after the day you receive the distribution from your traditional IRA or your employer's plan.

The IRS may waive the 60-day requirement where the failure to do so would be against equity or good conscience, such as in the event of a casualty, disaster, or other event beyond your reasonable control.

Extension of rollover period. If an amount distributed to you from a traditional IRA or a qualified employer retirement plan is a frozen deposit at any time during the 60-day period allowed for a rollover, special rules extend the rollover period.

Rollover From One IRA Into Another

You can withdraw, tax free, all or part of the assets from one traditional IRA if you reinvest them within 60 days in the same or another traditional IRA. Because this is a rollover, you cannot deduct the amount that you reinvest in an IRA.

Waiting period between rollovers. If you make a tax-free rollover of any part of a distribution from a traditional IRA, you cannot, within a 1-year period, make a tax-free rollover of any later distribution from that same IRA. You also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, from the IRA into which you made the tax-free rollover.

The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over into an IRA.

Example. You have two traditional IRAs, IRA-1 and IRA-2. You make a tax-free rollover of a distribution from IRA-1 into a new traditional IRA (IRA-3). You cannot, within 1 year of the distribution from IRA-1, make a tax-free rollover of any distribution from either IRA-1 or IRA-3 into another traditional IRA.

However, the rollover from IRA-1 into IRA-3 does not prevent you from making a tax-free rollover from IRA-2 into any other traditional IRA. This is because you have not, within the last year, rolled over, tax free, any distribution from IRA-2 or made a tax-free rollover into IRA-2.

Exception. There is an exception to the rule that amounts rolled over tax free into an IRA cannot be rolled over tax free again within the 1-year period beginning on the date of the original distribution. The exception applies to a distribution which meets ***all three*** of the following requirements.

1) It is made from a failed financial institution by the Federal Deposit Insurance Corporation (FDIC) as receiver for the institution.
2) It was ***not*** initiated by either the custodial institution or the depositor.
3) It was made because:
    a) The custodial institution is insolvent, and
    b) The receiver is unable to find a buyer for the institution.

Partial rollovers. If you withdraw assets from a traditional IRA, you can roll over part of the withdrawal tax free and keep the rest of it. The amount you keep will generally be taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10% additional tax on early distributions, discussed later under *What Acts Result in Penalties or Additional Taxes* .

Required distributions. Amounts that must be distributed during a particular year under the required distribution rules (discussed later) ***are not eligible for rollover*** treatment.

Inherited IRAs. If you inherit a traditional IRA from your spouse, you generally can roll it over, or you can choose to make the inherited IRA your own.

Reporting rollovers from IRAs. Report any rollover from one traditional IRA to the same or another traditional IRA on lines 15a and 15b, Form 1040 or lines 11a and 11b, Form 1040A.

Enter the total amount of the distribution on line 15a, Form 1040 or line 11a, Form 1040A. If the total amount on line 15a, Form 1040 or line 11a, Form 1040A was rolled over, enter zero on line 15b, Form 1040 or line 11b, Form 1040A. Otherwise, enter the taxable portion of the part that was not rolled over on line 15b, Form 1040 or line 11b, Form 1040A.

If you rolled over the distribution into a qualified plan (other than an IRA) or you make the rollover in 2012, attach a statement explaining what you did.

Rollover From Employer's Plan Into an IRA

You can roll over into a traditional IRA all or part of an ***eligible rollover distribution*** you receive from your (or your deceased spouse's):

1) Employer's qualified pension, profit-sharing or stock bonus plan,
2) Annuity plan,
3) Tax-sheltered annuity plan (section 403(b) plan), or
4) Governmental deferred compensation plan (section 457 plan).

Eligible rollover distribution. Generally, an eligible rollover distribution is any distribution of all or part of the balance to your credit in a qualified retirement plan ***except:***

1) A required minimum distribution.
2) Hardship distributions.
3) Any of a series of substantially equal periodic distributions paid at least once a year over:
    a) Your lifetime or life expectancy,
    b) The lifetimes or life expectancies of you and your beneficiary, or
    c) A period of 10 years or more.
4) Corrective distributions of excess contributions or excess deferrals, and any income allocable to the excess, or of excess annual additions and any allocable gains.
5) A loan treated as a distribution because it does not satisfy certain requirements either when made or later (such as upon default), unless the participant’s accrued benefits are reduced (offset) to repay the loan.
6) Dividends on employer securities.
7) The cost of life insurance coverage.

Transfers Incident to Divorce

If an interest in a traditional IRA is transferred from your spouse or former spouse to you by a divorce or separate maintenance decree or a written document related to such a decree, the interest in the IRA, starting from the date of the transfer, is treated as your IRA. ***The transfer is tax free.***

Converting from any traditional IRA. You can convert amounts from a traditional IRA into a Roth IRA if, for the tax year you make the withdrawal from the traditional IRA, ***both*** of the following requirements are met.

1) Your modified AGI (explained earlier) is not more than $100,000.
2) You are not a married individual filing a separate return.

Required distributions. Amounts that must be distributed from your traditional IRA for a particular year (including the calendar year in which you reach age 70½) under the required distribution rules (discussed under *Traditional IRAs,* later) cannot be converted.

Income. You must include in your gross income distributions from a traditional IRA that you would have to include in income if you had not converted them into a Roth IRA. These amounts are included in income on your return for the year that you converted them from a traditional IRA to a Roth IRA. You do not include in gross income any part of a distribution from a traditional IRA that is a return of your basis, as discussed later.

If you must include any amount in your gross income, you may have to increase your withholding or make estimated tax payments. See chapter 4.

Recharacterizations

You may be able to treat a contribution made to one type of IRA as having been made to a different type of IRA. This is called recharacterizing the contribution.

How to recharacterize a contribution. To recharacterize a contribution, you generally must have the contribution transferred from the first IRA (the one to which it was made) to the second IRA in a trustee-to-trustee transfer. If the transfer is made by the due date (including extensions) for your tax return for the year during which the contribution was made, you can elect to treat the contribution as having been originally made to the second IRA instead of to the first IRA. If you recharacterize your contribution, you must do all three of the following.

- Include in the transfer any net income allocable to the contribution. If there was a loss, the net income you must transfer may be a negative amount.
- Report the recharacterization on your tax return for the year during which the contribution was made.
- Treat the contribution as having been made to the second IRA on the date that it was actually made to the first IRA.

No deduction allowed. You cannot deduct the contribution to the first IRA. Any net income you transfer with the recharacterized contribution is treated as earned in the second IRA.

Required notifications. To recharacterize a contribution, you must notify both the trustee of the first IRA (the one to which the contribution was actually made) and the trustee of the second IRA (the one to which the contribution is being moved) that you have elected to treat the contribution as having been made to the second IRA rather than the first. You must make the notifications by the date of the transfer. Only one notification is required if both IRAs are maintained by the same trustee. The notification(s) must include all of the following information.

- The type and amount of the contribution to the first IRA that is to be recharacterized.
- The date on which the contribution was made to the first IRA and the year for which it was made.
- A direction to the trustee of the first IRA to transfer in a trustee-to-trustee transfer the amount of the contribution and any net income (or loss) allocable to the contribution to the trustee of the second IRA.
- The name of the trustee of the first IRA and the name of the trustee of the second IRA.
- Any additional information needed to make the transfer.

Reporting a recharacterization. If you elect to recharacterize a contribution to one IRA as a contribution to another IRA, you must report the recharacterization on your tax return as directed by Form 8606 and its instructions. You must treat the contribution as having been made to the second IRA.

WHEN CAN I WITHDRAW OR USE IRA ASSETS?

There are rules limiting use of your IRA assets and distributions from it. Violation of the rules generally results in additional taxes in the year of violation. See *What Acts Result in Penalties or Additional Taxes.*

Contributions returned before the due date. If you made IRA contributions for 2011, you can withdraw them tax free by the due date of your return. If you have an extension of time to file your return, you can withdraw them tax free by the extended due date. You can do this if, for each contribution you withdraw, ***both*** of the following conditions apply.

- You did not take a deduction for the contribution.
- You also withdraw any interest or other income earned on the contribution. You can take into account any loss on the contribution while it was in the IRA when calculating the amount that must be withdrawn. If there was a loss, the net income earned on the contribution may be a negative amount.

You must include in income any earnings on the contributions you withdraw. Include the earnings in income for the year in which you made the contributions, not in the year in which you withdraw them.

Early distributions tax. The 10% additional tax on distributions made before you reach age 59½ does not apply to these tax-free withdrawals of your contributions. However, the distribution of interest or other income must be reported on Form 5329 and, unless the distribution qualifies as an exception to the age 59½ rule, it will be subject to this tax.

WHEN MUST I WITHDRAW IRA ASSETS? (REQUIRED MINIMUM DISTRIBUTIONS)

You cannot keep funds in your traditional IRA indefinitely. Eventually they ***must*** be distributed. If there are no distributions, or if the distributions are not large enough, you may have to pay a 50% excise tax on the amount not distributed as required. See *Excess Accumulations (Insufficient Distributions),* later. The requirements for distributing IRA funds differ depending on whether you are the IRA owner or the beneficiary of a decedent's IRA.

Required distributions not eligible for rollover. Amounts that must be distributed (required distributions) during a particular year are not eligible for rollover treatment.

IRA owners. If you are the owner of a traditional IRA, you must start receiving distributions from your IRA by April 1 of the year following the year in which you reach age 70½. April 1 of the year following the year in which you reach age 70½ is referred to as the ***required beginning date***.

Distributions by the required beginning date. You must receive at least a minimum amount for each year starting with the year you reach age 70½ (your 70½ year). If you do not (or did not) receive that minimum amount in your 70½ year, then you must receive distributions for your 70½ year by April 1 of the next year. If an IRA owner dies after reaching age 70½, but before April 1 of the next year, no minimum distribution is required because death occurred before the required beginning date.

Caution. *Even if you begin receiving distributions before you attain age 70½, you must begin calculating and receiving required minimum distributions by your required beginning date.*

Distributions after the required beginning date. The required minimum distribution for any year after your 70½ year must be made by December 31 of that later year.

Beneficiaries. If you are the beneficiary of a decedent's traditional IRA, the requirements for distributions from that IRA generally depend on whether the IRA owner died before or after the required beginning date for distributions.

ARE DISTRIBUTIONS TAXABLE?

In general, distributions from a traditional IRA are taxable in the year you receive them.

Exceptions. Exceptions to distributions from traditional IRAs being taxable in the year you receive them are:

- Rollovers,
- Qualified charitable distributions, discussed later,
- Tax-free withdrawals of contributions, discussed earlier, and
- The return of nondeductible contributions, discussed later under *Distributions Fully or Partly Taxable*.

Qualified charitable distributions. A qualified charitable distribution (QCD) is a nontaxable distribution made directly by the trustee of your IRA (other than a SEP or SIMPLE IRA) to an organization eligible to receive tax-deductible contributions. You must have been at least age 70½ when the distribution was made. Your total QCDs for the year cannot be more than $100,000. If you file a joint return, your spouse can also have a QCD of up to $100,000. However, the amount of the QCD is limited to the amount of the distribution that would otherwise be included in income. If your IRA includes nondeductible contributions, the distribution is first considered to be paid out of otherwise taxable income.

Caution. *You cannot claim a charitable contribution deduction for any QCD not included in your income.*

Ordinary income. Distributions from traditional IRAs that you include in income are taxed as ordinary income.

No special treatment. In figuring your tax, you cannot use the 10-year tax option or capital gain treatment that applies to lump-sum distributions from qualified employer plans.

Distributions Fully or Partly Taxable

Distributions from your traditional IRA may be fully or partly taxable, depending on whether your IRA includes any nondeductible contributions.

Fully taxable. If only deductible contributions were made to your traditional IRA (or IRAs, if you have more than one), you have ***no basis*** in your IRA. Because you have no basis in your IRA, any distributions are fully taxable when received. See *Reporting taxable distributions on your return,* later.

Partly taxable. If you made nondeductible contributions to any of your traditional IRAs, you have a ***cost basis*** (investment in the contract) equal to the amount of those contributions. These nondeductible contributions are not taxed when they are distributed to you. They are a return of your investment in your IRA.

Only the part of the distribution that represents nondeductible contributions (your cost basis) is tax free. If nondeductible contributions have been made, distributions consist partly of nondeductible contributions (basis) and partly of deductible contributions, earnings, and gains (if there are any). Until all of your basis has been distributed, each distribution is partly nontaxable and partly taxable.

Form 8606. You must complete Form 8606 and attach it to your return if you receive a distribution from a traditional IRA and have ever made nondeductible contributions to any of your traditional IRAs. Using the form, you will figure the nontaxable distributions for 2011 and your total IRA basis for 2011 and earlier years.

Distributions reported on Form 1099-R. If you receive a distribution from your traditional IRA, you will receive Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* or a similar statement. IRA distributions are shown in boxes 1 and 2a of Form 1099-R. A number or letter code in box 7 tells you what type of distribution you received from your IRA.

Withholding. Federal income tax is withheld from distributions from traditional IRAs unless you choose not to have tax withheld. See chapter 4.

IRA distributions delivered outside the United States. In general, if you are a U.S. citizen or resident alien and your home address is outside the United States or its possessions, you cannot choose exemption from withholding on distributions from your traditional IRA.

Reporting taxable distributions on your return. Report fully taxable distributions, including early distributions, on line 15b, Form 1040 (no entry is required on line 15a), or line 11b, Form 1040A. If only part of the distribution is taxable, enter the total amount on line 15a, Form 1040, or line 11a, Form 1040A, and the taxable part on line 15b, Form 1040, or line 11b, Form 1040A. You cannot report distributions on Form 1040EZ.

WHAT ACTS RESULT IN PENALTIES OR ADDITIONAL TAXES?

The tax advantages of using traditional IRAs for retirement savings can be offset by additional taxes and penalties if you do not follow the rules. For example, there are additions to the regular tax for using your IRA funds in prohibited transactions. There are also additional taxes for the following activities.

- Investing in collectibles.
- Making excess contributions.
- Taking early distributions.
- Allowing excess amounts to accumulate (failing to take required distributions).

There are penalties for overstating the amount of nondeductible contributions and for failure to file a Form 8606, if required.

Prohibited Transactions

Generally, a prohibited transaction is any improper use of your traditional IRA by you, your beneficiary, or any disqualified person.

Disqualified persons include your fiduciary and members of your family (spouse, ancestor, lineal descendent, and any spouse of a lineal descendent).

The following are examples of prohibited transactions with a traditional IRA.

- Borrowing money from it.
- Selling property to it.
- Receiving unreasonable compensation for managing it.
- Using it as security for a loan.
- Buying property for personal use (present or future) with IRA funds.

Effect on an IRA account. Generally, if you or your beneficiary engages in a prohibited transaction in connection with your traditional IRA account at any time during the year, the account stops being an IRA as of the first day of that year.

Taxes on prohibited transactions. If someone other than the owner or beneficiary of a traditional IRA engages in a prohibited transaction, that person may be liable for certain taxes. In general, there is a 15% tax on the amount of the prohibited transaction and a 100% additional tax if the transaction is not corrected.

Investment in Collectibles

If your traditional IRA invests in collectibles, the amount invested is considered distributed to you in the year invested. You may have to pay the 10% additional tax on early distributions, discussed later.

Collectibles. These include:

- Art works,
- Rugs,
- Antiques,
- Metals,
- Gems,
- Stamps,
- Coins,
- Alcoholic beverages, and
- Certain other tangible personal property.

Exception. Your IRA can invest in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins, or one-ounce silver coins minted by the Treasury Department. It can also invest in certain platinum coins and certain gold, silver, palladium, and platinum bullion.

Excess Contributions

Generally, an excess contribution is the amount contributed to your traditional IRA(s) for the year that is more than the smaller of:

- Your taxable compensation for the year, or
- The maximum deductible amount for the year. For 2011, this is $5,000 ($6,000 if 50 or older).

Tax on excess contributions. In general, if the excess contributions for a year are not withdrawn by the date your return for the year is due (including extensions), you are subject to a 6% tax. You must pay the 6% tax each year on excess amounts that remain in your traditional IRA at the end of your tax year. The tax cannot be more than 6% of the value of your IRA as of the end of your tax year.

Excess contributions withdrawn by due date of return. You will not have to pay the 6% tax if you withdraw an excess contribution made during a tax year ***and*** you also withdraw interest or other income earned on the excess contribution. You must complete your withdrawal by the date your tax return for that year is due, including extensions.

How to treat withdrawn contributions. Do not include in your gross income an excess contribution that you withdraw from your traditional IRA before your tax return is due if ***both*** the following conditions are met.

1) No deduction was allowed for the excess contribution.
2) You withdraw the interest or other income earned on the excess contribution.

You can take into account any loss on the contribution while it was in the IRA when calculating the amount that must be withdrawn. If there was a loss, the net income earned on the contribution may be a negative amount.

How to treat withdrawn interest or other income. You must include in your gross income the interest or other income that was earned on the excess contribution. Report it on your return for the year in which the excess contribution was made. Your withdrawal of interest or other income may be subject to an additional 10% tax on early distributions, discussed later.

Excess contributions withdrawn after due date of return. In general, you must include all distributions (withdrawals) from your traditional IRA in your gross income. However, if the following conditions are met, you can withdraw excess contributions from your IRA and not include the amount withdrawn in your gross income.

1) Total contributions (other than rollover contributions) for 2011 to your IRA were not more than $5,000 ($6,000 if 50 or older).
2) You did not take a deduction for the excess contribution being withdrawn.

The withdrawal can take place at any time, even after the due date, including extensions, for filing your tax return for the year.

Excess contribution deducted in an earlier year. If you deducted an excess contribution in an earlier year for which the total contributions were not more than the maximum deductible amount for that year ($5,000 for 2008, 2009, and 2010 ($6,000 if you were age 50 or older)), you can still remove the excess from your traditional IRA and not include it in your gross income. To do this, file Form 1040X, *Amended U.S. Individual Income Tax Return,* for that year and do not deduct the excess contribution on the amended return. Generally, you can file an amended return within 3 years after you filed your return, or 2 years from the time the tax was paid, whichever is later.

Early Distributions

You must include early distributions of taxable amounts from your traditional IRA in your gross income. Early distributions are also subject to an ***additional 10% tax.*** See the discussion of Form 5329 under *Reporting Additional Taxes,* later, to figure and report the tax.

Early distributions defined. Early distributions are amounts distributed from your traditional IRA account or annuity before you are age 59½.

Age 59½ rule. Generally, if you are under age 59½, you must pay a 10% additional tax on the distribution of any assets (money or other property) from your traditional IRA. Distributions before you are age 59½ are called early distributions.

The 10% additional tax applies to the part of the distribution that you have to include in gross income. It is in addition to any regular income tax on that amount.

Exceptions. There are several exceptions to the age 59½ rule. Even if you receive a distribution before you are age 59½, you may not have to pay the 10% additional tax if you are in one of the following situations.

- You have unreimbursed medical expenses that are more than 7.5% of your adjusted gross income.
- The distributions are not more than the cost of your medical insurance.
- You are disabled.
- You are the beneficiary of a deceased IRA owner.
- You are receiving distributions in the form of an annuity.
- The distributions are not more than your qualified higher education expenses.
- You use the distributions to buy, build, or rebuild a first home.
- The distribution is due to an IRS levy of the qualified plan.
- The distribution is a qualified reservist distribution.

Additional 10% tax. The additional tax on early distributions is 10% of the amount of the early distribution that you must include in your gross income. This tax is in addition to any regular income tax resulting from including the distribution in income.

Nondeductible contributions. The tax on early distributions does not apply to the part of a distribution that represents a return of your nondeductible contributions (basis).

Excess Accumulations (Insufficient Distributions)

You cannot keep amounts in your traditional IRA indefinitely. Generally, you must begin receiving distributions by April 1 of the year following the year in which you reach age 70½ (your 70½ year). The required minimum distribution for any year after your 70 year must be made by December 31 of that later year.

Tax on excess. If distributions are less than the required minimum distribution for the year, you may have to pay a 50% excise tax for that year on the amount not distributed as required.

Request to waive the tax. If the excess accumulation is due to reasonable error, and you have taken, or are taking, steps to remedy the insufficient distribution, you can request that the tax be waived. If you believe you qualify for this relief, file Form 5329, and attach a statement of explanation.

Exemption from tax. If you are unable to take required distributions because you have a traditional IRA invested in a contract issued by an insurance company that is in state insurer delinquency proceedings, the 50% excise tax does not apply if the conditions and requirements of Revenue Procedure 92-10 are satisfied.

V. Roth IRAs

Regardless of your age, you may be able to establish and make nondeductible contributions to a retirement plan called a Roth IRA.

Contributions not reported. You do not report Roth IRA contributions on your return.

WHAT IS A ROTH IRA?

A Roth IRA is an individual retirement plan that, except as explained in this chapter, is subject to the rules that apply to a traditional IRA (defined below). It can be either an account or an annuity.

To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up. Neither a SEP-IRA nor a SIMPLE IRA can be designated as a Roth IRA.

Unlike a traditional IRA, you cannot deduct contributions to a Roth IRA. But, if you satisfy the requirements, qualified distributions (discussed later) are tax free. Contributions can be made to your Roth IRA after you reach age 70½ and you can leave amounts in your Roth IRA as long as you live.

WHEN CAN A ROTH IRA BE SET UP?

You can set up a Roth IRA at any time. However, the time for making contributions for any year is limited. See *When Can I Make Contributions*, later under *Can I Contribute to a Roth IRA.*

CAN I CONTRIBUTE TO A ROTH IRA?

Generally, you can contribute to a Roth IRA if you have taxable ***compensation*** (defined later) and your ***modified AGI*** (defined later) is less than:

- $179,000 for married filing jointly, or qualifying widow(er),
- $10,000 for married filing separately and you lived with your spouse at any time during the year, and
- $122,000 for single, head of household, or married filing separately and you did not live with your spouse at any time during the year.

Is there an age limit for contributions? Contributions can be made to your Roth IRA regardless of your age.

Can I contribute to a Roth IRA for my spouse? You can contribute to a Roth IRA for your spouse provided the contributions satisfy the spousal IRA limit (discussed in *How Much Can Be Contributed?* under *Traditional IRAs*), you file jointly, and your modified AGI is less than $179,000.

Compensation. Compensation includes wages, salaries, tips, professional fees, bonuses, and other amounts received for providing personal services. It also includes commissions, self-employment income, and taxable alimony and separate maintenance payments.

Modified AGI. Your modified AGI for Roth IRA purposes is your adjusted gross income (AGI) as shown on your return modified as follows.

1) ***Subtract*** the following:
   a) Roth IRA conversions included on Form 1040, line 15b; or Form 1040A, line 11b.
   b) Roth IRA rollovers from qualified retirement plans included on Form 1040, line 16b; or Form 1040A, line 12b.
   c) Minimum required distributions from IRAs (for conversions and rollovers from qualified retirement plans only).
2) ***Add*** the following deductions and exclusions:
   a) Traditional IRA deduction,
   b) Student loan interest deduction,
   c) Tuition and fees deduction,
   d) Foreign earned income exclusion,
   e) Foreign housing exclusion or deduction,
   f) Exclusion of qualified savings bond interest shown on Form 8815,
   g) Exclusion of employer-provided adoption benefits shown on Form 8839, and
   h) Domestic production activities deduction.

You can use *Worksheet 17-2* to figure your modified AGI.

Worksheet 17-2. Modified Adjusted Gross Income for Roth IRA Purposes

Use this worksheet to figure your modified adjusted gross income for Roth IRA purposes.

1. Enter your adjusted gross income from Form 1040, line 38, or Form 1040A, line 22	1. ____________
2. Enter any income resulting from the conversion of an IRA (other than a Roth IRA) to a Roth IRA, and a rollover from a qualified retirement plan to a Roth IRA	2. ____________
3. Subtract line 2 from line 1	3. ____________
4. Enter any traditional IRA deduction from Form 1040, line 32, or Form 1040A, line 17	4. ____________
5. Enter any student loan interest deduction from Form 1040, line 33, or Form 1040A, line 18	5. ____________
6. Enter any tuition and fees deduction from Form 1040, line 34, or Form 1040A, line 19	6. ____________
7. Enter any domestic production activities deduction from Form 1040, line 35	7. ____________
8. Enter any foreign earned income and/or housing exclusion from Form 2555, line 45, or Form 2555-EZ, line 18	8. ____________
9. Enter any foreign housing deduction from Form 2555, line 50	9. ____________
10. Enter any excludable savings bond interest from Form 8815, line 14	10.____________
11. Enter any excluded employer-provided adoption benefits from Form 8839, line 26	11. ____________
12. Add the amounts on lines 3 through 11	12. ____________
13. Enter: • $179,000 if married filing jointly or qualifying widow(er) • $10,000 if married filing separately and you lived with your spouse at any time during the year • $122,000 for all others	13. ____________
Is the amount on line 12 more than the amount on line 13? **If yes, then** see the ***Note*** below. **If no, then** the amount on line 13 is your ***modified AGI*** for Roth IRA purposes.	

Note. If the amount on line 12 is more than the amount on line 13 and you have other income or loss items, such as social security income or passive activity losses, that are subject to AGI-based phaseouts, you can refigure your AGI solely for the purpose of figuring your modified AGI for Roth IRA purposes. When figuring your modified AGI for conversion purposes, refigure your AGI without taking into account any income from conversions or minimum required distributions from IRAs. (If you receive social security benefits, use *Worksheet 1* in *Appendix B* of Publication 590 to refigure your AGI.) Then go to list item (2) under *Modified AGI* or line 3 above in *Worksheet 17-2* to refigure your modified AGI. If you do not have other income or loss items subject to AGI-based phaseouts, your modified AGI for Roth IRA purposes is the amount on line 12.

How Much Can Be Contributed?

The contribution limit for Roth IRAs depends on whether contributions are made only to Roth IRAs or to both traditional IRAs and Roth IRAs.

Roth IRAs only. If contributions are made only to Roth IRAs, your contribution limit generally is the lesser of:

- $5,000 ($6,000 if you are 50 or older in 2011), or
- Your taxable compensation.

However, If your modified AGI is above a certain amount, your contribution limit may be reduced, as explained later under *Contribution limit reduced.*

Roth IRAs and traditional IRAs. If contributions are made to both Roth IRAs and traditional IRAs established for your benefit, your contribution limit for Roth IRAs generally is the same as your limit would be if contributions were made only to Roth IRAs, but then reduced by all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

This means that your contribution limit is the lesser of:

- $5,000 ($6,000 if you are 50 or older in 2011) minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs, or
- Your taxable compensation minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

However, if your modified AGI is above a certain amount, your contribution limit may be reduced, as explained next under *Contribution limit reduced.*

Contribution limit reduced. If your modified AGI is above a certain amount, your contribution limit is gradually reduced. Use *Table 17-3* to determine if this reduction applies to you.

Table 17-3. **Effect of Modified AGI on Roth IRA Contribution**

This table shows whether your contribution to a Roth IRA is affected by the amount of your modified adjusted gross income (modified AGI).

IF you have taxable compensation and your filing status is…	**AND your modified AGI is…**	**THEN…**
married filing jointly, or qualifying widow(er)	less than $169,000	you can contribute up to $5,000 ($6,000 if you are 50 or older in 2011).
	at least $169,000 but less than $179,000	the amount you can contribute is reduced as explained under *Contribution limit reduced* in Publication 590.
	$179,000 or more	you cannot contribute to a Roth IRA.
married filing separately and you lived with your spouse at any time during the year	zero (-0-)	you can contribute up to $5,000 ($6,000 if you are 50 or older in 2011).
	more than zero (-0-) but less than $10,000	the amount you can contribute is reduced as explained under *Contribution limit reduced* in Publication 590.
	$10,000 or more	you cannot contribute to a Roth IRA.
single, head of household, or married filing separately and you did not live with your spouse at any time during the year	less than $107,000	you can contribute up to $5,000 ($6,000 if you are 50 or older in 2011).
	at least $107,000 but less than $122,000	the amount you can contribute is reduced as explained under *Contribution limit reduced* in Publication 590.
	$122,000 or more	you cannot contribute to a Roth IRA.

When Can I Make Contributions?

You can make contributions to a Roth IRA for a year at any time during the year or by the due date of your return for that year (not including extensions).

Tip. *You can make contributions for 2011 by the due date (not including extensions) for filing your 2011 tax return.*

What If I Contribute Too Much?

A 6% excise tax applies to any ***excess contribution*** to a Roth IRA.

Excess contributions. These are the contributions to your Roth IRAs for a year that equal the ***total*** of:

1) Amounts contributed for the tax year to your Roth IRAs (other than amounts properly and timely rolled over from a Roth IRA or properly converted from a traditional IRA, as described later) that are more than your contribution limit for the year, plus

2) Any excess contributions for the preceding year, reduced by the total of:
    a) Any distributions out of your Roth IRAs for the year, plus
    b) Your contribution limit for the year minus your contributions to all your IRAs for the year.

Withdrawal of excess contributions. For purposes of determining excess contributions, any contribution that is withdrawn on or before the due date (including extensions) for filing your tax return for the year is treated as an amount not contributed. This treatment applies only if any earnings on the contributions are also withdrawn and are reported as income earned and receivable in the year the contribution was made.

Applying excess contributions. If contributions to your Roth IRA for a year were more than the limit, you can apply the excess contribution in one year to a later year if the contributions for that later year are less than the maximum allowed for that year.

CAN YOU MOVE AMOUNTS INTO A ROTH IRA?

Conversions

You can convert a traditional IRA to a Roth IRA. The conversion is treated as a rollover, regardless of the conversion method used. Most of the rules for rollovers, described under *Rollover From One IRA Into Another* under *Traditional IRAs,* earlier, apply to these rollovers. However, the 1-year waiting period does not apply.

Conversion methods. You can convert amounts from a traditional IRA to a Roth IRA in ***any*** of the following three ways.

1) ***Rollover***. You can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days after the distribution.
2) ***Trustee-to-trustee transfer***. You can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.
3) ***Same trustee transfer***. If the trustee of the traditional IRA also maintains the Roth IRA, you can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.

Same trustee. Conversions made with the same trustee can be made by redesignating the traditional IRA as a Roth IRA, rather than opening a new account or issuing a new contract.

Rollover from an employer's plan into a Roth IRA. You can roll over into a Roth IRA all or part of an eligible rollover distribution you receive from your (or your deceased spouse's):

- Employer's qualified pension, profit-sharing or stock bonus plan,
- Annuity plan,
- Tax-sheltered annuity plan (section 403(b) plan), or
- Governmental deferred compensation plan (section 457 plan).

Any amount rolled over is subject to the same rules for converting a traditional IRA into a Roth IRA. Also, the rollover contribution must meet the rollover requirements that apply to the specific type of retirement plan.

Income. You must include in your gross income distributions from a qualified retirement plan that you would have had to include in income if you had not rolled them over into a Roth IRA. You do not include in gross income any part of a distribution from a qualified retirement plan that is a return of contributions (after-tax contributions) to the plan that were taxable to you when paid.

Caution. *If you must include any amount in your gross income, you may have to increase your withholding or make estimated tax payments.*

Converting from a SIMPLE IRA. Generally, you can convert an amount in your SIMPLE IRA to a Roth IRA under the same rules explained earlier under *Converting from any traditional IRA.*

However, you cannot convert any amount distributed from the SIMPLE IRA during the 2-year period beginning on the date you first participated in any SIMPLE IRA plan maintained by your employer.

Failed Conversions and Rollovers

If, when you converted amounts from a traditional IRA or SIMPLE IRA into a Roth IRA, or when you rolled over amounts from a qualified retirement plan into a Roth IRA, you expected to have modified AGI of less than $100,000 and a filing status other than married filing separately, but your expectations did not come true, you have made a failed conversion or failed rollover.

Results of failed conversions and failed rollovers. If the converted amount (contribution) is not recharacterized (explained earlier), the contribution will be treated as a regular contribution to the Roth IRA and subject to the following tax consequences.

1) A 6% excise tax per year will apply to any excess contribution not withdrawn from the Roth IRA.
2) The distributions from the traditional IRA or qualified retirement plan must be included in your gross income.
3) The 10% additional tax on early distributions may apply to any distribution.

Rollover From a Roth IRA

You can withdraw, tax free, all or part of the assets from one Roth IRA if you contribute them within 60 days to another Roth IRA. Most of the rules for rollovers explained under *Rollover From One IRA Into Another* under *Traditional IRAs,* earlier, apply to these rollovers.

Rollover from designated Roth account. A rollover from a designated Roth account can only be made to another designated Roth account or to a Roth IRA.

<u>ARE DISTRIBUTIONS FROM MY ROTH IRA TAXABLE?</u>

You do not include in your gross income ***qualified distributions*** or distributions that are a return of your regular contributions from your Roth IRA(s). You also do not include distributions from your Roth IRA that you roll over tax free into another Roth IRA. You may have to include part of other distributions in your income. See *Ordering rules for distributions,* later.

What are qualified distributions? A qualified distribution is any payment or distribution from your Roth IRA that meets the following requirements.

1) It is made after the 5-year period beginning with the first taxable year for which a contribution was made to a Roth IRA set up for your benefit, and
2) The payment or distribution is:
   a) Made on or after the date you reach age 59½,
   b) Made because you are disabled,
   c) Made to a beneficiary or to your estate after your death, or
   d) To pay up to $10,000 (lifetime limit) of certain qualified first-time homebuyer amounts.

Additional tax on distributions of conversion and certain rollover contributions within 5-year period. If, within the 5-year period starting with the first day of your tax year in which you convert an amount from a traditional IRA or rollover an amount from a qualified retirement plan to a Roth IRA, you take a distribution from a Roth IRA, you may have to pay the 10% additional tax on early distributions. You generally must pay the 10% additional tax on any amount attributable to the part of the amount converted or rolled over (the conversion or rollover contribution) that you had to include in income. A separate 5-year period applies to each conversion and rollover. See *Ordering rules for distributions*, later, to determine the amount, if any, of the distribution that is attributable to the part of the conversion or rollover contribution that you had to include in income.

Additional tax on other early distributions. Unless an exception applies, the taxable part of other distributions from your Roth IRA(s) that are not qualified distributions is subject to the 10% additional tax on early distributions.

Ordering rules for distributions. If you receive a distribution from your Roth IRA that is ***not*** a qualified distribution, part of it may be taxable. There is a set order in which contributions (including conversion contributions) and earnings are considered to be distributed from your Roth IRA. Regular contributions are distributed first.

Must I withdraw or use Roth IRA assets? You are not required to take distributions from your Roth IRA at any age. The minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive. However, after the death of a Roth IRA owner, certain of the minimum distribution rules that apply to traditional IRAs also apply to Roth IRAs.

PART II: MOVING EXPENSES

I. <u>Important Change</u>

Standard mileage rate. The standard mileage rate for moving expenses has changed to 19 cents per mile for the first half of 2011, and 23.5 cents for the second half of 2011.

II. <u>Introduction</u>

This chapter explains the deduction of certain expenses of moving to a new home because you changed job locations or started a new job. This includes the following topics.

- Who can deduct moving expenses.
- What moving expenses are deductible.

- What moving expenses are not deductible.
- How to report moving expenses.

You may qualify for the moving expense deduction whether you are self-employed or an employee. However, you must meet the requirements explained under *Who Can Deduct Moving Expenses*.

III. Who Can Deduct Moving Expenses

You can deduct your moving expenses if your move is closely related to the start of work. You also must meet the distance test and the time test. These two tests are discussed later.

RELATED TO START OF WORK

Your move must be closely related, both in time and in place, to the start of work at your new job location.

Closely related in time. You can generally consider moving expenses incurred within 1 year from the date you first reported to work at the new location as closely related in time to the start of work. It is not necessary that you arrange to work before moving to a new location, as long as you actually do go to work.

If you do not move within 1 year of the date you begin work, you ordinarily cannot deduct the expenses unless you can show that circumstances existed that prevented the move within that time.

Example. Your family moved more than a year after you started work at a new location. You delayed the move for 18 months to allow your child to complete high school. You can deduct your allowable moving expenses.

Closely related in place. You can generally consider your move closely related in place to the start of work if the distance from your new home to the new job location is not more than the distance from your former home to the new job location. A move that does not meet this requirement may qualify if you can show that:

1) You are required to live at your new home as a condition of your employment, or
2) You will spend less time or money commuting from your new home to your new job location.

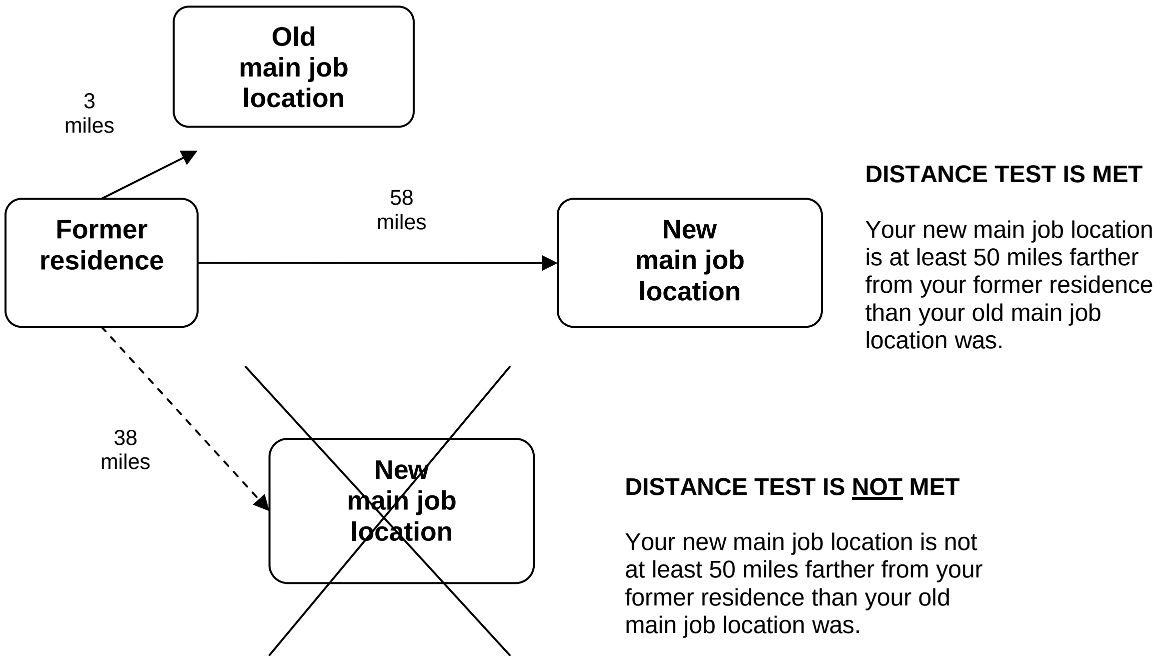
Home defined. Your ***home*** means your main home (residence). It can be a house, apartment, condominium, houseboat, house trailer, or similar dwelling. It does not include other homes owned or kept up by you or members of your family. It also does not include a seasonal home, such as a summer beach cottage. Your ***former home*** means your home before you left for your new job location. Your ***new home*** means your home within the area of your new job location.

DISTANCE TEST

Your move will meet the distance test if your new main job location is ***at least 50 miles*** farther from your former home than your old main job location was from your former home. For example, if your old main job location was 3 miles from your former home, your new main job location must be at least 53 miles from that former home.

The distance between a job location and your home is the shortest of the more commonly traveled routes between them. The distance test considers only the location of your former home. It does not take into account the location of your new home. See *Illustration of Distance Test* figure next.

Figure. Illustration of Distance Test



Example. You moved to a new home less than 50 miles from your former home because you changed main job locations. Your old main job location was 3 miles from your former home. Your new main job location is 60 miles from that home. Because your new main job location is 57 miles farther from your former home than the distance from your former home to your old main job location, you meet the distance test.

First job or return to full-time work. If you go to work full time for the first time, your place of work must be at least 50 miles from your former home to meet the distance test.

If you go back to full-time work after a substantial period of part-time work or unemployment, your place of work must also be at least 50 miles from your former home.

Exception for Armed Forces. If you are in the Armed Forces and you moved because of a permanent change of station, you do not have to meet the distance test. See *Members of the Armed Forces*, later.

Main job location. Your main job location is usually the place where you spend most of your working time. If there is no one place where you spend most of your working time, your main job location is the place where your work is centered, such as where you report for work or are otherwise required to "base" your work.

Union members. If you work for several employers on a short-term basis and you get work under a union hall system (such as a construction or building trades worker), your main job location is the union hall.

More than one job. If you have more than one job at any time, your main job location depends on the facts in each case. The more important factors to be considered are:

- The total time you spend at each place,
- The amount of work you do at each place, and
- How much money you earn at each place.

TIME TEST

To deduct your moving expenses, you also must meet one of the following two time tests.

1) The time test for employees.
2) The time test for self-employed persons.

See table below for a summary of these tests.

Table. Satisfying the Time Test for Employees and Self-Employed Persons

IF you are…	**THEN you satisfy the time test by meeting the…**
an employee	39-week test for employees.
both self-employed and an employee, but unable to satisfy the 39-week test for employees	78-week test for self-employed persons.
both self-employed and an employee at the same time	78-week test for a self-employed person or the 39-week test for an employee. Your principal place of work determines which test applies.
self-employed	78-week test for self-employed persons.

Time Test for Employees

If you are an employee, you must work full time for at least ***39 weeks during the first 12 months*** after you arrive in the general area of your new job location. Full-time employment depends on what is usual for your type of work in your area.

For purposes of this test, the following four rules apply.

1) You count only your full-time work as an employee, not any work you do as a self-employed person.
2) You do not have to work for the same employer for all 39 weeks.
3) You do not have to work 39 weeks in a row.
4) You must work full time within the same general commuting area for all 39 weeks.

Temporary absence from work. You are considered to have worked full time during any week you are temporarily absent from work because of illness, strikes, lockouts, layoffs, natural disasters, or similar causes. You are also considered to have worked full time during any week you are absent from work for leave or vacation provided for in your work contract or agreement.

Seasonal work. If your work is seasonal, you are considered to be working full time during the off-season only if your work contract or agreement covers an off-season period and that period is less than 6 months. For example, a school teacher on a 12-month contract who teaches on a full-time basis for more than 6 months is considered to have worked full time for the entire 12 months.

Time Test for Self-Employed Persons

If you are self-employed, you must work full time for at least ***39 weeks during the first 12 months AND*** for a total of at least ***78 weeks during the first 24 months*** after you arrive in your new job location.

For purposes of this test, the following three rules apply.

1) You count any full-time work you do either as an employee or as a self-employed person.
2) You do not have to work for the same employer or be self-employed in the same trade or business for the 78 weeks.
3) You must work within the same general commuting area for all 78 weeks.

If you were both an employee and self-employed, see table earlier for the requirements.

Self-employment. You are self-employed if you work as the sole owner of an unincorporated business or as a partner in a partnership carrying on a business. You are not considered self-employed if you are semiretired, are a part-time student, or work only a few hours each week.

Full-time work. You can count only those weeks during which you work full time as a week of work. Whether you work full time during any week depends on what is usual for your type of work in your area.

Joint return. If you are married and file a joint return and both you and your spouse work full time, either of you can satisfy the full-time work test. However, you cannot combine the weeks your spouse worked with the weeks you worked to satisfy that test.

Time test not yet met. You can deduct your moving expenses on your 2011 tax return even if you have not yet met the time test by the date your 2011 return is due. You can do this if you expect to meet the 39-week test in 2012, or the 78-week test in 2012 or 2013. If you deduct moving expenses but do not meet the time test in 2012 or 2013, you must either:

1) Report your moving expense deduction as other income on your Form 1040 for the year you cannot meet the test, or
2) Amend your 2011 return.

Use Form 1040X, *Amended U.S. Individual Income Tax Return,* to amend your return.

If you do not deduct your moving expenses on your 2011 return and you later meet the time test, you can file an amended return for 2011 to take the deduction.

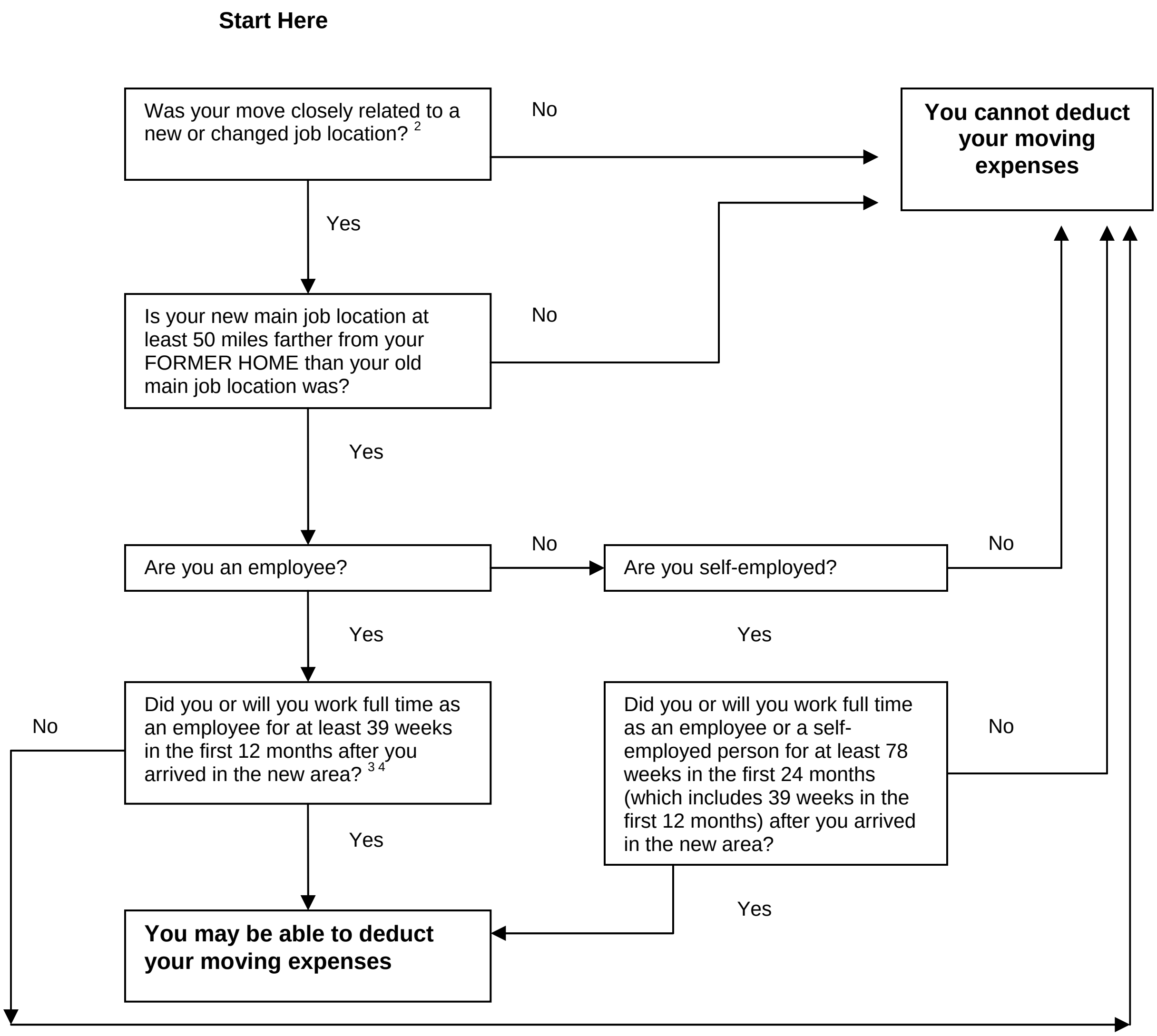
Exceptions to the Time Test

You do not have to meet the time test if one of the following applies.

1) You are in the Armed Forces and you moved because of a permanent change of station. See *Members of the Armed Forces,* later.
2) You moved to the United States because you retired. See *Retirees or Survivors Who Move to the United States,* later.

3) You are the survivor of a person whose main job location at the time of death was outside the United States. See *Retirees or Survivors Who Move to the United States,* later.
4) Your job at the new location ends because of death or disability.
5) You are transferred for your employer's benefit or laid off for a reason other than willful misconduct. For this exception, you must have obtained full-time employment and you must have expected to meet the test at the time you started the job.

Figure. <u>Can You Deduct Expenses for a Non-Military Move Within the United States?</u> [1]



[1] Members of the Armed Forces for special rules that apply to them.
[2] Your move must be closely related to the start of work at your new job location. See *Related to Start of Work*.
[3] If you deduct expenses and do not meet the test later, you must either file an amendment or report your moving expense deduction as other income. See *Time test not yet met.*
[4] If you become self-employed during the first 12 months, answer YES if your time as a full-time employee added to your time as a self-employed person equals or will equal at least 78 weeks in the first 24 months including 39 weeks in the first twelve months after you arrived in the new area.

Members of the Armed Forces

If you are a member of the Armed Forces on active duty and you move because of a permanent change of station, you do not have to meet the ***distance and time tests,*** discussed earlier. You can deduct your unreimbursed moving expenses.

A permanent change of station includes:

- A move from your home to your first post of active duty,
- A move from one permanent post of duty to another, and
- A move from your last post of duty to your home or to a nearer point in the United States. The move must occur within 1 year of ending your active duty or within the period allowed under the Joint Travel Regulations.

Spouse and dependents. If a member of the Armed Forces dies, is imprisoned, or deserts, a permanent change of station for the spouse or dependent includes a move to:

- The place of enlistment,
- The member's, spouse's, or dependent's home of record, or
- A nearer point in the United States.

If the military moves you and your spouse and dependents to or from separate locations, the moves are treated as a single move to your new main job location.

RETIREES OR SURVIVORS WHO MOVE TO THE UNITED STATES

Retirees who were working abroad. You can deduct moving expenses for a move to a new home in the United States when you permanently retire. However, both your former main job location and your former home must have been outside the United States.

Permanently retired. You are considered permanently retired when you cease gainful full-time employment or self-employment. If, at the time you retire, you intend your retirement to be permanent, you will be considered retired though you later return to work. Your intention to retire permanently may be determined by:

1) Your age and health,
2) The customary retirement age for people who do similar work,
3) Whether you receive retirement payments from a pension or retirement fund, and
4) The length of time before you return to full-time work.

Survivors of decedents who were working abroad. If you are the spouse or the dependent of a person whose main job location at the time of death was outside the United States, you can deduct moving expenses if the following five requirements are met.

1) The move is to a home in the United States.
2) The move begins within 6 months after the decedent's death. (When a move begins is described later.)
3) The move is from the decedent's former home.
4) The decedent's former home was outside the United States.
5) The decedent's former home was also your home.

When a move begins. A move begins when one of the following events occurs.

1) You contract for your household goods and personal effects to be moved to your home in the United States, but only if the move is completed within a reasonable time.
2) Your household goods and personal effects are packed and on the way to your home in the United States.
3) You leave your former home to travel to your new home in the United States.

IV. Deductible Moving Expenses

If you meet the requirements discussed earlier under *Who Can Deduct Moving Expenses*, you can deduct the reasonable expenses of:

1) Moving your household goods and personal effects (including in-transit or foreign-move storage expenses), and
2) Traveling (including lodging but not meals) to your new home.

Reasonable expenses. You can deduct only those expenses that are reasonable for the circumstances of your move. For example, the cost of traveling from your former home to your new one should be by the shortest, most direct route available by conventional transportation. If, during your trip to your new home, you stop over, or make side trips for sightseeing, the additional expenses for your stopover or side trips are not deductible as moving expenses.

Travel by car. If you use your car to take yourself, members of your household, or your personal effects to your new home, you can figure your expenses by deducting either:

1) Your ***actual expenses***, such as gas and oil for your car, if you keep an accurate record of each expense, or
2) The ***standard mileage rate*** of 19 cents a mile for the first half of 2011, and 23.5 cents for the second half of 2011.

Whether you use actual expenses or the standard mileage rate to figure your expenses, you can deduct parking fees and tolls you paid in moving. You cannot deduct any part of general repairs, general maintenance, insurance, or depreciation for your car.

Member of household. You can deduct moving expenses you pay for yourself and members of your household. A member of your household is anyone who has both your former and new home as his or her home. It does not include a tenant or employee, unless that person is your dependent.

Location of move. There are different rules for moving within or to the United States than for moving outside the United States. This chapter only discusses moves within or to the United States.

HOUSEHOLD GOODS AND PERSONAL EFFECTS

You can deduct the cost of packing, crating, and transporting your household goods and personal effects and those of the members of your household from your former home to your new home. If you use your own car to move your things, see *Travel by car,* earlier. You can include the cost of storing and insuring household goods and personal effects within ***any period of 30 consecutive days*** after the day your things are moved from your former home and before they are delivered to your new home.

You can deduct any costs of connecting or disconnecting utilities required because you are moving your household goods, appliances, or personal effects.

You can deduct the cost of shipping your car and household pets to your new home.

You can deduct the cost of moving your household goods and personal effects from a place other than your former home. Your deduction is limited to the amount it would have cost to move them from your former home.

TRAVEL EXPENSES

You can deduct the cost of transportation and lodging for yourself and members of your household while traveling from your former home to your new home. This includes expenses for the day you arrive.

You can include any lodging expenses you had in the area of your former home within one day after you could no longer live in your former home because your furniture had been moved.

You can deduct expenses for only one trip to your new home for yourself and members of your household. However, all of you do not have to travel together or at the same time. If you use your own car, see *Travel by car*, earlier.

V. Nondeductible Expenses

You cannot deduct the following items as moving expenses.

- Any part of the purchase price of your new home.
- Car tags.
- Driver's license.
- Expenses of buying or selling a home.
- Expenses of getting or breaking a lease.
- Home improvements to help sell your home.
- Loss on the sale of your home.
- Losses from disposing of memberships in clubs.
- Meal expenses.
- Mortgage penalties.
- Pre-move househunting expenses.
- Real estate taxes.
- Refitting of carpets and draperies.
- Security deposits (including any given up due to the move).
- Storage charges except those incurred in transit and for foreign moves.
- Temporary living expenses.

VI. How and When to Report

Form 3903. Use Form 3903 to report your moving expenses.

Where to deduct. Deduct your moving expenses on line 26 of Form 1040. The amount of moving expenses you can deduct is shown on line 5 of Form 3903.

Reimbursements. If you received a reimbursement for your allowable moving expenses, how you report this amount and your expenses depends on whether the reimbursement was paid to you under an accountable plan or a nonaccountable plan.

WHEN TO DEDUCT EXPENSES

If you were not reimbursed, deduct your allowable moving expenses either in the year you incurred them or in the year you paid them.

Example. In December 2011, your employer transferred you to another city in the United States, where you still work. You are single and were not reimbursed for your moving expenses. In 2011, you paid for moving your furniture. You deducted these expenses in 2011. In January 2012, you paid for travel to the new city. You can deduct these additional expenses in 2012.

Reimbursed expenses. If you are reimbursed for your expenses, you may be able to deduct your allowable expenses either in the year you incurred them or in the year you paid them. If you use the cash method of accounting, you can choose to deduct the expenses in the year you are reimbursed even though you paid the expenses in a different year.

If you are reimbursed for your expenses in a year after you paid the expenses, you may want to delay taking the deduction until the year you receive the reimbursement. If you do not choose to delay your deduction until the year you are reimbursed, you must include the reimbursement in your income.

Choosing when to deduct. If you use the cash method of accounting, which is used by most individuals, you can choose to deduct moving expenses in the year your employer reimburses you if:

1) You paid the expenses in a year before the year of reimbursement, or
2) You paid the expenses in the year immediately after the year of reimbursement but by the due date, including extensions, for filing your return for the reimbursement year.

CHAPTER 17 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. An advantage of a traditional IRA is that generally the amounts in the account, including all earnings and gains, are:

   a) always made up of fully deductible pre-tax contributions
   b) never required to be withdrawn by the owner
   c) excluded from all taxes by the person inheriting the account from a parent
   d) not taxed until the funds are distributed

2. Contributions can be made to your traditional IRA for a year at any time during the year or by the due date for filing your return for that year, including extensions.

   a) true
   b) false

3. You are covered by your employer's defined benefit plan for the plan year that ends within your tax year unless you declined to participate in the plan.

   a) true
   b) false

4. To designate nondeductible contributions made to a traditional IRA, you would need to complete and file which form:

   a) 1099-R
   b) 8606
   c) W-2
   d) W-4

5. If you inherit a traditional IRA from your spouse, which of the following is not a valid option for handling the account receipt:

   a) treat it as your own by designating yourself as the account owner
   b) treat required distributions received as additional contributions to your own IRA
   c) treat it as your own by rolling it over into your traditional IRA
   d) treat yourself as the beneficiary rather than treating the IRA as your own

6. You can roll over amounts from an employer's qualified retirement plan for its employees into a traditional IRA.

   a) true
   b) false

7. Distributions from traditional IRAs are not taxed.

   a) true
   b) false

8. Generally, if you are under age 59½, you must pay a 10% additional tax on the distribution of any assets from your traditional IRA.

   a) true
   b) false

9. You cannot deduct contributions to a Roth IRA, except:

   a) after age 70½
   b) after age 59 and before 70½
   c) if you satisfy other requirements
   d) never; Roth contributions are not deductible

10. The excise tax rate on excess contributions made to a Roth IRA equals:

    a) 1% of excess contribution
    b) 2% of excess contribution
    c) 5% of excess contribution
    d) 6% of excess contribution

11. You are not required to take distributions from your Roth IRA at any age.

    a) true
    b) false

12. Excluding members of the Armed Forces, you can generally deduct moving expenses related to a job change if the move occurred within ______ year(s) from the start of work at the new job location.

    a) 1
    b) 2
    c) 3
    d) 5

13. Deductible moving expenses include reasonable expenses of moving your household goods and personal effects. Which of the following items would not be deductible:

    a) auto travel for family members to your new home
    b) packing and transporting your household goods
    c) lodging near former home after home furniture departure
    d) meal expenses

14. You cannot deduct as moving expenses the costs incurred for home improvements to help sell your home, pre-move househunting expenses, or security deposits (including any given up due to the move).

    a) true
    b) false

CHAPTER 17 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Depending upon the taxpayer's financial circumstances, not all contributions to traditional IRA accounts will be deductible against taxable income.

   B: Incorrect. Required distributions from traditional IRA accounts must begin upon the owner reaching the age of 70½.

   C: Incorrect. Special rules apply to inherited IRAs, however, ultimately the new owner will pay tax on IRA assets once distributions begin.

   D: Correct. A major advantage of a traditional IRA is that contributions and earnings are not taxed until the funds are distributed.

2. A: True is incorrect. Contributions can be made up to the filing due date for that year, not including extensions. For most people, this means that contributions must be made by April 15^{th} of the following year.

   B: False is correct. Contributions cannot be made to your traditional IRA for the year in which you reach age 70½ or for any later year.

3. A: True is incorrect. You are covered by the plan whether or not you declined to participate in the plan, did not make a required contribution, or did not perform the minimum service required to accrue a benefit for the year.

   B: False is correct. You cannot revoke eligibility in a company defined benefit plan by declining to participate in the plan, not making required contributions, or not performing the minimum service required to accrue a benefit for the year.

4. A: Incorrect. The 1099-R document is issued by the payer of the IRA.

   B: Correct. Form 8606 must be completed and attached to your return if you made nondeductible contributions. Filing this form is required even if no tax return is due during that tax year.

   C: Incorrect. Form W-2 has no relationship to IRA contributions.

   D: Incorrect. Form W-4 is not a requirement to IRA contributions.

5. A: Incorrect. This is one of three valid choices for handling an inherited IRA from your spouse.

   B: Correct. Utilizing required distributions to fund contributions to another IRA is <u>not</u> generally one of the three valid choices for handling an inherited IRA from a spouse.

   C: Incorrect. This is one of three valid choices for handling an inherited IRA.

   D: Incorrect. Treating yourself as the beneficiary rather than as owner of the inherited IRA is a valid option and complies with special rules applicable to spouse-inherited IRAs.

6. **A: True is correct.** You cannot deduct a rollover contribution, but you must report the rollover distribution on your tax return.

   B: False is incorrect. You can also rollover another traditional IRA, a deferred compensation plan of a state or local government, or a tax-sheltered annuity into a traditional IRA.

7. A: True is incorrect. In general, distributions from traditional IRAs are taxable in the year you received them. Exceptions include rollovers, tax-free withdrawals of contributions, and the return of nondeductible contributions.

   B: False is correct. Distributions from traditional IRAs that you include in income are taxed as ordinary income.

8. **A: True is correct.** Distributions before you are age 59½ are called early distributions.

   B: False is incorrect. The 10% additional tax applies to the part of the distribution that you have to include in gross income. It is in addition to any regular income tax on that amount.

9. A: Incorrect. Contributions to Roth IRAs are never deductible, regardless of the account owner's age.

   B: Incorrect. Contributions to Roth IRAs are never deductible, regardless of age.

   C: Incorrect. There are no other requirements to satisfy which can make contributions to Roth IRAs deductible.

   D: Correct. Contributions to Roth IRAs are not deductible, but if you satisfy the requirements, qualified distributions are tax free.

10. A: Incorrect. The excise tax rate applied for excess contributions made into a Roth IRA is greater than 1%.

    B: Incorrect. The excise tax rate applied for excess contributions made into a Roth IRA and not withdrawn before the due date of the taxpayer's tax return is greater than 2%.

    C: Incorrect. This rate is not correct.

    D: Correct. A 6% excise tax applies to excess contributions made into a Roth IRA and not withdrawn before the tax return due date (including extensions).

11. **A: True is correct.** The minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive.

    B: False is incorrect. After the death of a Roth IRA owner, certain of the minimum distribution rules that apply to traditional IRAs also apply to Roth IRAs.

12. **A: Correct**. You can deduct your moving expenses if your move is closely related to the start of work, generally occurs within one (1) year, and meets the 50 mile distance test.

    B: Incorrect. Unless special circumstances existed that prevented the move from occurring within one (1) year, you generally cannot deduct moving expenses occurring after the first year.

    C: Incorrect. The move must occur in a shorter period of time.

    D: Incorrect. This time period is too long.

13. A: Incorrect. Auto travel expense to a new residence, whether calculated by a standard mileage rate or at actual cost, is a deductible moving expense when meeting time and distance tests.

    B: Incorrect. Reasonable packing and transportation expenses associated with a move are typically deductible moving expenses.

    C: Incorrect. You can include as a deductible expense any lodging expense you had in the area of your former home within one day after you could no longer live in your former home because your furniture had been moved.

    D: Correct. Meal expenses are <u>not</u> deductible as moving expenses, even if incurred while traveling between an old and new residence.

14. **A: True is correct.** Other expenses that cannot be deducted include any part of the purchase price of your new home, expenses of buying or selling a home, or the loss on the sale of your home.

    B: False is incorrect. The costs that can be included are those reasonable for moving your household goods and personal effects and traveling (including lodging) to your new home.

Chapter 18: Alimony

I. Introduction

This chapter discusses the rules that apply if you pay or receive alimony. It covers the following topics:

- What payments are alimony,
- What payments are not alimony, such as child support,
- How to deduct alimony you paid,
- How to report alimony income you received, and
- Whether you must recapture the tax benefits of alimony. Recapture means adding back in your income all or part of a deduction you took in a prior year.

Alimony is a payment to or for a spouse or former spouse under a divorce or separation instrument. It does not include voluntary payments that are not made under a divorce or separation instrument.

Alimony is deductible by the payer and must be included in the spouse's or former spouse's income. Although this chapter is generally written for the payer of the alimony, the recipient can use the information to determine whether an amount received is alimony.

To be alimony, a payment must meet certain requirements. Different requirements apply to payments under instruments executed after 1984 and to payments under instruments executed before 1985. This chapter discusses the rules for payments under instruments executed after 1984.

Use *Table 18-1* in this chapter as a guide to determine whether certain payments are considered alimony.

Table 18-1. **<u>Alimony Requirements (Instruments Executed After 1984)</u>**

Payments ARE alimony if <u>all</u> of the following are true:	**Payments are NOT alimony if <u>any</u> of the following are true:**
Payments are required by a divorce or separation instrument.	Payments are not required by a divorce or separation instrument.
Payer and recipient spouse do not file a joint return with each other.	Payer and recipient spouse file a joint return with each other.
Payment is in cash (including checks or money orders).	Payment is: • Not in cash, • A noncash property settlement, • Spouse's part of community income, or • To keep up the payer's property.
Payment is not designated in the instrument as not alimony.	Payment is designated in the instrument as not alimony.
Spouses legally separated under a decree of divorce or separate maintenance are not members of the same household.	Spouses legally separated under a decree of divorce or separate maintenance are members of the same household.
Payments are not required after death of the recipient spouse.	Payments are required after death of the recipient spouse.
Payment is not treated as child support.	Payment is treated as child support.
These payments are deductible by the payer and includible in income by the recipient.	*These payments are neither deductible by the payer nor includible in income by the recipient.*

Definitions. The following definitions apply throughout this chapter.

Spouse or former spouse. Unless otherwise stated in the following discussions about alimony, the term "spouse" includes former spouse.

Divorce or separation instrument. The term "divorce or separation instrument" means:

1) A decree of divorce or separate maintenance or a written instrument incident to that decree,
2) A written separation agreement, or
3) A decree or any type of court order requiring a spouse to make payments for the support or maintenance of the other spouse. This includes a temporary decree, an interlocutory (not final) decree, and a decree of alimony *pendente lite* (while awaiting action on the final decree or agreement).

II. <u>General Rules</u>

The following rules apply to alimony regardless of when the divorce or separation instrument was executed.

Payments not alimony. Not all payments under a divorce or separation instrument are alimony. Alimony does not include any of the following.

1) Child support.
2) Noncash property settlements.
3) Payments that are your spouse's part of community income.
4) Payments to keep up the payer's property.
5) Use of the payer's property.

Payments to a third party. Cash payments (including checks and money orders) to a third party on behalf of your spouse under the terms of your divorce or separation instrument may be alimony if they otherwise qualify. These include payments for your spouse's medical expenses, housing costs (rent, utilities, etc.), taxes, tuition, etc. The payments are treated as received by your spouse and then paid to the third party.

Life insurance premiums. Alimony includes premiums you must pay under your divorce or separation instrument for insurance on your life to the extent your spouse owns the policy.

Payments for jointly-owned home. If your divorce or separation instrument states that you must pay expenses for a home owned by you and your spouse or former spouse, some of your payments may be alimony.

Mortgage payments. If you must pay all the mortgage payments (principal and interest) on a jointly-owned home, and they otherwise qualify, you can deduct one-half of the total payments as alimony. If you itemize deductions and the home is a qualified home, you can claim half of the interest in figuring your deductible interest. Your spouse must report one-half of the payments as alimony received. If your spouse itemizes deductions and the home is a qualified home, he or she can claim one-half of the interest on the mortgage in figuring deductible interest.

Taxes and insurance. If you must pay all the real estate taxes or insurance on a home held as ***tenants in common,*** you can deduct one-half of these payments as alimony. Your spouse must report one-half of these payments as alimony received. If you and your spouse itemize deductions, you can each claim one-half of the real estate taxes and none of the home insurance.

If your home is held as ***tenants by the entirety*** or ***joint tenants***, none of your payments for taxes or insurance are alimony. But if you itemize deductions, you can claim all of the real estate taxes and none of the home insurance.

III. <u>Instruments Executed After 1984</u>

The following rules for alimony apply to payments under divorce or separation instruments executed after 1984.

Exception for instruments executed before 1985. There are two situations where the rules for instruments executed after 1984 apply to instruments executed before 1985.

1) A divorce or separation instrument executed before 1985 and then modified after 1984 to specify that the after-1984 rules will apply.

2) A temporary divorce or separation instrument executed before 1985 and incorporated into, or adopted by, a final decree executed after 1984 that:
    a) Changes the amount or period of payment, or
    b) Adds or deletes any contingency or condition.

For the rules for alimony payments under pre-1985 instruments not meeting these exceptions, see the 2004 revision of Publication 504.

Example 1. In November 1984, you and your former spouse executed a written separation agreement. In February 1985, a decree of divorce was substituted for the written separation agreement. The decree of divorce did not change the terms for the alimony you pay your former spouse. The decree of divorce is treated as executed before 1985. Alimony payments under this decree are not subject to the rules for payments under instruments executed after 1984.

Example 2. Assume the same facts as in *Example 1* except that the decree of divorce changed the amount of the alimony. In this example, the decree of divorce is not treated as executed before 1985. The alimony payments are subject to the rules for payments under instruments executed after 1984.

Alimony requirements. A payment to or for a spouse under a divorce or separation instrument is alimony if the spouses do not file a joint return with each other and ***all*** the following requirements are met.

1) The payment is in cash.
2) The instrument does not designate the payment as not alimony.
3) The spouses are not members of the same household at the time the payments are made. This requirement applies only if the spouses are legally separated under a decree of divorce or separate maintenance.
4) There is no liability to make any payment (in cash or property) after the death of the recipient spouse.
5) The payment is not treated as child support.

Each of these requirements is discussed next.

Payment must be in cash. Only cash payments, including checks and money orders, qualify as alimony. The following do not qualify as alimony.

- Transfers of services or property (including a debt instrument of a third party or an annuity contract).
- Execution of a debt instrument by the payer.
- The use of the payer’s property.

Payments to a third party. Cash payments to a third party under the terms of your divorce or separation instrument can qualify as a cash payment to your spouse. See *Payments to a third party* under *General Rules,* earlier.

Also, cash payments made to a third party at the written request of your spouse qualify as alimony if ***all*** the following requirements are met.

1) The payments are in lieu of payments of alimony directly to your spouse.
2) The written request states that both spouses intend the payments to be treated as alimony.
3) You receive the written request from your spouse before you file your return for the year you made the payments.

Payments designated as not alimony. You and your spouse can designate that otherwise qualifying payments are not alimony. You do this by including a provision in your divorce or separation instrument that states the payments are not deductible as alimony by you and are excludable from your spouse's income. For this purpose, any instrument (written statement) signed by both of you that makes this designation and that refers to a previous written separation agreement is treated as a written separation agreement. If you are subject to temporary support orders, the designation must be made in the original or a later temporary support order.

Your spouse can exclude the payments from income only if he or she attaches a copy of the instrument designating them as not alimony to his or her return. The copy must be attached each year the designation applies.

Spouses cannot be members of the same household. Payments to your spouse while you are members of the same household are not alimony if you are legally separated under a decree of divorce or separate maintenance. A home you formerly shared is considered one household, even if you physically separate yourselves in the home.

You are not treated as members of the same household if one of you is preparing to leave the household and does leave no later than 1 month after the date of the payment.

Exception. If you are not legally separated under a decree of divorce or separate maintenance, a payment under a written separation agreement, support decree, or other court order may qualify as alimony even if you are members of the same household when the payment is made.

Liability for payments after death of recipient spouse. If you must continue to make payments for any period after your spouse's death, none of the payments made before or after the death are alimony.

The divorce or separation instrument does not have to expressly state that the payments cease upon the death of your spouse if, for example, the liability for continued payments would end under state law.

Example. You must pay your former spouse $10,000 in cash each year for 10 years. Your divorce decree states that the payments will end upon your former spouse's death. You must also pay your former spouse or your former spouse's estate $20,000 in cash each year for 10 years. The death of your spouse would not terminate these payments under state law.

The $10,000 annual payments are alimony. But because the $20,000 annual payments will not end upon your former spouse's death, they are not alimony.

Substitute payments. If you must make any payments in cash or property after your spouse's death as a substitute for continuing otherwise qualifying payments, the otherwise qualifying payments are not alimony. To the extent that your payments begin, accelerate, or increase because of the death of your spouse, otherwise qualifying payments you made may be treated as payments that were not alimony. Whether or not such payments will be treated as not alimony depends on all the facts and circumstances.

Example 1. Under your divorce decree, you must pay your former spouse $30,000 annually. The payments will stop at the end of 6 years or upon your former spouse's death, if earlier.

Your former spouse has custody of your minor children. The decree provides that if any child is still a minor at your spouse's death, you must pay $10,000 annually to a trust until the youngest child reaches the age of majority. The trust income and corpus (principal) are to be used for your children's benefit.

These facts indicate that the payments to be made after your former spouse's death are a substitute for $10,000 of the $30,000 annual payments. $10,000 of each of the $30,000 annual payments is not alimony.

Example 2. Under your divorce decree, you must pay your former spouse $30,000 annually. The payments will stop at the end of 15 years or upon your former spouse's death, if earlier. The decree provides that if your former spouse dies before the end of the 15-year period, you must pay the estate the difference between $450,000 ($30,000 X 15) and the total amount paid up to that time. For example, if your spouse dies at the end of the tenth year, you must pay the estate $150,000 ($450,000 - $300,000).

These facts indicate that the lump-sum payment to be made after your former spouse's death is a substitute for the full amount of the $30,000 annual payments. None of the annual payments are alimony. The result would be the same if the payment required at death were to be discounted by an appropriate interest factor to account for the prepayment.

Child support. A payment that is specifically designated as child support or treated as specifically designated as child support under your divorce or separation instrument is not alimony. The designated amount or part may vary from time to time. Child support payments are neither deductible by the payer nor taxable to the recipient.

Specifically designated as child support. A payment will be treated as specifically designated as child support to the extent that the payment is reduced either:

1) On the happening of a contingency relating to your child, or
2) At a time that can be clearly associated with the contingency.

A payment may be treated as specifically designated as child support even if other separate payments are specifically designated as child support.

Contingency relating to your child. A contingency relates to your child if it depends on any event relating to that child. It does not matter whether the event is certain or likely to occur. Events relating to your child include the child's:

- Becoming employed,
- Dying,
- Leaving the household,
- Leaving school,
- Marrying, or
- Reaching a specified age or income level.

Clearly associated with a contingency. Payments are presumed to be reduced at a time clearly associated with the happening of a contingency relating to your child only in the following situations.

1) The payments are to be reduced not more than 6 months before or after the date the child will reach 18, 21, or local age of majority.
2) The payments are to be reduced on two or more occasions that occur not more than 1 year before or after a different one of your children reaches a certain age from 18 to 24. This certain age must be the same for each child, but need not be a whole number of years.

In all other situations, reductions in payments are not treated as clearly associated with the happening of a contingency relating to your child.

Either you or the IRS can overcome the presumption in the two situations above. This is done by showing that the time at which the payments are to be reduced was determined independently of any contingencies relating to your children. For example, if you can show that the period of alimony payments is customary in the local jurisdiction, such as a period equal to one-half of the duration of the marriage, you can overcome the presumption and may be able to treat the amount as alimony.

IV. How to Deduct Alimony Paid

You can deduct alimony you paid, whether or not you itemize deductions on your return. You must file Form 1040. You cannot use Form 1040A or Form 1040EZ.

Enter the amount of alimony you paid on line 31a of Form 1040. In the space provided on line 31b, enter your spouse's social security number.

If you paid alimony to more than one person, enter the social security number of one of the recipients. Show the social security number and amount paid to each other recipient on an attached statement. Enter your total payments on line 31a.

V. How to Report Alimony Received

Report alimony you received on line 11 of Form 1040. You cannot use Form 1040A or Form 1040EZ.

VI. Recapture Rule

If your alimony payments decrease or terminate during the first 3 calendar years, you may be subject to the recapture rule. If you are subject to this rule, you have to include in income in the third year part of the alimony payments you previously deducted. Your spouse can deduct in the third year part of the alimony payments he or she previously included in income.

The 3-year period starts with the first calendar year you make a payment qualifying as alimony under a decree of divorce or separate maintenance or a written separation agreement. Do not include any time in which payments were being made under temporary support orders. The second and third years are the next 2 calendar years, whether or not payments are made during those years.

The reasons for a reduction or termination of alimony payments that can require a recapture include:

- A change in your divorce or separation instrument,
- A failure to make timely payments,
- A reduction in your ability to provide support, or
- A reduction in your spouse's support needs.

When to apply the recapture rule. You are subject to the recapture rule in the third year if the alimony you pay in the third year decreases by more than $15,000 from the second year or the alimony you pay in the second and third years decreases significantly from the alimony you pay in the first year.

When you figure a decrease in alimony, do not include the following amounts.

1) Payments made under a temporary support order.
2) Payments required over a period of at least 3 calendar years of a fixed part of your income from a business or property, or from compensation for employment or self-employment.
3) Payments that decrease because of the death of either spouse or the remarriage of the spouse receiving the payments before the end of the third year.

Figuring the recapture. For a blank worksheet for you to use to figure recaptured alimony, see *Worksheet A* in Publication 504.

Including the recapture in income. If you must include a recapture amount in income, show it on Form 1040, line 11 ("Alimony received"). Cross out "received" and enter "recapture." On the dotted line next to the amount, enter your spouse's last name and social security number.

Deducting the recapture. If you can deduct a recapture amount, show it on Form 1040, line 31a ("Alimony paid"). Cross out "paid" and print "recapture." In the space provided, enter your spouse's social security number.

CHAPTER 18 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Not all payments under a divorce or separation instrument are alimony. Generally, alimony does not include:

    a) a cash payment required by a separation instrument to your former spouse
    b) a cash payment required by a separation instrument to a third party such as medical insurance company
    c) a noncash property settlement required in the divorce decree
    d) life insurance premiums you must pay under a divorce agreement

2. If you must continue to make payments for any period after your spouse's death, none of the payments made before or after the death are alimony.

    a) true
    b) false

CHAPTER 18 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A cash payment required by a separation instrument paid to your former spouse with whom you do not file a joint return is considered alimony and is deductible on the payer's tax return.

   B: Incorrect. A cash payment required by a separation instrument and paid to a third party for the benefit of a former spouse is generally considered alimony.

   C: Correct. A noncash property settlement required by either a divorce decree or separation instrument is generally <u>not</u> defined as alimony. It therefore cannot be deducted as an alimony payment.

   D: Incorrect. Life insurance premiums can be considered alimony in certain situations.

2. **A: True is correct.** The divorce or separation instrument does not have to expressly state that the payments would cease upon the death of your spouse if the liability for continued payments would end under state law.

   B: False is incorrect. If you must make any payments in cash or property after your spouse's death as a substitute for continuing qualifying payments, the otherwise qualifying payments are not alimony.

Chapter 19: Education-Related Adjustments

I. Educator Expenses

If you were an eligible educator in 2011, you can deduct up to $250 of qualified expenses you paid in 2011 as an adjustment to gross income, rather than as a miscellaneous itemized deduction. If you and your spouse are filing jointly and both of you were eligible educators, the maximum deduction is $500. However, neither spouse can deduct more than $250 of his or her qualified expenses. You may be able to deduct expenses that are more than the $250 (or $500) limit on Schedule A (Form 1040), line 21.

Eligible educator. An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year.

Qualified expenses. Qualified expenses include ordinary and necessary expenses paid in connection with books, supplies, equipment (including computer equipment, software, and services), and other materials used in the classroom. An ordinary expense is one that is common and accepted in your educational field. A necessary expense is one that is helpful and appropriate for your profession as an educator. An expense does not have to be required to be considered necessary.

Qualified expenses do not include expenses for home schooling or for nonathletic supplies for courses in health or physical education.

You must reduce your qualified expenses by the following amounts.

- Tax-free distribution of interest under an education savings bond program (Form 8815).
- Tax-free distribution of earnings from a qualified tuition program (QTP).
- Tax-free distribution of earnings from a Coverdell education savings account (ESA).
- Any reimbursements you received for these expenses that were not reported to you in box 1 of your Form W-2.

How the deduction is claimed. To claim the deduction, enter the allowable amount on line 23 of Form 1040, or line 16 of Form 1040A.

II. Student Loan Interest Deduction

Generally, personal interest you pay, other than certain mortgage interest, is not deductible on your tax return. However, if your modified adjusted gross income (MAGI) is less than $75,000 ($150,000 if filing a joint return) there is a special deduction allowed for paying interest on a student loan (also known as an education loan) used for higher education. For most taxpayers, MAGI is the adjusted gross income as figured on their federal income tax return before subtracting any deduction for student loan interest. This deduction can reduce the amount of your income subject to tax by up to $2,500 in 2011. Table 19-1 summarizes the features of the student loan interest deduction.

Table 19-1. Student Loan Interest Deduction at a Glance
Do not rely on this table alone. Refer to the text for more details.

Feature	Description
Maximum benefit	You can reduce your income subject to tax by up to $2,500.
Loan qualifications	Your student loan: • must have been taken out solely to pay qualified education expenses, and • cannot be from a related person or made under a qualified employer plan.
Student qualifications	The student must be: • you, your spouse, or your dependent, and • enrolled at least half-time in a degree program.
Time limit on deduction	You can deduct interest paid during the remaining period of your student loan.
Phaseout	The amount of your deduction depends on your income level.

STUDENT LOAN INTEREST DEFINED

Student loan interest is interest you paid during the year on a qualified student loan. It includes both required and voluntary interest payments.

Qualified Student Loan

This is a loan you took out solely to pay qualified education expenses (defined later) that were:

- For you, your spouse, or a person who was your dependent (defined in chapter 3) when you took out the loan,
- Paid or incurred within a reasonable period of time before or after you took out the loan, and
- For education provided during an academic period for an eligible student.

Loans from the following sources are not qualified student loans.

- A related person.
- A qualified employer plan.

Exceptions. For purposes of the student loan interest deduction, the following are exceptions to the general rules for dependents.

- An individual can be your dependent even if you are the dependent of another taxpayer.
- An individual can be your dependent even if the individual files a joint return with a spouse.
- An individual can be your dependent even if the individual had gross income for the year that was equal to or more than the exemption amount for the year ($3,700 for 2011).

Reasonable period of time. Qualified education expenses are treated as paid or incurred within a reasonable period of time before or after you take out the loan if they are paid with the proceeds of student loans that are part of a federal postsecondary education loan program.

Even if not paid with the proceeds of that type of loan, the expenses are treated as paid or incurred within a reasonable period of time if both of the following requirements are met.

1) The expenses relate to a specific academic period, and
2) The loan proceeds are disbursed within a period that begins 90 days before the start of that academic period and ends 90 days after the end of that academic period.

If neither of the above situations applies, the reasonable period of time usually is determined based on all the relevant facts and circumstances.

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Eligible student. This is a student who was enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential.

Enrolled at least half-time. A student was enrolled at least half-time if the student was taking at least half the normal full-time work load for his or her course of study.

The standard for what is half of the normal full-time work load is determined by each eligible educational institution. However, the standard may not be lower than any of those established by the Department of Education under the Higher Education Act of 1965.

Related person. You cannot deduct interest on a loan you get from a related person. Related persons include:

- Your spouse,
- Your brothers and sisters,
- Your half brothers and half sisters,
- Your ancestors (parents, grandparents, etc.),
- Your lineal descendants (children, grandchildren, etc.), and
- Certain corporations, partnerships, trusts, and exempt organizations.

Loan from a qualified employer plan. You cannot deduct interest on a loan made under a qualified employer plan or under a contract purchased under such a plan.

Qualified Education Expenses

Generally, for purposes of the student loan interest deduction, these expenses are the total costs of attending an eligible educational institution, including graduate school. They include amounts paid for the following items.

- Tuition and fees.
- Room and board.
- Books, supplies, and equipment.
- Other necessary expenses (such as transportation).

The cost of room and board qualified only to the extent that it is not more than the greater of the following amounts.

- The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.
- The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions.

Certain educational institutions located outside the United States also participate in the U.S. Department of Education's Federal Student Aid (FSA) programs.

For purposes of the student loan interest deduction, an eligible educational institution also includes an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility that offers postgraduate training.

An educational institution must meet the above criteria only during the academic period(s) for which the student loan was incurred. The deductibility of interest on the loan is not affected by the institution's subsequent loss of eligibility.

Tip. The educational institution should be able to tell you if it is an eligible educational institution.

Adjustments to qualified education expenses. You must reduce your qualified education expenses by certain tax-free items (such as the tax-free part of scholarships and fellowships).

Include as Interest

In addition to simple interest on the loan, certain loan origination fees, capitalized interest, interest on revolving lines of credit, and interest on refinanced student loans can be student loan interest if all other requirements are met.

Loan origination fee. In general, this is a one-time fee charged by the lender when a loan is made. To be deductible as interest, the fee must be for the use of money, rather than for property or services (such as commitment fees or processing costs) provided by the lender. A loan origination fee treated as interest accrues over the life of the loan.

Capitalized interest. This is unpaid interest on a student loan that is added by the lender to the outstanding principal balance of the loan.

Interest on revolving lines of credit. This interest, which includes interest on credit card debt, is student loan interest if the borrower uses the line of credit (credit card) only to pay qualified education expenses. See *Qualified Education Expenses*, earlier.

Interest on refinanced student loans. This includes interest on both:

- Consolidated loans – loans used to refinance more than one student loan of the same borrower, and
- Collapsed loans – two or more loans of the same borrower that are treated by both the lender and the borrower as one loan.

Caution. *If you refinance a qualified student loan for more than your original loan and you use the additional amount for any purpose other than qualified education expenses, you cannot deduct any interest paid on the refinanced loan.*

Voluntary interest payments. These are payments made on a qualified student loan during a period when interest payments are not required, such as when the borrower has been granted a deferment or the loan has not yet entered repayment status.

Do Not Include as Interest

You cannot claim a student loan interest deduction for:

- Interest you paid on a loan if, under the terms of the loan, you are not legally obligated to make interest payments.
- Loan origination fees that are payments for property or services provided by the lender, such as commitment fees or processing costs.
- Interest you paid on a loan to the extent payments were made through your participation in the National Health Service Corps Loan Repayment Program (the "NHSC Loan Repayment Program") or certain other state loan repayment programs.

Can You Claim the Deduction

Generally, you can claim the deduction if all four of the following requirements are met.

- Your filing status is any filing status except married filing separately.
- No one else is claiming an exemption for you on his or her tax return.
- You are legally obligated to pay interest on a qualified student loan.
- You paid interest on a qualified student loan.

Interest paid by others. If you are the person legally obligated to make interest payments and someone else makes a payment of interest on your behalf, you are treated as receiving the payments from the other person and, in turn, paying the interest.

No Double Benefit Allowed

You cannot deduct as interest on a student loan any amount you can deduct under any other provision of the tax law (for example, home mortgage interest).

HOW MUCH CAN YOU DEDUCT

Your student loan interest deduction for 2011 is generally the smaller of:

- $2,500, or
- The interest you paid in 2011.

The amount determined above is phased out (gradually reduced) if your MAGI is between $60,000 and $75,000 ($120,000 and $150,000 if you file a joint return). You cannot take a student loan interest deduction if your MAGI is $75,000 or more ($150,000 or more if you file a joint return).

III. Tuition and Fees Deduction

You may be able to deduct qualified education expenses paid during the year for yourself, your spouse, or a dependent. You cannot claim this deduction if your filing status is married filing separately or if another person can claim an exemption for you as a dependent on his or her tax return. The qualified expenses must be for higher education, as explained later under *What Expenses Qualify*.

The tuition and fees deduction can reduce your income subject to tax by up to $4,000.

CAN YOU CLAIM THE DEDUCTION

The following rules will help you determine if you can claim the tuition and fees deduction.

Who Can Claim the Deduction

Generally, you can claim the tuition and fees deduction if all three of the following requirements are met.

1) You paid qualified education expenses of higher education.
2) You paid the education expenses for an eligible student.
3) The eligible student is yourself, your spouse, or a dependent for whom you claim an exemption (defined in chapter 3) on your tax return.

Qualified education expenses are defined in the section entitled *What Expenses Qualify*. Eligible students are defined later under *Who Is an Eligible Student*.

Who Cannot Claim the Deduction

You cannot claim the tuition and fees deduction if any of the following apply.

- Your filing status is married filing separately.
- Another person can claim an exemption for you as a dependent on his or her tax return. You cannot take the deduction even if the other person does not actually claim that exemption.
- Your modified adjusted gross income (MAGI) is more than $80,000 ($160,000 if filing a joint return).
- You (or your spouse) were a nonresident alien for any part of the year and the nonresident alien did not elect to be treated as a resident alien for tax purposes.
- You or anyone else claims an American opportunity or lifetime learning credit in 2011 with respect to expenses of the student for whom the qualified education expenses were paid.

WHAT EXPENSES QUALIFY

The tuition and fees deduction is based on qualified education expenses you pay for yourself, your spouse, or a dependent for whom you claim an exemption on your tax return. Generally, the deduction is allowed for qualified education expenses paid in 2011 in connection with enrollment at an institution of higher education during 2011 or for an academic period (defined earlier under *Student Loan Interest Deduction*) beginning in 2011 or in the first 3 months of 2012.

Payments with borrowed funds. You can claim a tuition and fees deduction for qualified education expenses paid with the proceeds of a loan. You use the expenses to figure the deduction for the year in which the expenses are paid, not in the year in which the loan is repaid. Treat loan payments sent directly to the educational institution as paid on the date the institution credits the student's account.

Student withdraws from class(es). You can claim a tuition and fees deduction for qualified education expenses not refunded when a student withdraws.

Qualified Education Expenses

For purposes of the tuition and fees deduction, qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an eligible educational institution.

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

Related expenses. Student-activity fees and fees for course-related books, supplies, and equipment are included in qualified education expenses only if the fees and expenses must be paid to the institution as a condition of enrollment or attendance.

No Double Benefit Allowed

You cannot do any of the following.

- Deduct qualified education expenses you deduct under any other provision of the law, for example, as a business expense.
- Deduct qualified education expenses for a student on your income tax return if you or anyone else claims an American opportunity, Hope, or lifetime learning credit for that same student in the same year.
- Deduct qualified education expenses that have been used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or a qualified tuition program (QTP).
- Deduct qualified education expenses that have been paid with tax-free interest on U.S. savings bonds (Form 8815).
- Deduct qualified education expenses that have been paid with tax-free educational assistance such as scholarship, grant, or employer-provided educational assistance. See the following section on *Adjustments to qualified education expenses*.

Adjustments to qualified education expenses. If you paid qualified education expenses with certain tax-free funds, you cannot claim a deduction for those amounts. You must reduce the qualified expenses by the amount of any tax-free educational assistance and refunds you received.

Tax-free educational assistance. This includes:

- Tax-free part of scholarships and fellowships,
- Pell grants,
- Employer-provided educational assistance,
- Veterans' educational assistance,
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Refunds. Qualified education expenses do not include expenses for which you, or someone else who paid qualified education expenses on behalf of a student, receive a refund.

If a refund of expenses paid in 2011 is received before you file your tax return for 2011, simply reduce the amount of the expenses paid by the amount of the refund received.

You are considered to receive a refund of expenses when an eligible educational institution refunds loan proceeds to the lender on behalf of the borrower. Follow the above instructions according to when you are considered to receive the refund.

Amounts that do not reduce qualified education expenses. Do not reduce qualified education expenses by amounts paid with funds the student receives as:

- Payment for services, such as wages,
- A loan,
- A gift,
- An inheritance, or
- A withdrawal from the student's personal savings.

Do not reduce the qualified education expenses by any scholarship or fellowship reported as income on the student's tax return in the following situations.

- The use of the money is restricted to costs of attendance (such as room and board) other than qualified education expenses.
- The use of the money is not restricted and is used to pay education expenses that are not qualified (such as room and board).

Expenses That Do Not Qualify

Qualified education expenses do not include amounts paid for:

- Insurance,
- Medical expenses (including student health fees),
- Room and board,
- Transportation, or
- Similar personal, living, or family expenses.

This is true even if the amount must be paid to the institution as a condition of enrollment or attendance.

Sports, games, hobbies, and noncredit courses. Qualified education expenses generally do not include expenses that relate to any course of instruction or other education that involves sports, games or hobbies, or any non-credit course. However, if the course of instruction or other education is part of the student's degree program, these expenses can qualify.

Comprehensive or bundled fees. Some eligible educational institutions combine all of their fees for an academic period into one amount. If you do not receive or do not have access to an allocation showing how much you paid for qualified education expenses and how much you paid for personal expenses, such as those listed above, contact the institution. The institution is required to make this allocation and provide you with the amount you paid (or were billed) for qualified education expenses on Form 1098-T, Tuition Statement. See *How Do You Figure the Deduction*, later, for more information about Form 1098-T.

WHO IS AN ELIGIBLE STUDENT

For purposes of the tuition and fees deduction, an eligible student is a student who is enrolled in one or more courses at an eligible educational institution. The student must have either a high school diploma or a General Education Development (GED) credential.

WHO CAN CLAIM A DEPENDENT'S EXPENSES

Generally, to claim the tuition and fees deduction for qualified education expenses for a dependent, you must:

- Have paid the expenses, and
- Claim an exemption for the student as a dependent.

HOW MUCH CAN I DEDUCT

The maximum tuition and fees deduction in 2011 is $4,000, $2,000, or $0, depending on the amount of your modified adjusted gross income (MAGI).

How Do I Figure the Deduction

To help you figure your tuition and fees deduction, you should receive Form 1098-T, Tuition Statement. Generally, an eligible educational institution (such as a college or university) must send Form 1098-T (or acceptable substitute) to each enrolled student by January 31, 2012.

To claim the deduction, enter the allowable amount on Form 1040, line 34, or Form 1040A, line 19, and attach your completed Form 8917.

CHAPTER 19 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. A deduction for student loan interest paid can be claimed for taxpayers with a MAGI of less than:

    a) $75,000 for single filing taxpayer
    b) $150,000 if filing a joint return
    c) both a and b are correct
    d) none of the above; personal interest is not deductible

2. For purposes of the tuition and fees deduction, room and board are qualified expenses.

    a) true
    b) false

CHAPTER 19 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. This MAGI amount is correct for a single filer, but this is not the best answer.

   B: Incorrect. This MAGI amount is correct for married joint filers, but this is not the best answer.

   C: Correct. The student loan interest deduction is limited to taxpayers whose MAGI is less than $75,000 for single filers and $150,000 for married filing jointly.

   D: Incorrect. If a taxpayer meets certain caps mentioned previously, a special deduction is allowed for paying interest on a student/educational loan used for higher education.

2. A: True is incorrect. Room and board expenses are among the expenses that do not qualify for the tuition and fees deduction, along with insurance, medical expenses, transportation, and similar personal, living or family expenses, even if the amount must be paid to the institution as a condition of enrollment or attendance.

   B: False is correct. Qualified expenses include tuition and certain related expenses required for enrollment or attendance at an eligible educational institution, including student-activity fees and fees for course-related books, supplies, and equipment if the fees and expenses are paid to the institution as a condition of enrollment or attendance. Room and board expenses are not a qualified expense, even if they are paid to the institution as a condition of enrollment or attendance.

PART FIVE. STANDARD DEDUCTION AND ITEMIZED DEDUCTIONS

After you have figured your adjusted gross income, you are ready to subtract the deductions used to figure taxable income. You can subtract either the standard deduction or itemized deductions. Itemized deductions are deductions for certain expenses that are listed on Schedule A (Form 1040). The ten chapters in this part discuss the standard deduction, each itemized deduction, and the limit on some of your itemized deductions if your adjusted gross income exceeds certain amounts. See chapter 20 for the factors to consider when deciding whether to subtract the standard deduction or itemized deductions.

Chapter 20: Standard Deduction

I. Important Changes

Increase in standard deduction. The standard deduction for taxpayers who do not itemize deductions on Schedule A of Form 1040 is higher for some taxpayers in 2011 than it was in 2010. The amount depends on your filing status. In addition to the annual increase due to inflation adjustments, your 2011 standard deduction is increased to:

- Single or married separate – $5,800
- Married joint or qualifying widow(er) – $11,600
- Head of household – $8,500

You can use the 2011 Standard Deduction Worksheet in this chapter to figure your standard deduction.

II. Introduction

This chapter discusses:

- How to figure the amount of your standard deduction,
- The standard deduction for dependents, and
- Who should itemize deductions.

Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions. If you have a choice, you can use the method that gives you the lower tax. The standard deduction is a dollar amount that reduces the amount of income on which you are taxed.

III. Standard Deduction Amount

The standard deduction amount depends on your filing status, whether you are 65 or older or blind, whether an exemption can be claimed for you by another taxpayer, whether you pay state or local real estate taxes, whether you have a net disaster loss from a federally declared disaster. Generally, the standard deduction amounts are adjusted each year for inflation. Use Worksheet 20-1 to figure your standard deduction amount.

Decedent's final return. The amount of the standard deduction for a decedent's final return is the same as it would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed.

Higher Standard Deduction for Age (65 or Older)

If you do not itemize deductions, you are entitled to a higher standard deduction if you are age 65 or older at the end of the year. You are considered 65 on the day before your 65th birthday. Therefore, you can take a higher standard deduction for 2011 if you were born before January 2, 1947.

Use *Table 20-2* to figure the standard deduction amount.

Higher Standard Deduction for Blindness

If you are blind on the last day of the year and you do not itemize deductions, you are entitled to a higher standard deduction. You qualify for this benefit if you are totally or partly blind.

Partly blind. If you are partly blind, you must get a certified statement from an eye doctor or registered optometrist that:

1) You cannot see better than 20/200 in the better eye with glasses or contact lenses, or
2) Your field of vision is not more than 20 degrees.

If your eye condition will never improve beyond these limits, the statement should include this fact. You must keep the statement in your records.

If your vision can be corrected beyond these limits only by contact lenses that you can wear only briefly because of pain, infection, or ulcers, you can take the higher standard deduction for blindness if you otherwise qualify.

Spouse 65 or Older or Blind

You can take the higher standard deduction if your spouse is age 65 or older or blind and:

1) You file a joint return, or
2) You file a separate return and can claim an exemption for your spouse because your spouse had no gross income and an exemption for your spouse could not be claimed by another taxpayer.

Caution. *You cannot claim the higher standard deduction for an individual other than yourself and your spouse.*

Higher Standard Deduction for Net Disaster Loss

Your standard deduction may be increased by any net disaster loss from a federally declared disaster that occurred in 2008 or 2009, but did not become deductible until 2011 because it became clear in 2011 that the loss would not be reimbursed. This amount is on Form 4684, line 18.

Examples

The following examples illustrate how to determine your standard deduction using Worksheet 20-1.

Example 1. Larry, 46, and Donna, 33, are filing a joint return for 2011. Neither is blind, and neither can be claimed as a dependent. They did not have a net disaster loss. They decide not to itemize their deductions. Because they are married filing jointly, they enter $11,600 on line 1 of Worksheet 20-1. They check the “No” box on line 2, so they also enter $11,600 on lines 4 and 10. Their standard deduction is $11,600.

Example 2. The facts are the same as in Example 1, except that Larry is blind at the end of 2011, so he and Donna enter $1,150 on line 5 of Worksheet 20-1. They then enter $12,750 ($11,600 + $1,150) on line 10, so their standard deduction is $12,750.

Example 3. Bill and Lisa are filing a joint return for 2011. Both are over age 65. Neither is blind, and neither can be claimed as a dependent. They did not have a net disaster loss. They do not itemize deductions, so they use Worksheet 20-1. Because they are married filing jointly, they enter $11,600 on line 1. They check the "No" box on line 2, so they also enter $11,600 on line 4. Because they are both over age 65, they enter $2,300 ($1,150 × 2) on line 5. They enter $13,900 ($11,600 + $2,300) on line 10, so their standard deduction is $13,900.

Example 4. The facts are the same as in Example 3 except that Bill and Lisa had a net disaster loss from a federally declared disaster of $8,000. That is the amount on line 18 of their Form 4684. They enter $8,000 on line 6 of their Standard Deduction Worksheet. On line 10 of the worksheet, they enter $21,900 ($11,600 + $2,300 + $8,000), which is their standard deduction. Because line 6 (and line 9) is greater than zero, they must complete Schedule L (Form 1040A or 1040) and attach it to their return.

IV. Standard Deduction for Dependents

The standard deduction for an individual for whom an exemption can be claimed on another person's tax return is generally limited to the greater of:

1) $950, or
2) The individual's earned income for the year plus $300 (but not more than the regular standard deduction amount, generally $5,800).

However, the standard deduction may be higher if the individual is 65 or older or blind, or had a net disaster loss from a federally declared disaster.

If an exemption for you (or your spouse if you are filing jointly) can be claimed on someone else's return, use Worksheet 20-1 to determine your standard deduction.

Earned income defined. Earned income is salaries, wages, tips, professional fees, and other amounts received as pay for work you actually perform.

For purposes of the standard deduction, earned income also includes any part of a ***scholarship or fellowship grant*** that you must include in your gross income.

V. Who Should Itemize

You should itemize deductions if your total deductions are more than the standard deduction amount. Also, you should itemize if you do not qualify for the standard deduction.

You should first figure your itemized deductions and compare that amount to your standard deduction to make sure you are using the method that gives you the greater benefit.

When to itemize. You may benefit from itemizing your deductions on Schedule A (Form 1040) if you:

1) Do not qualify for the standard deduction, or the amount you can claim is limited,
2) Had large uninsured medical and dental expenses during the year,
3) Paid interest and taxes on your home,
4) Had large unreimbursed employee business expenses or other miscellaneous deductions,
5) Had large uninsured casualty or theft losses,
6) Made large contributions to qualified charities, or
7) Have total itemized deductions that are more than the standard deduction to which you otherwise are entitled.

These deductions are explained in chapters 21-28.

If you decide to itemize your deductions, complete Schedule A and attach it to your Form 1040. Enter the amount from Schedule A, line 29, on Form 1040, line 40.

Electing to itemize for state tax or other purposes. Even if your itemized deductions are less than the amount of your standard deduction, you can elect to itemize deductions on your federal return rather than take the standard deduction. You may want to do this, for example, if the tax benefit of being able to itemize your deductions on your state tax return is greater than the tax benefit you lose on your federal return by not taking the standard deduction. To make this election, you must check the box on line 30 of Schedule A.

Changing your mind. If you do not itemize your deductions and later find that you should have itemized – or if you itemize your deductions and later find you should not have – you can change your return by filing Form 1040X, *Amended U.S. Individual Income Tax Return.* See *Amended Returns and Claims for Refund* in chapter 1 for more information on amended returns.

Married persons who filed separate returns. You can change methods of taking deductions only if you and your spouse both make the same changes. Both of you must file a consent to assessment for any additional tax either one may owe as a result of the change.

You and your spouse can use the method that gives you the lower total tax, even though one of you may pay more tax than you would have paid by using the other method. You both must use the same method of claiming deductions. If one itemizes deductions, the other should itemize because he or she will not qualify for the standard deduction.

Worksheet 20-1. **2011 Standard Deduction Worksheet**

Caution. If your filing status is married filing separate and your spouse itemizes deductions on his or her tax return, or if you are a dual-status alien, do not complete this worksheet. You cannot take the standard deduction even if you were born before January 2, 1947, are blind, or had a net disaster loss. *If you are filing Form 1040EZ, do not use this worksheet. Instead see line 5 of Form 1040EZ.*		
1. Enter the amount shown below for your filing status. • Single or married filing separately - $5,800 • Married filing jointly or Qualifying widow(er) - $11,600 • Head of household - $8,500	1. _______	
2. Can you (or your spouse if filing jointly) be claimed as a dependent on someone else's return? ☐ **No.** Skip line 3; enter the amount from line 1 on line 4, and go to line 5. ☐ **Yes.** Go to line 3		
3. Is your **earned income*** more than $650? ☐ **Yes.** Add $300 to your earned income. Enter the total ☐ **No.** Enter $950.	3. _______	
4. Enter the **smaller** of line 1 or line 3		4. _______
5. If born before January 2, 1947, or blind, multiply the number on Form 1040, line 39a (or Form 1040A, line 23a**) by $1,150 ($1,450 if single or head of household). Otherwise, enter -0-		5. _______
6. Enter any net disaster loss from Form 4684, line 17**.		6. _______
7. Add lines 4, 5, 6, and 9. **This is your standard deduction for 2011.**		7. _______
****Earned income*** *includes wages, salaries, tips, professional fees, and other compensation received for personal services you performed. It also includes any amount received as a scholarship that you must include in your income. Generally, your earned income is the total of the amount(s) you reported on Form 1040, lines 7, 12, and 18, minus the amount, if any, on line 27 (or the amount you reported on Form 1040A, line 7).* ***If the amount on line 6 of this worksheet is more than zero, you must complete Schedule L (Form 1040A or 1040) and attach it to your return. Also, if the amount on line 6 of this worksheet is more than zero, you cannot file Form 1040A; you must file Form 1040.*		

CHAPTER 20 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Generally, the standard deduction amounts are adjusted each year for inflation.

   a) true
   b) false

2. The standard deduction amount varies based upon, among other factors, a taxpayer's filing status. Which of the following conditions do not alter the standard deduction:

   a) your age (if you or your spouse are at least 65)
   b) your sight (full or partial blindness of you or your spouse)
   c) certain net disaster losses
   d) it is a decedent's final tax return

CHAPTER 20 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** The standard deduction amounts are generally adjusted each year for inflation and depend on your filing status, whether you are 65 or older or blind, whether an exemption can be claimed for you by another taxpayer, whether you pay state or local real estate taxes, and whether you have a net disaster loss from a federally declared disaster.

   B: False is incorrect. The amount of the standard deduction is generally adjusted for inflation each year.

2. A: Incorrect. Age can be a factor increasing your standard deduction. You are entitled to a higher standard deduction of you are age 65 or older at the end of the tax year.

   B: Incorrect. The condition of your eyesight can increase your standard deduction. If you are blind on the last day of the tax year and you do not itemize deductions, you and your spouse are entitled to a higher standard deduction. You qualify for this benefit if either of you are totally or partly blind.

   C: Incorrect. Your standard deduction may be increased by certain net disaster losses incurred due to federally declared disasters in 2008 or 2009.

   D: Correct. The fact that a tax return is a decedent's final return does not increase the allowed standard deduction when all other factors are left unchanged.

Chapter 21: Medical and Dental Expenses

I. Important Changes

Standard mileage rate. The standard mileage rate allowed for out-of-pocket expenses for your car when you use your car for medical reasons is 19 cents a mile for the first half of 2011, and 23.5 cents for the second half of 2011.

Health Coverage Exclusion Extended to Children Under Age 27

The exclusions for employer-paid health coverage and employer reimbursements of medical expenses apply to an employee's children who are under age 27 at the end of the year, regardless of whether they can be claimed as dependents by the employee.

II. Introduction

This chapter will help you determine:

- What medical expenses are,
- What expenses you can include this year,
- How much of the expenses you can deduct,
- Whose medical expenses you can include,
- What medical expenses are includible,
- How you treat reimbursements,
- How to report the deduction on your tax return,
- How to report impairment-related work expenses, and
- How to report health insurance costs if you are self-employed.

III. What Are Medical Expenses?

Medical expenses are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the cost for treatments affecting any part or function of the body. These expenses include payments for legal medical services rendered by physicians, surgeons, dentists, and other medical practitioners. They include the costs of equipment, supplies, and diagnostic devices needed for these purposes.

Medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness. Do not include expenses that are merely beneficial to general health, such as vitamins or a vacation.

Medical expenses include the premiums you pay for insurance that covers the expenses of medical care, and the amounts you pay for transportation to get medical care. Medical expenses also include amounts paid for qualified long-term care services and limited amounts paid for any qualified long-term care insurance contract.

IV. What Expenses Can You Include This Year?

You can include only the medical and dental expenses you paid this year, regardless of when the services were provided. If you pay medical expenses by check, the day you mail or deliver the check generally is the date of payment. If you use a "pay-by-phone" or "on-line" account to pay your medical expenses, the date reported on the statement of the financial institution showing when payment was made is the date of payment. You can include medical expenses you charge to your credit card in the year the charge is made. It does not matter when you actually pay the amount charged.

Separate returns. If you and your spouse live in a noncommunity property state and file separate returns, each of you can include only the medical expenses each actually paid. Any medical expenses paid out of a joint checking account in which you and your spouse have the same interest are considered to have been paid equally by each of you, unless you can show otherwise.

Community property states. If you and your spouse live in a community property state and file separate returns, any medical expenses paid out of community funds are divided equally. Each of you should include half the expenses. If medical expenses are paid out of the separate funds of one spouse, only the spouse who paid the medical expenses can include them.

V. How Much of The Expenses Can You Deduct?

You can deduct only the amount of your medical and dental expenses that is ***more than 7.5%*** of your adjusted gross income (line 38, Form 1040).

In this chapter, the term "7.5% limit" is used to refer to 7.5% of your adjusted gross income. The phrase "subject to the 7.5% limit" is also used. This phrase means that you must subtract 7.5% (.075) of your adjusted gross income from your medical expenses to figure your medical expense deduction.

Example. Your adjusted gross income is $40,000, 7.5% of which is $3,000. You paid medical expenses of $2,500. You cannot deduct any of your medical expenses because they are not more than 7.5% of your adjusted gross income.

VI. Whose Medical Expenses Can You Include?

You can include medical expenses you pay for yourself and for the individuals discussed in this section.

Spouse. You can include medical expenses you paid for your spouse. To claim these expenses, you must have been married either at the time your spouse received the medical services or at the time you paid the medical expenses.

Example 1. Mary received medical treatment before she married Bill. Bill paid for the treatment after they married. Bill can include these expenses in figuring his medical expense deduction even if Bill and Mary file separate returns.

If Mary had paid the expenses before she and Bill married, Bill could not include Mary's expenses in his separate return. Mary would include the amounts she paid during the year in her separate return. If they filed a joint return, the medical expenses both paid during the year would be used to figure their medical expense deduction.

Example 2. This year, John paid medical expenses for his wife, Louise, who died last year. John married Belle this year, and they file a joint return. Because John was married to Louise when she incurred the medical expenses, he can include those expenses in figuring his medical deduction for this year.

Dependent. You can include medical expenses you paid for your dependent. To claim these expenses, the person must have been your dependent either at the time the medical services were provided or at the time you paid the expenses. A person generally qualifies as your dependent for purposes of the medical expense deduction if:

1) The person was a qualifying child or a qualifying relative, and
2) The person was a U.S. citizen or national, or a resident of the United States, Canada, or Mexico.

You can include medical expenses you paid for an individual that would have been your dependent except that:

1) He or she received gross income of $3,700 or more in 2011,
2) He or she filed a joint return for 2011, or
3) You, or your spouse if filing jointly, could be claimed as a dependent on someone else's 2011 return.

Exception for adopted child. If you are a U.S. citizen or U.S. national and your adopted child lived with you as a member of your household for 2011, that child does not have to be a U.S. citizen or national or a resident of the United States, Canada, or Mexico.

Qualifying Child

A qualifying child is a child who:

1) Is your son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew),
2) At the end of 2011 was:
   a) Under age 19 and younger than you (or your spouse, if filing jointly),
   b) Under age 24 and a full-time student and younger than you (or your spouse, if filing jointly), or
   c) Any age and permanently and totally disabled,
3) Lived with you for more than half of 2011,
4) Did not provide over half of his or her own support for 2011, and
5) Did not file a joint return, other than to claim a refund.

Adopted child. A legally adopted child is treated as your own child. This includes a child lawfully placed with you for legal adoption. You can include medical expenses that you paid for a child before adoption, if the child qualified as your dependent when the medical services were provided or when the expenses were paid. If you pay back an adoption agency or other persons for medical expenses they paid under an agreement with you, you are treated as having paid those expenses provided you clearly substantiate that the payment is directly attributable to the medical care of the child. But if you pay back medical expenses incurred and paid before adoption negotiations began, you cannot include them as medical expenses.

Child of divorced or separated parents. For purposes of the medical and dental expenses deduction, a child of divorced or separated parents can be treated as a dependent of both parents. Each parent can include the medical expenses he or she pays for the child, even if the other parent claims the child's dependency exemption, if:

1) The child is in the custody of one or both parents for more than half the year,
2) The child receives over half of his or her support during the year from his or her parents, and
3) The child's parents:
    a) Are divorced or legally separated under a decree of divorce or separate maintenance,
    b) Are separated under a written separation agreement, or
    c) Live apart at all times during the last six months of the year.

This does not apply if the child's exemption is being claimed under a multiple support agreement.

Qualifying Relative

A qualifying relative is a person:

1) Who is your:
    a) Son, daughter, stepchild, foster child, or a descendant of any of them (for example, your grandchild),
    b) Brother, sister, or a son or daughter of either of them,
    c) Father, mother, or an ancestor or sibling of either of them (for example, your grandmother, grandfather, aunt, or uncle),
    d) Stepbrother, stepsister, stepfather, stepmother, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law, or
    e) Any other person (other than your spouse) who lived with you all year as a member of your household if your relationship does not violate local law,
2) Who was not a qualifying child (see *Qualifying Child*, earlier) of any other person for 2011, and
3) For whom you provided over half of the support in 2011. But see *Children of divorced or separated parents*, earlier and *Support claimed under a multiple support agreement*, next.

Support claimed under a multiple support agreement. A multiple support agreement is used when two or more people provide more than half of a person's support, but no one alone provides more than half. If you are considered to have provided more than half of a person's support under such an agreement, you can include medical expenses you pay for that person, even if you cannot claim the person as a dependent.

Any medical expenses paid by others who joined you in the agreement cannot be included as medical expenses by anyone. However, you can include the entire unreimbursed amount you paid for medical expenses.

Example. You and your three brothers each provide one-fourth of your mother's total support. Under a multiple support agreement, you claim your mother as a dependent. You paid all of her medical expenses. Your brothers repaid you for three-fourths of these expenses. In figuring your medical expense deduction, you can include only one-fourth of your mother's medical expenses. Your brothers cannot include any part of the expenses. However, if you and your brothers share the nonmedical support items and you separately pay all of your mother's medical expenses, you can include the amount you paid for her medical expenses in your medical expenses.

Decedent

Medical expenses paid before death by the decedent are included in figuring any deduction for medical and dental expenses on the decedent's final income tax return. This includes expenses for the decedent's spouse and dependents as well as for the decedent.

The survivor or personal representative of a decedent can choose to treat certain expenses paid by the decedent's estate for the decedent's medical care as paid by the decedent at the time the medical services were provided. The expenses must be paid within the 1-year period beginning with the day after the date of death. If you are the survivor or personal representative making this choice, you must attach a statement to the decedent's Form 1040 (or the decedent's amended return, Form 1040X) saying that the expenses have not been and will not be claimed on the estate tax return.

Caution. *Qualified medical expenses paid before death by the decedent are not deductible if paid with a tax-free distribution from any Archer MSA, Medicare Advantage MSA, or health savings account.*

What if you pay medical expenses of a deceased spouse or dependent? If you paid medical expenses for your deceased spouse or dependent, include them as medical expenses on your Form 1040 in the year paid, whether they are paid before or after the decedent's death. The expenses can be included if the person was your spouse or dependent either at the time the medical services were provided or at the time you paid the expenses.

VII. What Medical Expenses Are Includible?

Use *Table 21-1* in this chapter as a guide to determine which medical and dental expenses you can include on Schedule A (Form 1040).

This table does not include all possible medical expenses. To determine if an expense not listed can be included in figuring your medical expenses, see *What Are Medical Expenses*, earlier.

Table 21-1. Medical and Dental Expenses Checklist

You can include:		You cannot include:	
• Bandages • Birth control pills prescribed by your doctor • Body scan • Capital expenses for equipment or improvements to your home needed for medical care (see the worksheet in Publication 502) • Diagnostic devices • Expenses of an organ donor • Eye surgery — to promote the correct function of the eye • Fertility enhancement, certain procedures • Guide dogs or other animals aiding the blind, deaf, and disabled • Hospital services fees (lab work, therapy, nursing services, surgery, etc.) • Lead-based paint removal • Legal abortion • Legal operation to prevent having children such as a vasectomy or tubal ligation • Long-term care contracts, qualified • Meals and lodging provided by a hospital during medical treatment • Medical services fees (from doctors, dentists, surgeons, specialists, and other medical practitioners) • Medicare Part D premiums	• Medical and hospital insurance premiums • Oxygen equipment and oxygen • Part of life-care fee paid to retirement home designated for medical care • Physical examination • Pregnancy test kit • Prescription medicines (prescribed by a doctor) and insulin • Psychiatric and psychological treatment • Social security tax, Medicare tax, FUTA, and state employment tax for worker providing medical care (see *Wages for nursing services*, below) • Special items (artificial limbs, false teeth, eye-glasses, contact lenses, hearing aids, crutches, wheelchair, etc.) • Special education for mentally or physically disabled persons • Stop-smoking programs • Transportation for needed medical care • Treatment at a drug or alcohol center (includes meals and lodging provided by the center) • Wages for nursing services • Weight-loss, certain expenses for obesity	• Baby sitting and childcare • Bottled water • Contributions to Archer MSAs (see Publication 969) • Diaper service • Expenses for your general health (even if following your doctor's advice) such as - — Health club dues — Household help (even if recommended by a doctor) — Social activities, such as dancing or swimming lessons — Trip for general health improvement • Flexible spending account reimbursements for medical expenses (if contributions were on a pre-tax basis) • Funeral, burial, or cremation expenses • Health savings account payments for medical expenses • Illegal operation or treatment • Life insurance or income protection policies, or policies providing payment for loss of life, limb, sight, etc. • Maternity clothes	• Medical insurance included in a car insurance policy covering all persons injured in or by your car • Medicine you buy without a prescription • Nursing care for a healthy baby • Prescription drugs you brought in (or ordered shipped) from another country, in most cases • Nutritional supplements, vitamins, herbal supplements, "natural medicines," etc., unless recommended by a medical practitioner as a treatment for a specific medical condition diagnosed by a physician • Surgery for purely cosmetic reasons • Toothpaste, toiletries, cosmetics, etc. • Teeth whitening • Weight-loss expenses not for the treatment of obesity or other disease

INSURANCE PREMIUMS

You can include in medical expenses insurance premiums you pay for policies that cover medical care. Policies can provide payment for treatment that includes:

- Hospitalization, surgical fees, X-rays,
- Prescription drugs and insulin,
- Dental care,
- Replacement of lost or damaged contact lenses,
- Long-term care (subject to additional limitations).

If you have a policy that provides more than one kind of payment, you can include the premiums for the medical care part of the policy if the charge for the medical part is reasonable. The cost of the medical part must be separately stated in the insurance contract or given to you in a separate statement.

Employer-sponsored health insurance plan. Do not include in your medical and dental expenses on Schedule A (Form 1040) any insurance premiums paid by an employer-sponsored health insurance plan unless the premiums are included in box 1 of your Form W-2. Also, do not include on Schedule A (Form 1040) any other medical and dental expenses paid by the plan unless the amount paid is included in box 1 of your Form W-2.

Example. You are a federal employee participating in the Federal Employee Health Benefits (FEHB) program. Your share of the FEHB premium is paid with pre-tax dollars. Because you are an employee whose insurance premiums are paid with money that is never included in your gross income, you cannot deduct the premiums paid with that money.

Long-term care services*.* Contributions made by your employer to provide coverage for qualified long-term care services under a flexible spending or similar arrangement must be included in your income. This amount will be reported as wages in box 1 of your Form W-2.

Health reimbursement arrangement (HRA). If you have medical expenses that are reimbursed by a health reimbursement arrangement, you cannot include those expenses in your medical expenses. This is because an HRA is funded solely by the employer.

Retired public safety officers. If you are a retired public safety officer, do not include as medical expenses any health or long-term care premiums that you elect to have paid with tax-free distributions from your retirement plan. This applies only to distributions that would otherwise be included in income.

Medicare A. If you are covered under social security (or if you are a government employee who paid Medicare tax), you are enrolled in Medicare A. The payroll tax paid for Medicare A is not a medical expense. If you are not covered under social security (or were not a government employee who paid Medicare tax), you can voluntarily enroll in Medicare A. In this situation the premiums paid for Medicare A can be included as a medical expense on your tax return.

Medicare B. Medicare B is a supplemental medical insurance. Premiums you pay for Medicare B are a medical expense. Check the information you received from the Social Security Administration to find out your premium.

Medicare D. Medicare D is a voluntary prescription drug insurance program for persons with Medicare A or B. You can include as a medical expense premiums you pay for Medicare D.

Prepaid insurance premiums. Premiums you pay before you are age 65 for insurance for medical care for yourself, your spouse, or your dependents after you reach age 65 are medical care expenses in the year paid if they are:

1) Payable in equal yearly installments, or more often, and
2) Payable for at least 10 years, or until you reach age 65 (but not for less than 5 years).

Unused sick leave used to pay premiums. You must include in gross income cash payments you receive at the time of retirement for unused sick leave. You must also include in gross income the value of unused sick leave that, at your option, your employer applies to the cost of your continuing participation in your employer's health plan after you retire. You can include this cost of continuing participation in the health plan as a medical expense.

If you participate in a health plan where your employer automatically applies the value of unused sick leave to the cost of your continuing participation in the health plan (and you do not have the option to receive cash), do not include the value of the unused sick leave in gross income. You cannot include this cost of continuing participation in that health plan as a medical expense.

MEALS AND LODGING

You can include in medical expenses the cost of meals and lodging at a hospital or similar institution if your main reason for being there is to receive medical care. See *Nursing home,* later.

You may be able to include in medical expenses the cost of lodging not provided in a hospital or similar institution. You can include the cost of such lodging while away from home if you meet all of the following requirements.

1) The lodging is primarily for and essential to medical care.
2) The medical care is provided by a doctor in a licensed hospital or in a medical care facility related to, or the equivalent of, a licensed hospital.
3) The lodging is not lavish or extravagant under the circumstances.
4) There is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

The amount you include in medical expenses for lodging cannot be more than $50 for each night for each person. You can include lodging for a person traveling with the person receiving the medical care. For example, if a parent is traveling with a sick child, up to $100 per night can be included as a medical expense for lodging. Meals are not included.

Nursing home. You can include in medical expenses the cost of medical care in a nursing home or home for the aged for yourself, your spouse, or your dependents. This includes the cost of meals and lodging in the home if the main reason for being there is to get medical care.

Do not include the cost of meals and lodging if the reason for being in the home is personal. You can, however, include in medical expenses the part of the cost that is for medical or nursing care.

TRANSPORTATION

You can include in medical expenses amounts paid for transportation primarily for, and essential to, medical care.

You Can Include:

- Bus, taxi, train, or plane fares, or ambulance service,
- Transportation expenses of a parent who must go with a child who needs medical care,
- Transportation expenses of a nurse or other person who can give injections, medications, or other treatment required by a patient who is traveling to get medical care and is unable to travel alone, and
- Transportation expenses for regular visits to see a mentally ill dependent, if these visits are recommended as a part of treatment.

You Cannot Include:

- Transportation expenses to and from work even if your condition requires an unusual means of transportation.
- Travel for purely personal reasons to another city for an operation or other medical care.
- Travel that is merely for the general improvement of one's health.
- The costs of operating a specially equipped car for other than medical reasons.

Car expenses. You can include out-of-pocket expenses for your car, such as gas and oil, when you use your car for medical reasons. You cannot include depreciation, insurance, general repair, or maintenance expenses.

If you do not want to use your actual expenses, you can use a standard rate of 19 cents a mile for the use of your car for medical reasons in the first half of 2011, and 23.5 cents in the second half of 2011.

You can also include the cost of parking fees and tolls. You can add these fees and tolls to your medical expenses whether you use actual expenses or use the standard mileage rate.

Example. Bill Jones drove 2,400 miles for medical reasons during the first half of the year. He spent $400 for gas, $30 for oil, and $100 for tolls and parking. He wants to figure the amount he can include in medical expenses both ways to see which gives him the greater deduction.

He figures the actual expenses first. He adds the $400 for gas, the $30 for oil, and the $100 for tolls and parking for a total of $530.

He then figures the standard mileage amount. He multiplies the 2,400 miles by 19 cents a mile for a total of $456. He then adds the $100 in tolls and parking for a total of $556.

Bill includes the $556 of car expenses with his other medical expenses for the year because the $556 is more than the $530 he figured using actual expenses.

DISABLED DEPENDENT CARE EXPENSES

Some disabled dependent care expenses may qualify as medical expenses or as work-related expenses for purposes of taking a credit for dependent care. (See chapter 32.) You can choose to apply them either way as long as you do not use the same expenses to claim both a credit and a medical expense deduction.

VIII. How Do You Treat Reimbursements?

You can deduct as medical expenses only those amounts paid during the taxable year for which you received no insurance or other reimbursement.

INSURANCE REIMBURSEMENT

You must reduce your total medical expenses for the year by all reimbursements for medical expenses that you receive from insurance or other sources during the year. This includes payments from Medicare.

Example. You have insurance policies which cover your hospital and doctors' bills but not your nursing bills. The insurance you receive for the hospital and doctors' bills is more than their charges. In figuring your medical deduction, you must reduce the total amount you spent for medical care by the total amount of insurance you received even if the policies do not cover some of your medical expenses.

Health reimbursement arrangement (HRA). A health reimbursement arrangement is an employer-funded plan that reimburses employees for medical care expenses and allows unused amounts to be carried forward. An HRA is funded solely by the employer and the reimbursements for medical expenses, up to a maximum dollar amount for a coverage period, are not included in your income.

Other reimbursements. Generally, you do not reduce medical expenses by payments you receive for:

- Permanent loss or loss of use of a member of function of the body (loss of limb, sight, hearing, etc.) or disfigurement to the extent the payment is based on the nature of the injury without regard to the amount of time lost from work, or
- Loss of earnings.

You must, however, reduce your medical expenses by any part of these payments that is designated for medical costs. See *How Do You Figure and Report the Deduction on Your Tax Return*, later.

For how to treat damages received for personal injury or sickness, see *Damages for Personal Injuries*, later.

You do not have a medical deduction if you are reimbursed for all of your medical expenses for the year.

Excess reimbursement. If you are reimbursed more than your medical expenses, you may have to include the excess in income. You may want to use *Figure 21-A* to help you decide if any of your reimbursement is taxable.

Premiums paid by you. If you pay the entire premium for your medical insurance or all of the costs of a plan similar to medical insurance and your insurance payments or other reimbursements are more than your total medical expenses for the year, you have an excess reimbursement. You generally do not include an excess reimbursement in your gross income.

Premiums paid by you and your employer. If both you and your employer contribute to your medical insurance plan and your employer's contributions are not included in your gross income, you must include in your gross income the part of an excess reimbursement that is from your employer's contribution.

See Publication 502 to figure the amount of the excess reimbursement you must include in gross income.

Reimbursement in a later year. If you are reimbursed in a later year for medical expenses you deducted in an earlier year, you must report the reimbursement as income up to the amount you previously deducted as medical expenses. However, do not report as income the reimbursement you received up to the amount of your medical deductions that did not reduce your tax for the earlier year. For more information about the recovery of an amount that you claimed as an itemized deduction in an earlier year, see *Itemized Deduction Recoveries* in chapter 12.

Medical expenses not deducted. If you did not deduct a medical expense in the year you paid it because your medical expenses were not more than 7.5% of your adjusted gross income, or because you did not itemize deductions, do not include in income the reimbursement for this expense that you receive in a later year. However, if the reimbursement is more than the expense, see *Excess reimbursement,* earlier.

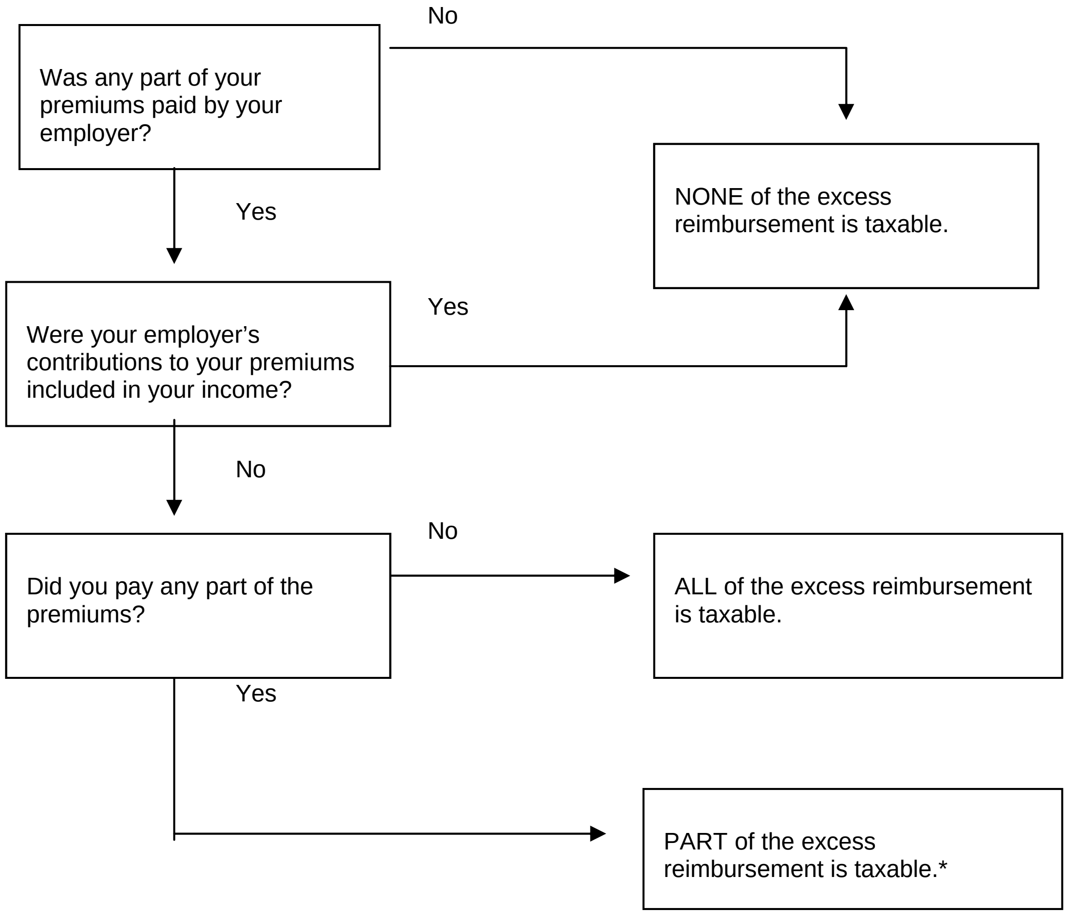
Example. Last year, you had medical expenses of $500. You cannot deduct the $500 because it is less than 7.5% of your adjusted gross income. If, in a later year, you are reimbursed for any of the $500 in medical expenses, you do not include that amount in your gross income.

IX. Damages for Personal Injuries

If you receive an amount in settlement of a personal injury suit, the part that is for medical expenses deducted in an earlier year is included in income in the later year if your medical deduction in the earlier year reduced your income tax in that year. See *Reimbursement in a later year,* earlier.

Future medical expenses. If you receive an amount in settlement of a damage suit for personal injuries that is properly allocable or determined to be for future medical expenses, you must reduce any medical expenses for these injuries until the amount you received has been completely used.

Figure 21-A. Is Your Excess Medical Reimbursement Taxable?



*See *Premiums paid by you and your employer* in this chapter.

X. How Do You Report the Deduction on Your Tax Return?

Once you have determined which medical care expenses you can include when figuring your deduction, you must report the deduction on your tax return.

WHAT TAX FORM DO YOU USE?

You figure your medical expense deduction on lines 1-4 of **Schedule A**, Form 1040. You cannot claim medical expenses on Form 1040A or Form 1040EZ. If you need more information on itemized deductions or you are not sure if you can itemize, see chapters 20 and 29.

Enter the amount you paid for medical and dental expenses on line 1, Schedule A (Form 1040). This should be your expenses that were not reimbursed by insurance or any other sources.

You can deduct only the amount of your medical and dental expenses that is more than 7.5% of your adjusted gross income shown on line 38, Form 1040.

XI. Impairment-Related Work Expenses (Business or Medical)

If you are disabled, you can take a business deduction for expenses that are necessary for you to be able to work. If you take a business deduction for these impairment-related work expenses, they are not subject to the 7.5% limit that applies to medical expenses.

You are disabled if you have:

- A physical or mental disability (for example, blindness or deafness) that functionally limits your being employed, or
- A physical or mental impairment (for example, a sight or hearing impairment) that substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, or working.

Impairment-related expenses defined. Impairment-related expenses are those ordinary and necessary business expenses that are:

- Necessary for you to do your work satisfactorily,
- For goods or services not required or used, other than incidentally, in your personal activities, and
- Not specifically covered under other income tax laws.

Example. You are blind. You must use a reader to do your work. You use the reader both during your regular working hours at your place of work and outside your regular working hours away from your place of work. The reader's services are only for your work. You can deduct your expenses for the reader as business expenses.

XII. Health Insurance Costs for Self-Employed Persons

If you were self-employed and had a net profit for the year, you may be able to deduct, as an adjustment to income, amounts paid for medical and qualified long-term care insurance on behalf of yourself, your spouse, your dependents, and your children who were under age 27 at the end of 2011.

For those purposes, you were self-employed if you were a general partner (or a limited partner receiving guaranteed payments) or you received wages from an S corporation in which you were more than a 2% shareholder.

The insurance plan must be established under your trade or business, and you cannot take this deduction to the extent that the amount of the deduction is more than your earned income from that trade or business.

You cannot take this deduction for any month in which you were eligible to participate in any subsidized health plan maintained by your employer, your spouse's employer, an employer of your dependent child, or your child under age 27 at the end of 2011. You cannot deduct payments for a qualified long-term care insurance contract for any month in which you were eligible to participate in a long-term care insurance plan subsidized by your employer or your spouse's employer.

If you qualify to take the deduction, use the Self-Employed Health Insurance Deduction Worksheet in the Form 1040 instructions to figure the amount you can deduct. But if any of the following applies, do not use the worksheet.

- You had more than one source of income subject to self-employment tax.
- You file Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income Exclusion.
- You are using amounts paid for qualified long-term care insurance to figure the deduction.

If you cannot use the worksheet in the Form 1040 instructions, use the worksheet in Publication 535, Business Expenses, to figure your deduction.

NOTE: When figuring the amount you can deduct for insurance premiums, do not include any advanced payments shown in box 1 of Form 1099-H, Health Coverage Tax Credit (HCTC) Advance Payments. Also, if you are claiming the health coverage tax credit, subtract the amount shown on Form 8885, line 4, from the total insurance premiums you paid. Also, do not include amounts paid for health insurance coverage with retirement plan distributions that were tax-free because you are a retired public safety officer.

Where to report. You take this deduction on Form 1040, line 29. If you itemize your deductions and do not claim 100% of your self-employed health insurance on line 29, include any remaining premiums with all other medical care expenses on Schedule A (Form 1040), subject to the 7.5% limit.

CHAPTER 21 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. You can only include the medical and dental expenses you paid this year in your medical expense deduction, regardless of when the services were provided.

   a) true
   b) false

2. Payments that can be included as a medical and dental expense deduction <u>exclude</u> which of the following:

   a) medical and hospital insurance premiums
   b) long-term care contracts
   c) stop-smoking programs
   d) health club dues

CHAPTER 21 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct**. If you pay medical expenses by check, the day you mail or deliver the check is generally the date of payment.

   B: False is incorrect. You can only include the medical expenses that were paid for. In the case of medical expenses charged to a credit card, they are included in the year of the charge rather than the year the charge card payment is made.

2. A: Incorrect. Payments made for medical and hospital insurance premiums are deductible expenses.

   B: Incorrect. Payments made for long-term care contracts are deductible as medical expenses in the year that the payment was made.

   C: Incorrect. Expenditures for stop-smoking programs are deductible medical expenses.

   D: Correct. Health club dues are generally not deductible medical expenses because they do not meet the test for such expenses. Specifically, medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness.

Chapter 22: Taxes

I. Introduction

This chapter discusses which taxes you can deduct if you itemize deductions on Schedule A (Form 1040). It also explains which taxes you can deduct on other schedules or forms and which taxes you cannot deduct.

This chapter covers:

- Income taxes (federal, state, local, and foreign),
- General sales taxes (state and local),
- Real estate taxes (state, local, and foreign),
- Personal property taxes (state and local), and
- Taxes and fees you cannot deduct.

Use *Table 22-1* as a guide to determine which taxes you can deduct.

At the end of the chapter is a section that explains which form you use to deduct the different types of taxes.

Business taxes. You can deduct certain taxes only if they are ordinary and necessary expenses of your trade or business or of producing income.

State or local taxes. These are taxes imposed by the 50 states, U.S. possessions, or any of their political subdivisions (such as a county or city), or by the District of Columbia.

Indian tribal government. An Indian tribal government that is recognized by the Secretary of the Treasury as performing substantial government functions will be treated as a state for this purpose. Income taxes, real estate taxes, and personal property taxes imposed by that Indian tribal government (or by any of its subdivisions that are treated as political subdivisions of a state) are deductible.

General sales taxes. These are taxes imposed at one rate on retail sales of a broad range of classes of items.

Foreign taxes. These are taxes imposed by a foreign country or any of its political subdivisions.

II. Tests to Deduct Any Tax

The following two tests must be met for any tax to be deductible by you.

1) The tax must be imposed on you.
2) The tax must be paid during your tax year.

The tax must be imposed on you. Generally, you can deduct only taxes that are imposed on you.

Generally, you can deduct property taxes only if you are the property owner. If your spouse owns property and pays real estate taxes on it, the taxes are deductible on your spouse's separate return or on your joint return.

The tax must be paid during your tax year. If you are a cash basis taxpayer, you can deduct only those taxes actually paid during your tax year. If you pay your taxes by check, the day you mail or deliver the check is generally the date of payment. If you use a pay-by-phone account, the date reported on the statement of the financial institution showing when payment was made is the date of payment. If you contest a tax liability and are a cash basis taxpayer, you can deduct the tax only in the year you actually pay it (or transfer money or other property to provide for satisfaction of the contested liability).

Table 22-1. **Which Taxes Can You Deduct?**

Type of Tax	You Can Deduct	You Cannot Deduct
Fees and Charges	Fees and charges that are expenses of your trade or business or of producing income.	Fees and charges that are not expenses of your trade or business or of producing income, such as fees for driver's licenses, car inspections, parking, or charges for water bills (see *Taxes and Fees You Cannot Deduct*). Fines and penalties.
General Sales Taxes	State and local general sales taxes, including compensating use taxes.	State and local income taxes (if you choose to deduct state and local general sales taxes).
Income Taxes	State and local income taxes. Foreign income taxes. Employee contributions to state funds listed under *Contributions to state benefit funds*.	Federal income taxes. Employee contributions to private or voluntary disability plans.
Other Taxes	Taxes that are expenses of your trade or business. Taxes on property producing rent or royalty income. Occupational taxes. See chapter 28. One-half of self-employment tax paid.	Federal excise taxes, such as tax on gasoline, that are not expenses of your trade or business or of producing income. Per capita taxes.
Personal Property Taxes	State and local personal property taxes.	Customs duties that are not expenses of your trade or business or of producing income.
Real Estate Taxes	State and local real estate taxes. Foreign real estate taxes Tenant's share of real estate taxes paid by cooperative housing corporation.	Foreign real estate taxes, if you take the standard deduction and the real property is not used in your trade or business or does not produce rental income. Real estate taxes that are treated as imposed on someone else (see *Division of real estate taxes between buyers and sellers).*

		Taxes for local benefits (with exceptions). See *Real Estate-Related Items You Cannot Deduct.* Trash and garbage pickup fees (with exceptions). See *Real Estate-Related Items You Cannot Deduct.* Rent increase due to higher real estate taxes. Homeowners' association charges.

III. Income Taxes

This section discusses the deductibility of state and local income taxes (including employee contributions to state benefit funds) and foreign income taxes.

STATE AND LOCAL INCOME TAXES

You can deduct state and local income taxes. However, you can elect to deduct state and local general sales taxes instead of state and local income taxes.

Exception. You cannot deduct state and local income taxes you pay on income that is exempt from federal income tax, unless the exempt income is interest income. For example, you cannot deduct the part of a state's income tax that is on a cost-of-living allowance that is exempt from federal income tax.

What to Deduct

Your deduction may be for withheld taxes, estimated tax payments, or other tax payments as follows.

Withheld taxes. Deduct state and local income taxes withheld from your salary in the year they are withheld. For 2011, these taxes will be shown in boxes 17 and 19 of your Form W-2. You may also have state or local income tax withheld on Form W-2G (box 14), Form 1099-MISC (box 16), or Form 1099-R (boxes 10 and 13).

Estimated tax payments. Deduct estimated tax payments you made during the year under a pay-as-you-go plan of a state or local government. However, you must have a reasonable basis for making the estimated tax payments. Any estimated state or local tax payments you make that are not reasonably determined in good faith at the time of payment are not deductible. For example, you made an estimated state income tax payment. However, the estimate of your state tax liability shows that you will get a refund of the full amount of your estimated payment. You had no reasonable basis to believe you had any additional liability for state income taxes and you cannot deduct the estimated tax payment.

Refund applied to taxes. Deduct any part of a refund of prior-year state or local income taxes that you chose to have credited to your 2011 estimated state or local income taxes.

Do not reduce your deduction by either of the following items.

- Any state or local income tax refund (or credit) you expect to receive for 2011.
- Any refund of (or credit for) prior year state and local income taxes you actually received in 2011.

However, part or all of this refund (or credit) may be taxable.

Separate federal returns. If you and your spouse file separate state, local, and federal income tax returns, you each can deduct on your federal return only the amount of your own state and local income tax that you paid during the tax year.

Joint state and local returns. If you and your spouse file joint state and local returns and separate federal returns, each of you can deduct on your separate federal return part of the state and local income taxes. You can deduct only the amount of the total taxes that is proportionate to your gross income compared to the combined gross income of you and your spouse. However, you cannot deduct more than the amount you actually paid during the year. You can avoid this calculation if you and your spouse are jointly and individually liable for the full amount of the state and local income taxes. If so, you and your spouse can deduct on your separate federal returns the amount you each actually paid.

Joint federal return. If you file a joint federal return, you can deduct the total of the state and local income taxes both of you paid.

Contributions to state benefit funds. As an employee, you can deduct mandatory contributions to state benefit funds that provide protection against loss of wages. Mandatory payments made to the following state benefit funds are deductible as state income taxes on Schedule A (Form 1040), line 5.

- Alaska Unemployment Compensation Fund.
- California Nonoccupational Disability Benefit Fund.
- New Jersey Nonoccupational Disability Benefit Fund.
- New Jersey Unemployment Compensation Fund.
- New York Nonoccupational Disability Benefit Fund.
- Pennsylvania Unemployment Compensation Fund.
- Rhode Island Temporary Disability Benefit Fund.
- Washington State Supplemental Workmen’s Compensation Fund.

FOREIGN INCOME TAXES

Generally, you can take either a deduction or a credit for income taxes imposed on you by a foreign country or a U.S. possession. However, you cannot take a deduction or credit for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion.

IV. General Sales Taxes

For 2011, you can elect to deduct state and local general sales taxes, instead of state and local income taxes, as an itemized deduction on Schedule A (Form 1040), line 5. Generally, you can use either your actual expenses or the state and local sales tax tables to figure your sales tax deduction.

Actual expenses. Generally, you can deduct the actual state and local general sales taxes (including compensating use taxes) if the tax rate was the same as the general sales tax rate. However, sales taxes on food, clothing, medical supplies, and motor vehicles are deductible as a general sales tax even if the tax rate was less than the general sales tax rate. If you paid sales tax on a motor vehicle at a rate higher than the general sales tax rate, you can deduct only the amount of tax that you would have paid at the general sales tax rate on that vehicle. If you use the actual expenses method, you must have receipts to show the general sales taxes paid.

Optional sales tax tables. Instead of using your actual expenses, you can figure your state and local general sales tax deduction using the state and local sales tax tables in the Instructions for Schedule A (Form 1040). You may also be able to add the state and local general sales taxes paid on certain specified items, such as motor vehicles (purchased or leased), aircraft, boats, homes (including mobile and prefabricated homes) and home building materials.

Your applicable table amount is based on the state where you live, your income, and the number of exemptions claimed on your tax return. Your income is your adjusted gross income plus any nontaxable items such as the following.

- Tax-exempt interest.
- Veterans' benefits.
- Nontaxable combat pay.
- Workers' compensation.
- Nontaxable unemployment compensation.
- Nontaxable part of social security and railroad retirement benefits.
- Nontaxable part of IRA, pension, or annuity distributions, excluding rollovers.
- Public assistance payments.

If you lived in different states during the same tax year, you must prorate your applicable table amount for each state based on the days you lived in each state. See the instructions for Schedule A (Form 1040), line 5, for details.

V. Real Estate Taxes

Deductible real estate taxes are any state, local, or foreign taxes on real property levied for the general public welfare. The taxes must be based on the assessed value of the real property and must be charged uniformly against all property under the jurisdiction of the taxing authority.

Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of the property. They also do not include itemized charges for services (such as trash collection) to specific property or people, even if the charge is paid to the taxing authority. For more information about taxes and charges that are not deductible, see *Real Estate-Related Items You Cannot Deduct,* later.

Tenant-shareholders in a cooperative housing corporation. Generally, if you are a tenant-stockholder in a cooperative housing corporation, you can deduct the amount paid to the corporation that represents your share of the real estate taxes the corporation paid or incurred for your dwelling unit. The corporation should provide you with a statement showing your share of the taxes.

Division of real estate taxes between buyers and sellers. If you bought or sold real estate during the year, the real estate taxes must be divided between the buyer and the seller.

The buyer and the seller must divide the real estate taxes according to the number of days in the ***real property tax year*** (the period to which the tax imposed relates) that each owned the property. The seller is treated as paying the taxes up to, but not including, the date of sale. The buyer is treated as paying the taxes beginning with the date of sale. This applies regardless of the lien dates under local law. Generally, this information is included on the settlement statement provided at the closing.

If you (the seller) cannot deduct taxes until they are paid because you use the cash method of accounting, and the buyer of your property is personally liable for the tax, ***you are considered to have paid your part of the tax at the time of the sale.*** This lets you deduct the part of the tax to the date of sale even though you did not actually pay it. However, you must also include the amount of that tax in the selling price of the property. The buyer must include the same amount in his or her cost of the property.

You figure your deduction for taxes on each property bought or sold during the real property tax year as follows:

1. Enter the total real estate taxes for the real property tax year…	_________
2. Enter the number of days in the real property tax year that you owned the property…	_________
3. Divide line 2 by 365 (for leap years, divide line 2 by 366)	_________
4. Multiple line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040)	_________

NOTE: Repeat steps 1 through 4 for each property you bought or sold during the real property tax year. Your total deduction is the sum of the line 4 amounts for all of the properties.

Real estate taxes for prior years. Do not divide delinquent taxes between the buyer and seller if the taxes are for any real property tax year before the one in which the property is sold. Even if the buyer agrees to pay the delinquent taxes, the buyer cannot deduct them. The buyer must add them to the cost of the property. The seller can deduct these taxes paid by the buyer. However, the seller must include them in the selling price.

Examples. The following examples illustrate how real estate taxes are divided between buyer and seller.

Example 1. Dennis and Beth White's real property tax year for both their old home and their new home is the calendar year, with payment due August 1. The tax on their old home, sold on May 7, was $620. The tax on their new home, bought on May 3, was $732. Dennis and Beth are considered to have paid a proportionate share of the real estate taxes on the old home even though they did not actually pay them to the taxing authority. On the other hand, they can claim only a proportionate share of the taxes they paid on their new property even though they paid the entire amount.

Dennis and Beth owned their old home during the real property tax year for 126 days (January 1 to May 6, the day before the sale). They figure their deduction for taxes on their old home as follows.

Taxes on Old Home

1. Enter the total real estate taxes for the real property tax year…	$620
2. Enter the number of days in the real property tax year that you owned the property…	126
3. Divide line 2 by 365 (for leap years, divide line 2 by 366)	.3452
4. Multiple line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040)	$214

Since the buyers of their old home paid all of the taxes, Dennis and Beth also include the $214 in the selling price of the old home. (The buyers add the $214 to their cost of the home.)

Dennis and Beth owned their new home during the real property tax year for 243 days (May 3 to December 31, including their date of purchase). They figure their deduction for taxes on their new home as follows:

Taxes on New Home

1. Enter the total real estate taxes for the real property tax year…	$732
2. Enter the number of days in the real property tax year that you owned the property…	243
3. Divide line 2 by 365 (for leap years, divide line 2 by 366)	.6658
4. Multiple line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040)	$487

Since Dennis and Beth paid all of the taxes on the new home, they add $245 ($732 paid less $487 deduction) to their cost of the new home. (The sellers add this $245 to their selling price and deduct the $245 as a real estate tax.)

Dennis and Beth's real estate tax deduction for their old and new homes is the sum of $214 and $487, or $701. They will enter this amount on line 6 of Schedule A (Form 1040).

Example 2. George and Helen Brown bought a new home on May 3, 2011. Their real property tax year for the new home is the calendar year. Real estate taxes for 2010 were assessed in their state on January 1, 2011. The taxes became due on May 31, 2011 and October 31, 2011.

The Browns agreed to pay all taxes due after the date of purchase. Real estate taxes for 2010 were $680. They paid $340 on May 31, 2011, and $340 on October 31, 2011. These taxes were for the 2010 real property tax year. The Browns cannot deduct them since they did not own the property until 2011. Instead, they must add $680 to the cost of their new home.

In January 2012, the Browns receive their 2011 property tax statement for $752, which they will pay in 2012. The Browns owned their new home during the 2011 real property tax year for 243 days (May 3 to December 31). They will figure their 2012 deduction for taxes as follows.

1. Enter the total real estate taxes for the real property tax year…	$752
2. Enter the number of days in the real property tax year that you owned the property…	243
3. Divide line 2 by 365 (for leap years, divide line 2 by 366)	.6658
4. Multiple line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040)	$501

The remaining $251 ($752 paid less $501 deduction) of taxes paid in 2012, along with the $680 paid in 2011, is added to the cost of their new home.

Because the taxes up to the date of sale are considered paid by the seller on the date of sale, the seller is entitled to a 2011 tax deduction of $931. This is the sum of the $680 for 2010 and the $251 for the 123 days the seller owned the home in 2011. The seller must also include the $931 in the selling price when he or she figures the gain or loss on the sale. The seller should contact the Browns in January 2012 to find out how much real estate tax is due for 2011.

Form 1099-S. For certain sales or exchanges of real estate, the person responsible for closing the sale (generally the settlement agent) prepares Form 1099-S, *Proceeds From Real Estate Transactions,* to report certain information to the IRS and to the seller of the property. Box 2 of the form is for the gross proceeds of the sale and should include the portion of the seller's real estate tax liability that the buyer will pay after the date of sale. The buyer includes these taxes in the cost basis of the property, and the seller both deducts this amount as a tax paid and includes it in the sales price of the property.

For a real estate transaction that involves a home, any real estate tax the seller paid in advance but that is the liability of the buyer appears in box 5 of Form 1099-S. The buyer deducts this amount as a real estate tax, and the seller reduces his or her real estate tax deduction (or includes it in income) by the same amount. See *Refund (or rebate),* later.

Taxes placed in escrow. If your monthly mortgage payment includes an amount placed in escrow (put in the care of a third party) for real estate taxes, you may not be able to deduct the total amount placed in escrow. You can deduct only the real estate tax that the third party actually paid to the taxing authority. If the third party does not notify you of the amount of real estate tax that was paid for you, contact the third party or the taxing authority to find the proper amount to show on your return.

Tenants by the entirety. If you and your spouse held property as tenants by the entirety and you file separate returns, each of you can deduct only the taxes each of you paid on the property.

Divorced individuals. If your divorce or separation agreement states that you must pay the real estate taxes for a home owned by you and your spouse, part of your payments may be deductible as alimony and part as real estate taxes. See *Taxes and insurance*, in chapter 18, for more information.

Minister's and military personnel housing allowances. If you are a minister or a member of the uniformed services and receive a housing allowance that you can exclude from income, you still can deduct all of the real estate taxes you pay on your home.

Refund (or rebate). If you receive a refund or rebate in 2011 of real estate taxes you paid in 2011, you must reduce your deduction by the amount refunded to you. If you receive a refund or rebate in 2011 of real estate taxes you deducted in an earlier year, you generally must include the refund or rebate in income in the year you receive it. However, you only need to include the amount of the deduction that reduced your tax in the earlier year. For more information, see *Recoveries* in chapter 12.

Tip. *If you did not itemize deductions in the year you paid the tax, do not report the refund as income.*

REAL ESTATE-RELATED ITEMS YOU CANNOT DEDUCT

Payments for the following items generally are not deductible as real estate taxes.

- Taxes for local benefits.
- Itemized charges for services (such as trash and garbage pickup fees).
- Transfer taxes (or stamp taxes).
- Rent increases due to higher real estate taxes.
- Homeowners' association charges.

Taxes for local benefits. Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of your property. These include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities, and similar improvements. You should increase the basis of your property by the amount of the assessment.

Local benefit taxes are deductible only if they are for maintenance, repair, or interest charges related to those benefits. If only a part of the taxes is for maintenance, repair, or interest, you must be able to show the amount of that part to claim the deduction. If you cannot determine what part of the tax is for maintenance, repair, or interest, none of it is deductible.

Taxes for local benefits may be included in your real estate tax bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it. You should use the rules above to determine if the local benefit tax is deductible.

Itemized charges for services. An itemized charge for services assessed against specific property or certain people is not a tax, even if the charge is paid to the taxing authority. For example, you cannot deduct the charge as a real estate tax if it is:

- A unit fee for the delivery of a service (such as a $5 fee charged for every 1,000 gallons of water you use),
- A periodic charge for a residential service (such as a $20 per month or $240 annual fee charged to each homeowner for trash collection), or
- A flat fee charged for a single service provided by your government (such as a $30 charge for mowing your lawn because it was allowed to grow higher than permitted under your local ordinance).

Caution: *You must look at your real estate tax bill to determine if any nondeductible itemized charges, such as those listed above, are included in the bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it.*

Exception. Service charges used to maintain or improve services (such as trash collection or police and fire protection) are deductible as real estate taxes if:

- The fees or charges are imposed at a like rate against all property in the taxing jurisdiction,

- The funds collected are not earmarked; instead, they are commingled with general revenue funds, and
- Funds used to maintain or improve services are not limited to or determined by the amount of these fees or charges collected.

Transfer taxes (or stamp taxes). Transfer taxes and similar taxes and charges on the sale of a personal home are not deductible. If they are paid by the seller, they are expenses of the sale and reduce the amount realized on the sale. If paid by the buyer, they are included in the cost basis of the property.

Rent increase due to higher real estate taxes. If your landlord increases your rent in the form of a tax surcharge because of increased real estate taxes, you cannot deduct the increase as taxes.

Homeowners' association charges. These charges are not deductible because they are imposed by the homeowners' association, rather than the state or local government.

VI. Personal Property Taxes

Personal property tax is deductible if it is a state or local tax that is:

1) Charged on personal property,
2) Based only on the value of the personal property, and
3) Charged on a yearly basis, even if it is collected more than once a year, or less than once a year.

A tax that meets the above requirements can be considered charged on personal property even if it is for the exercise of a privilege. For example, a yearly tax based on value qualifies as a personal property tax even if it is called a registration fee and is for the privilege of registering motor vehicles or using them on the highways.

If the tax is partly based on value and partly based on other criteria, it may qualify in part.

Example. Your state charges a yearly motor vehicle registration tax of 1% of value plus 50 cents per hundredweight. You paid $32 based on the value ($1,500) and weight (3,400 lbs.) of your car. You can deduct $15 (1% X $1,500) as a personal property tax, since it is based on the value. The remaining $17 ($.50 X 34), based on the weight, is not deductible.

VII. Taxes and Fees You Cannot Deduct

Many federal, state, and local government taxes are not deductible because they do not fall within the categories discussed earlier. Other taxes and fees, such as federal income taxes, are not deductible because the tax law specifically prohibits a deduction for them.

Taxes and fees that are generally not deductible include the following items.

- ***Employment taxes.*** This includes social security, Medicare, and railroad retirement taxes withheld from your pay. However, one-half of self-employment tax you pay is deductible. In addition, the social security and other employment taxes you pay on the wages of a household worker may be included in medical expenses that you can deduct or child care expenses that allow you to claim the child and dependent care credit. For more information, see chapters 21 and 32.

- ***Estate, inheritance, legacy, or succession taxes.*** These taxes are generally not deductible. However, you can deduct the estate tax attributable to income in respect of a decedent if you, as a beneficiary, must include that income in your gross income. In that case, deduct the estate tax as a miscellaneous deduction that is not subject to the 2%-of-adjusted-gross-income limit.
- ***Federal income taxes.*** This includes taxes withheld from your pay.
- ***Fines and penalties.*** You cannot deduct fines and penalties paid to a government for violation of any law, including related amounts forfeited as collateral deposits.
- ***Gift taxes.***
- ***License fees.*** You cannot deduct license fees for personal purposes (such as marriage, driver's, and dog license fees).
- ***Per capita taxes.*** You cannot deduct state or local per capita taxes.

Many taxes and fees other than those listed above are also nondeductible, unless they are ordinary and necessary expenses of a business or income producing activity. For other nondeductible items, see *Real Estate-Related Items You Cannot Deduct,* earlier.

VIII. Where to Deduct

You deduct taxes on the following schedules.

State and local income taxes. These taxes are deducted on line 5 of Schedule A (Form 1040), even if your only source of income is from business, rents, or royalties. Check box a on line 5 to indicate income taxes.

General sales taxes. Sales taxes are deducted on Schedule A (Form 1040), line 5. You must check box b on line 5. If you elect to deduct sales taxes, you cannot deduct state and local income taxes. If you elect to deduct sales taxes, you cannot deduct state and local income taxes on Schedule A (Form 1040), line 5, box a.

Foreign income taxes. Generally, income taxes you pay to a foreign country or U.S. possession can be claimed as an itemized deduction on line 8 of Schedule A (Form 1040), or as a credit against your U.S. income tax on line 47 of Form 1040. To claim the credit, you may have to complete and attach Form 1116.

Real estate taxes and personal property taxes. These taxes are deducted on lines 6 and 8 of Schedule A (Form 1040), unless they are paid on property used in your business in which case they are deducted on Schedule C or Schedule F (Form 1040). Taxes on property that produces rent or royalty income are deducted on Schedule E (Form 1040).

Self-employment tax. In prior years, 50% of the self-employment tax was the amount of the above-the-line deduction that could be claimed on Form 1040 (line 27), but for 2011, because of the 2% reduction in the self-employment tax rate, a special computation applies, and the deduction is larger.

Other taxes. All other deductible taxes are deducted on line 8 of Schedule A (Form 1040).

CHAPTER 22 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following income taxes are <u>not</u> deductible:

    a) federal income taxes
    b) state income taxes
    c) local income taxes
    d) foreign income taxes

2. Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of your property.

    a) true
    b) false

CHAPTER 22 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: Correct**. Federal income taxes paid are not deductible on federal personal income tax returns – 1040.

   B: Incorrect. State income taxes, among other types of taxes and fees are deductible for federal income tax purposes.

   C: Incorrect. Local income taxes can be deducted.

   D: Incorrect. Foreign income taxes are generally deductible on a U.S. 1040 return. This deduction assumes that foreign income taxes were paid on income that is <u>not</u> already exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion.

2. **A: True is correct.** These include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities, and similar improvements. You should increase the basis of your property by the amount of the assessment.

   B: False is incorrect. Local benefit taxes are deductible only if they are for maintenance, repair, or interest charges related to those benefits.

Chapter 23: Interest Expense

I. Important Reminder

Limit on itemized deductions. There is no reduction of itemized deductions for 2011 and 2012.

II. Introduction

This chapter discusses interest. Interest is the amount you pay for the use of borrowed money.

The types of interest you can deduct as itemized deductions on Schedule A (Form 1040) are:

- Home mortgage interest, including certain points and mortgage insurance premiums, and
- Investment interest.

This chapter explains these deductions. It also explains where to deduct other types of interest and lists some types of interest you cannot deduct.

Use *Table 23-1* to find out where to get more information on various types of interest, including investment interest.

III. Home Mortgage Interest

Generally, home mortgage interest is any interest you pay on a loan secured by your home (main home or a second home). The loan may be a mortgage to buy your home, a second mortgage, a line of credit, or a home equity loan.

You can deduct home mortgage interest only if you meet all the following conditions.

- You must file Form 1040 and itemize deductions on Schedule A (Form 1040).
- The mortgage is a secured debt on a qualified home in which you have an ownership interest. (Generally, your mortgage is a secured debt if you put your home up as collateral to protect the interests of the lender. The term "qualified home" means your main home or second home.)

Both you and the lender must intend that the loan be repaid.

AMOUNT DEDUCTIBLE

In most cases, you will be able to deduct all of your home mortgage interest. Whether you can deduct all of it depends on the date you took out the mortgage, the amount of the mortgage, and your use of its proceeds.

Fully deductible interest. If all of your mortgages fit into one or more of the following three categories at all times during the year, you can deduct all of the interest on those mortgages. (If any one mortgage fits into more than one category, add the debt that fits in each category to your other debt in the same category.)

The three categories are as follows:

1) Mortgages you took out on or before October 13, 1987 (called ***grandfathered debt***).
2) Mortgages you took out after October 13, 1987, to buy, build, or improve your home (called ***home acquisition debt***), but only if throughout 2011 these mortgages plus any grandfathered debt totaled $1 million or less ($500,000 or less if married filing separately).
3) Mortgages you took out after October 13, 1987, other than to buy, build, or improve your home (called ***home equity debt***), but only if throughout 2011 these mortgages totaled $100,000 or less ($50,000 or less if married filing separately) ***and*** totaled no more than the fair market value of your home reduced by (1) and (2).

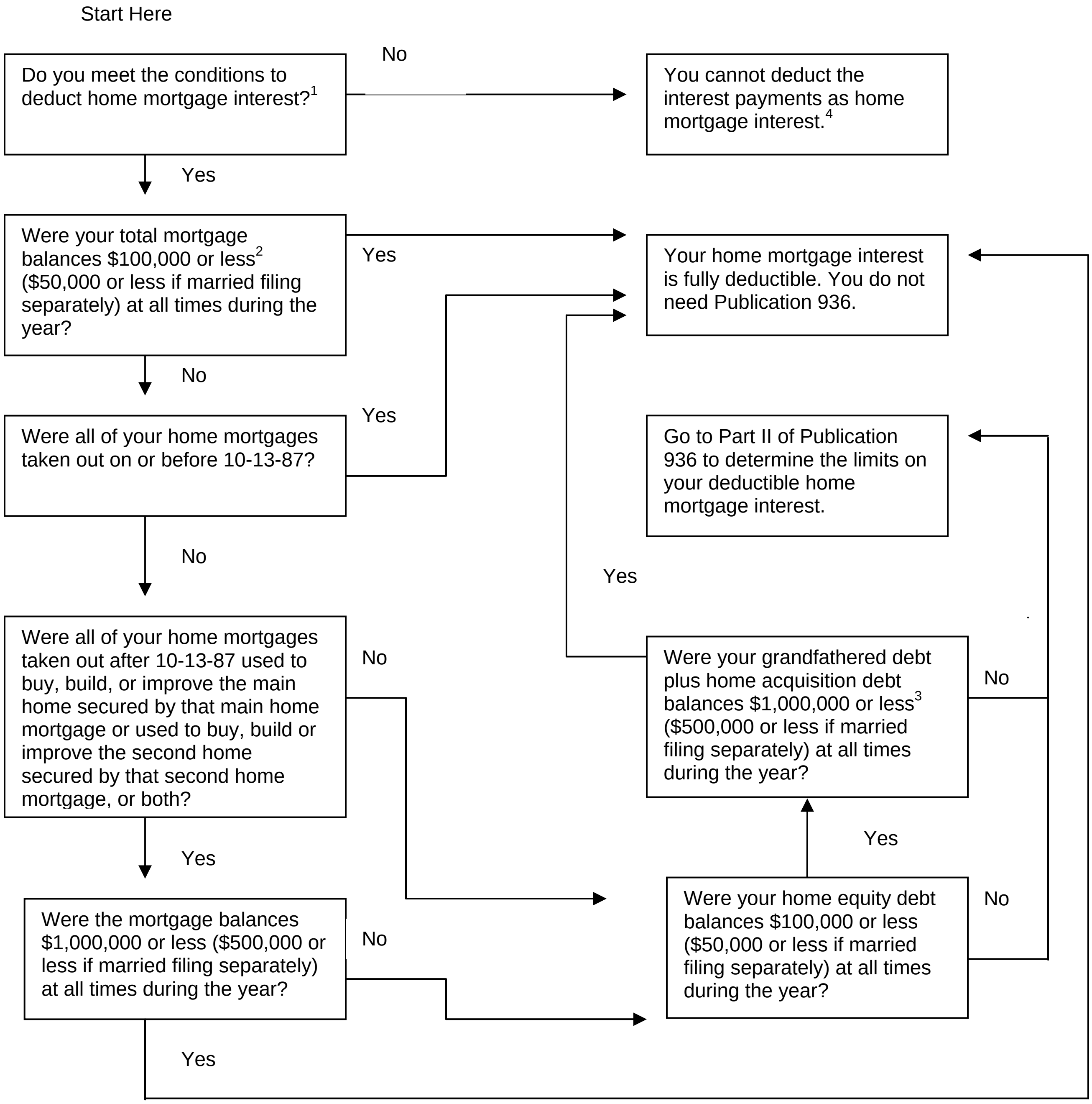
The dollar limits for the second and third categories apply to the combined mortgages on your main home and second home.

You can use *Figure 23-A* to check whether your home mortgage interest is fully deductible.

Limits on deduction. You cannot fully deduct interest on a mortgage that does not fit into any of the three categories listed above.

Figure 23-A. **Is My Home Mortgage Fully Deductible?**

(Instructions: Include balances of ALL mortgages secured by your main home and second home.



[1] You must itemize deductions on Schedule A (Form 1040) and be legally liable for the loan. The loan must be a secured debt on a qualified home. See *Home Mortgage Interest.*

[2] If all mortgages on your main or second home exceed the home's fair market value, a lower limit may apply. See *Home equity debt limit* under *Home Equity Debt* in *Part II* of Publication 936.

[3] Amounts over the $1,000,000 limit ($500,000 if married filing separately) qualify as home equity debt if they are not more than the total home equity debt limit. See Publication 936 for more information about grandfathered debt, home acquisition debt, and home equity debt.

[4] See Table 23-1 for where to deduct other types of interest payments.

Special Situations

This section describes certain items that can be included as home mortgage interest and others that cannot. It also describes certain special situations that may affect your deduction.

Late payment charge on mortgage payment. You can deduct as home mortgage interest a late payment charge if it was not for a specific service performed in connection with your mortgage loan.

Mortgage prepayment penalty. If you pay off your home mortgage early, you may have to pay a penalty. You can deduct that penalty as home mortgage interest provided the penalty is not for a specific service performed or cost incurred in connection with your mortgage loan.

Sale of home. If you sell your home, you can deduct your home mortgage interest (subject to any limits that apply) paid up to, but not including, the date of sale.

Example. John and Peggy Harris sold their home on May 7. Through April 30, they made home mortgage interest payments of $1,220. The settlement sheet for the sale of the home showed $50 interest for the 6-day period in May up to, but not including, the date of sale. Their mortgage interest deduction is $1,270 ($1,220 + $50).

Prepaid interest. If you pay interest in advance for a period that goes beyond the end of the tax year, you must spread this interest over the tax years to which it applies. You can deduct in each year only the interest that qualifies as home mortgage interest for that year. However, see *Points,* later.

Mortgage interest credit. You may be able to claim a mortgage interest credit if you were issued a mortgage credit certificate (MCC) by a state or local government. Figure the credit on Form 8396, Mortgage Interest Credit. If you take this credit, you must reduce your mortgage interest deduction by the amount of the credit.

For more information on the credit, see chapter 37.

Ministers' and military housing allowance. If you are a minister or a member of the uniformed services and receive a housing allowance that is not taxable, you can still deduct your home mortgage interest.

Mortgage assistance payments. If you qualify for mortgage assistance payments for lower-income families under section 235 of the National Housing Act, part or all of the interest on your mortgage may be paid for you. You cannot deduct the interest that is paid for you.

No other effect on taxes. Do not include these mortgage assistance payments in your income. Also, do not use these payments to reduce other deductions, such as real estate taxes.

Divorced or separated individuals. If a divorce or separation agreement requires you or your spouse or former spouse to pay home mortgage interest on a home owned by both of you, the payment of interest may be alimony. See the discussion of *Payments for jointly-owned home* in chapter 18.

Redeemable ground rents. If you make annual or periodic rental payments on a redeemable ground rent, you can deduct them as mortgage interest.

Payments made to end the lease and to buy the lessor's entire interest in the land are not deductible as mortgage interest.

Nonredeemable ground rents. Payments on a nonredeemable ground rent are not mortgage interest. You can deduct them as rent if they are a business expense or if they are for rental property.

Reverse mortgages. A reverse mortgage is a loan where the lender pays you (in a lump sum, a monthly advance, a line of credit, or a combination of all three) while you continue to live in your home. With a reverse mortgage, you retain title to your home. Depending on the plan, your reverse mortgage becomes due with interest when you move, sell your home, reach the end of a pre-selected loan period, or die. Because reverse mortgages are considered loan advances and not income, the amount you receive is not taxable. Any interest (including original issue discount) accrued on a reverse mortgage is not deductible until the loan is paid in full. Your deduction may be limited because a reverse mortgage loan generally is subject to the limit on Home Equity Debt.

Rental payments. If you live in a house before final settlement on the purchase, any payments you make for that period are rent and not interest. This is true even if the settlement papers call them interest. You cannot deduct these payments as home mortgage interest.

Mortgage proceeds invested in tax-exempt securities. You cannot deduct the home mortgage interest on grandfathered debt or home equity debt if you used the proceeds of the mortgage to buy securities or certificates that produce tax-free income. Grandfathered debt and home equity debt are defined earlier under *Amount Deductible.*

Refunds of interest. If you receive a refund of interest in the same tax year you paid it, you must reduce your interest expense by the amount refunded to you. If you receive a refund of interest you deducted in an earlier year, you generally must include the refund in income in the year you receive it. However, you need to include it only up to the amount of the deduction that reduced your tax in the earlier year. This is true whether the interest overcharge was refunded to you or was used to reduce the outstanding principal on your mortgage.

If you received a refund of interest you overpaid in an earlier year, you generally will receive a Form 1098, *Mortgage Interest Statement,* showing the refund in box 3. For information about Form 1098, see *Mortgage Interest Statement,* later.

POINTS

The term "points" is used to describe certain charges paid, or treated as paid, by a borrower to obtain a home mortgage. Points may also be called loan origination fees, maximum loan charges, loan discount, or discount points.

A borrower is treated as paying any points that a home seller pays for the borrower's mortgage. See *Points paid by the seller,* later.

General rule. You generally cannot deduct the full amount of points in the year paid. Because they are prepaid interest, you generally must deduct them over the life (term) of the mortgage.

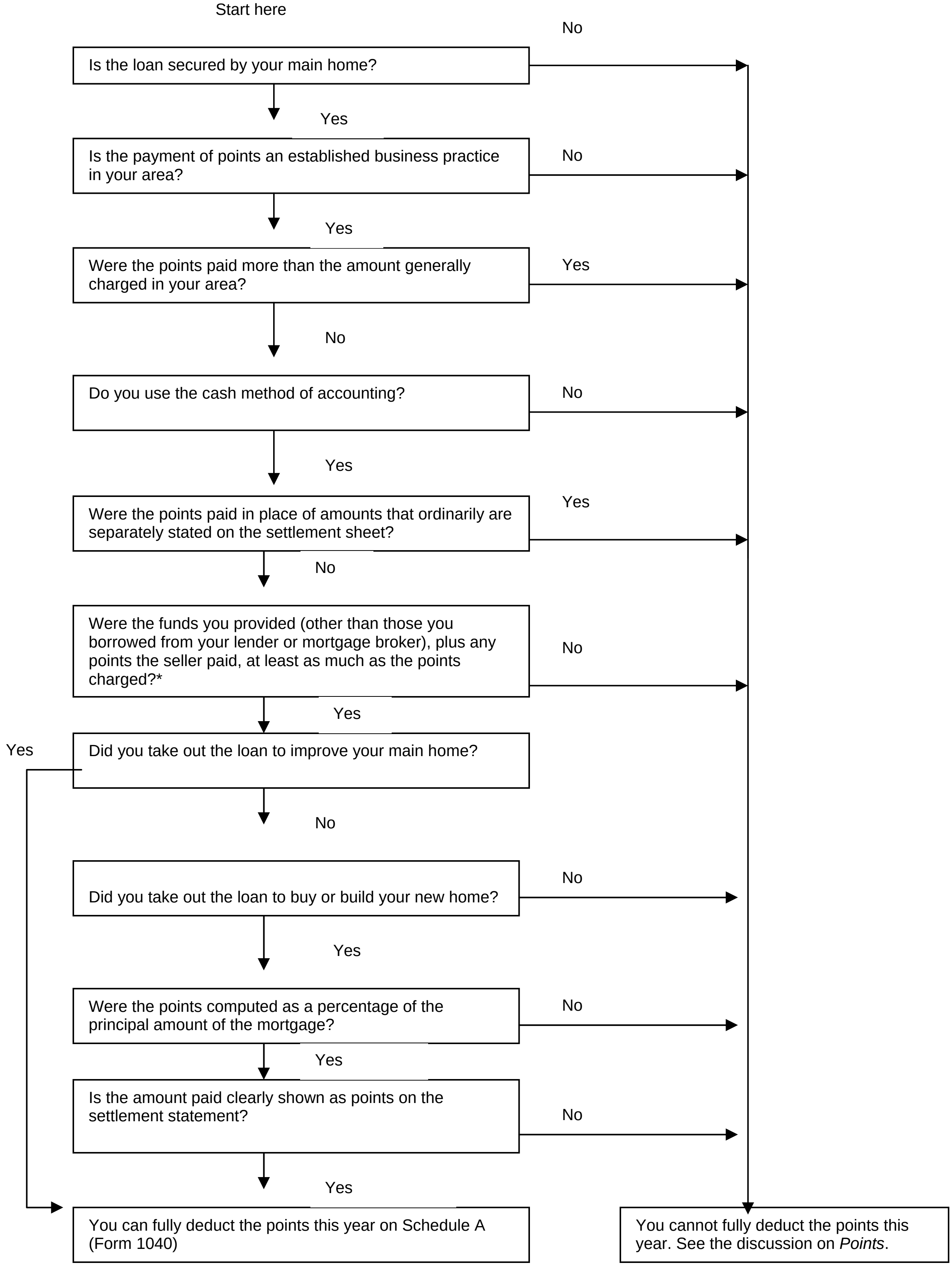
Deduction Allowed in Year Paid

You can fully deduct points in the year paid if you meet all the following tests. (You can use *Figure 23-B* as a quick guide to see whether your points are fully deductible in the year paid.)

1) Your loan is secured by your main home.
2) Paying points is an established business practice in the area where the loan was made.
3) The points paid were not more than the points generally charged in that area.
4) You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them. (If you want more information about this method, see *Accounting Methods* in chapter 1.)
5) The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
6) The funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged. The funds you provided do not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose. You cannot have borrowed these funds from your lender or mortgage broker.
7) You use your loan to buy or build your main home.
8) The points were computed as a percentage of the principal amount of the mortgage.
9) The amount is clearly shown on the settlement statement (such as the Uniform Settlement Statement, Form HUD-1) as points charged for the mortgage. The points may be shown as paid from either your funds or the seller's.

Note. If you meet all of these tests, you can choose to either fully deduct the points in the year paid, or deduct them over the life of the loan.

Figure 23-B. **Are My Points Fully Deductible This Year?**



* The funds you provided to not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose.

Home improvement loan. You can also fully deduct in the year paid points paid on a loan to improve your main home, if tests (1) through (6) are met.

Caution. Second home. *The Exception does not apply to points you pay on loans secured by your second home. You can deduct these points only over the life of the loan.*

Refinancing. Generally, points you pay to refinance a mortgage are not deductible in full in the year you pay them. This is true even if the new mortgage is secured by your main home.

However, if you use part of the refinanced mortgage proceeds to ***improve your main home*** and you meet the first six tests listed under *Exception,* earlier, you can fully deduct the part of the points related to the improvement in the year you paid them with your own funds. You can deduct the rest of the points over the life of the loan.

Example 1. In 1997, Bill Fields got a mortgage to buy a home. In 2011, Bill refinanced that mortgage with a 15-year $100,000 mortgage loan. The mortgage is secured by his home. To get the new loan, he had to pay three points ($3,000). Two points ($2,000) were for prepaid interest, and one point ($1,000) was charged for services, in place of amounts that ordinarily are stated separately on the settlement statement. Bill paid the points out of his private funds, rather than out of the proceeds of the new loan. The payment of points is an established practice in the area, and the points charged are not more than the amount generally charged there. Bill's first payment on the new loan was due July 1. He made six payments on the loan in 2011 and is a cash basis taxpayer.

Bill used the funds from the new mortgage to repay his existing mortgage. Although the new mortgage loan was for Bill's continued ownership of his main home, it was not for the purchase or improvement of that home. He cannot deduct all of the points in 2011. He can deduct two points ($2,000) ratably over the life of the loan. He deducts $67 [($2,000 ÷ 180 months) X 6 payments] of the points in 2011. The other point ($1,000) was a fee for services and is not deductible.

Example 2. The facts are the same as in *Example 1,* except that Bill used $25,000 of the loan proceeds to improve his home and $75,000 to repay his existing mortgage. Bill deducts 25% ($25,000 ÷ $100,000) of the points ($2,000) in 2011. His deduction is $500 ($2,000 X 25%).

Bill also deducts the ratable part of the remaining $1,500 ($2,000 - $500) that must be spread over the life of the loan. This is $50 [($1,500 ÷ 180 months) X 6 payments] in 2011. The total amount Bill deducts in 2011 is $550 ($500 + $50).

Deduction Allowed Ratably

If you do not meet the tests listed under *Deduction Allowed in Year Paid*, earlier, the loan is not a home improvement loan, or you choose not to deduct your points in full in the year paid, you can deduct the points ratably (equally) over the life of the loan if you meet all the following tests.

1) You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them. Most individuals use this method.
2) Your loan is secured by a home. (The home does not need to be your main home.)
3) Your loan period is not more than 30 years.

4) If your loan period is more than 10 years, the terms of your loan are the same as other loans offered in your area for the same or longer period.
5) Either your loan amount is $250,000 or less, or the number of points is not more than:
   a) 4, if your loan period is 15 years or less, or
   b) 6, if your loan period is more than 15 years.

Special Situations

This section describes certain special situations that may affect your deduction of points.

Original issue discount. If you do not qualify to either deduct the points in the year paid or deduct them ratably over the life of the loan, or if you choose not to use either of these methods, the points reduce the issue price of the loan. This reduction results in original issue discount.

Amounts charged for services. Amounts charged by the lender for specific services connected to the loan are not interest. Examples of these charges are:

1) Appraisal fees,
2) Notary fees, and
3) Preparation costs for the mortgage note or deed of trust.

You cannot deduct these amounts as points either in the year paid or over the life of the mortgage.

Points paid by the seller. The term "points" includes loan placement fees that the seller pays to the lender to arrange financing for the buyer.

Treatment by seller. The seller ***cannot*** deduct these fees as interest. But they are a selling expense that reduces the amount realized by the seller. See chapter 15 for information on the sale of your home.

Treatment by buyer. The buyer reduces the basis of the home by the amount of the seller-paid points and treats the points as if he or she had paid them. If all the tests under *Deductible Allowed in Year Paid,* earlier, are met, the buyer can deduct the points in the year paid. If any of those tests is not met, the buyer deducts the points over the life of the loan. For information about basis, see chapter 13.

Funds provided are less than points. If you meet all the tests in the *Exception,* earlier, except that the funds you provided were less than the points charged to you (test 6), you can deduct the points in the year paid, up to the amount of funds you provided. In addition, you can deduct any points paid by the seller.

Example 1. When you took out a $100,000 mortgage loan to buy your home in December, you were charged one point ($1,000). You meet all the tests for deducting points in the year paid, except the only funds you provided were a $750 down payment. Of the $1,000 charged for points, you can deduct $750 in the year paid. You spread the remaining $250 over the life of the mortgage.

Example 2. The facts are the same as in *Example 1,* except that the person who sold you your home also paid one point ($1,000) to help you get your mortgage. In the year paid, you can deduct $1,750 ($750 of the amount you were charged plus the $1,000 paid by the seller). You spread the remaining $250 over the life of the mortgage. You must reduce the basis of your home by the $1,000 paid by the seller.

Excess points. If you meet all the tests in *Deduction Allowed in Year Paid,* earlier, except that the points paid were more than are generally paid in your area (test 3), you deduct in the year paid only the points that are generally charged. You must spread any additional points over the life of the mortgage.

Mortgage ending early. If you spread your deduction for points over the life of the mortgage, you can deduct any remaining balance in the year the mortgage ends. However, if you refinance the mortgage with the same lender, you cannot deduct any remaining balance of spread points. Instead, deduct the remaining balance over the term of the new loan.

A mortgage may end early due to a prepayment, refinancing, foreclosure, or similar event.

Example. Dan paid $3,000 in points in 2000 that he had to spread out over the 15-year life of the mortgage. He deducts $200 points per year. He had deducted $2,200 of these points through 2010.

Dan prepaid his mortgage in full in 2011. He can deduct the remaining $800 of points in 2011.

Limits on deduction. You cannot fully deduct points on a mortgage unless the mortgage fits into one of the categories listed earlier under *Fully deductible interest.*

MORTGAGE INSURANCE PREMIUMS

You can treat amounts you paid during 2011 for qualified mortgage insurance as home mortgage interest. The insurance must be in connection with home acquisition debt, and the insurance contract must have been issued after 2006.

Qualified mortgage insurance. Qualified mortgage insurance is mortgage insurance provided by the Department of Veterans Affairs, the Federal Housing Administration, or the Rural Housing Service, and private mortgage insurance (as defined in section 2 of the Homeowners Protection Act of 1998 as in effect on December 20, 2006).

Mortgage insurance provided by the Department of Veterans Affairs is commonly known as a funding fee. If provided by the Rural Housing Service, it is commonly known as a guarantee fee. These fees can be deducted fully in 2011 if the mortgage insurance contract was issued in 2011. Contact the mortgage insurance issuer to determine the deductible amount if it is not reported in box 4 of Form 1098.

Special rules for prepaid mortgage insurance. Generally, if you paid premiums for qualified mortgage insurance that are allocable to periods after the close of the tax year, such premiums are treated as paid in the period to which they are allocated. You must allocate the premiums over the shorter of the stated term of the mortgage or 84 months, beginning with the month the insurance was obtained. No deduction is allowed for the unamortized balance if the mortgage is satisfied before its term. This paragraph does not apply to qualified mortgage insurance provided by the Department of Veterans Affairs or the Rural Housing Service. See the Example below.

Example. Ryan purchased a home in May of 2011 and financed the home with a 15-year mortgage. Ryan also prepaid all of the $9,240 in private mortgage insurance required at the time of closing in May. Since the $9,240 in private mortgage insurance is allocable to periods after 2011, Ryan must allocate the $9,240 over the shorter of the life of the mortgage or 84 months. Ryan's adjusted gross income (AGI) for 2011 is $76,000. Ryan can deduct $880 ($9,240 ÷ 84 × 8 months) for qualified mortgage insurance premiums in 2011. For 2012, Ryan can deduct $1,320 ($9,240 ÷ 84 × 12 months) if his AGI is $100,000 or less.

In this example, the mortgage insurance premiums are allocated over 84 months, which is shorter than the life of the mortgage of 15 years (180 months).

Limit on deduction. If your adjusted gross income on Form 1040, line 38, is more than $100,000 ($50,000 if your filing status is married filing separately), the amount of your mortgage insurance premiums that are otherwise deductible is reduced and may be eliminated. See *Line 13* in the instructions for Schedule A (Form 1040) and complete the *Qualified Mortgage Insurance Premiums Deduction Worksheet* to figure the amount you can deduct. If your adjusted gross income is more than $109,000 ($54,500 if married filing separately), you cannot deduct your mortgage insurance premiums.

FORM 1098, MORTGAGE INTEREST STATEMENT

If you paid $600 or more of mortgage interest (including certain points) during the year on any one mortgage, you generally will receive a Form 1098, *Mortgage Interest Statement,* or a similar statement from the mortgage holder. You will receive the statement if you pay interest to a person (including a financial institution or a cooperative housing corporation) in the course of that person's trade or business. A governmental unit is a person for purposes of furnishing the statement.

You should receive the statement for each year by January 31 of the following year. A copy of this form will also be sent to the IRS.

The statement will show the total interest you paid during the year. If you purchased a main home during the year, it will also show the deductible points paid during the year, including seller-paid points. However, it should not show any interest that was paid for you by a government agency.

As a general rule, Form 1098 will include only points that you can fully deduct in the year paid. However, certain points not included on Form 1098 also may be deductible, either in the year paid or over the life of the loan. See *Points,* earlier, to determine whether you can deduct points not shown on Form 1098.

Prepaid interest on Form 1098. If you prepaid interest in 2011 that accrued in full by January 15, 2012, this prepaid interest may be included in box 1 of Form 1098. However, you cannot deduct the prepaid amount for January 2012 in 2011. (See *Prepaid interest,* earlier.) You will have to figure the interest that accrued for 2012 and subtract it from the amount in box 1. You will include the interest for January 2012 with the other interest you pay for 2012. See *How to Report,* later.

Refunded interest. If you received a refund of mortgage interest you overpaid in an earlier year, you generally will receive a Form 1098 showing the refund in box 3. See *Refunds of interest,* earlier.

Mortgage insurance premiums. The amount of mortgage insurance premiums you paid during 2011 may be shown in box 4 of Form 1098. See *Mortgage Insurance Premiums*, earlier.

IV. Investment Interest

This section discusses the interest expenses you may be able to deduct as an investor.

If you borrow money to buy property you hold for investment, the interest you pay is investment interest. You can deduct investment interest subject to the limit discussed later. However, you cannot deduct interest you incurred to produce tax-exempt income. Nor can you deduct interest expenses on straddles.

Investment interest does not include any qualified home mortgage interest or any interest taken into account in computing income or loss from a passive activity.

INVESTMENT PROPERTY

Property held for investment includes property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. It also includes property that produces gain or loss (not derived in the ordinary course of a trade or business) from the sale or trade of property producing these types of income or held for investment (other than an interest in a passive activity). Investment property also includes an interest in a trade or business activity in which you did not materially participate (other than a passive activity).

Partners, shareholders, and beneficiaries. To determine your investment interest, combine your share of investment interest from a partnership, S corporation, estate, or trust with your other investment interest.

ALLOCATION OF INTEREST EXPENSE

If you borrow money for business or personal purposes as well as for investment, you must allocate the debt among those purposes. Only the interest expense on the part of the debt used for investment purposes is treated as investment interest. The allocation is not affected by the use of property that secures the debt.

LIMIT ON DEDUCTION

Generally, your deduction for investment interest expense is limited to the amount of your *net investment income.*

You can carry over the amount of investment interest that you could not deduct because of this limit to the next tax year. The interest carried over is treated as investment interest paid or accrued in that next year.

You can carry over disallowed investment interest to the next tax year even if it is more than your taxable income in the year the interest was paid or accrued.

Net Investment Income

Determine the amount of your net investment income by subtracting your investment expenses (other than interest expense) from your investment income.

Investment income. This generally includes your gross income from property held for investment (such as interest, dividends, annuities, and royalties). Investment income does not include Alaska Permanent Fund dividends. It also does not include qualified dividends or net capital gain unless you choose to include them.

Choosing to include qualified dividends. Investment income generally does not include qualified dividends, discussed in chapter 8. However, you can choose to include all or part of your qualified dividends in investment income.

You make this choice by completing Form 4952, line 4g, according to its instructions.

If you choose to include any amount of your qualified dividends in investment income, you must reduce your qualified dividends that are eligible for the lower capital gains tax rates by the same amount.

Choosing to include net capital gain. Investment income generally does not include net capital gain from disposing of investment property (including capital gain distributions from mutual funds). However, you can choose to include all or part of your net capital gain in investment income. You make this choice by completing line 4g of Form 4952 according to its instructions.

If you choose to include any amount of your net capital gain in investment income, you must reduce your net capital gain that is eligible for the lower capital gains tax rates by the same amount.

Tip. *Before making either choice, consider the overall effect on your tax liability. Compare your tax if you make one or both of these choices with your tax if you do not.*

Investment income of child reported on parent's return. Investment income includes the part of your child's interest and dividend income that you choose to report on your return. If the child does not have qualified dividends, Alaska Permanent Fund dividends, or capital gain distributions, this is the amount on line 6 of Form 8814, Parents' Election To Report Child's Interest and Dividends.

Child's qualified dividends. If part of the amount you report is your child's qualified dividends, that part (which is reported on Form 1040, line 9b) generally does not count as investment income. However, you can choose to include all or part of it in investment income, as explained under *Choosing to include qualified dividends*, earlier.

Your investment income also includes the amount on Form 8814, line 12 (or, if applicable, the reduced amount figured next under *Child's Alaska Permanent Fund dividends*).

Child's Alaska Permanent Fund dividends. If part of the amount you report is your child's Alaska Permanent Fund dividends, that part does not count as investment income. To figure the amount of your child's income that you can consider your investment income, start with the amount on Form 8814, line 6. Multiply that amount by a percentage that is equal to the Alaska Permanent Fund dividends divided by the total amount on Form 8814, line 4. Subtract the result from the amount on Form 8814, line 12.

Child's capital gain distributions. If part of the amount you report is your child's capital gain distributions, that part (which is reported on line 13 of Schedule D or line 13 of Form 1040) generally does not count as investment income. However, you can choose to include all or part of it in investment income. Your investment income also includes the amount on line 12 of Form 8814.

Investment expenses. Investment expenses include all income-producing expenses (other than interest expense) relating to investment property that are allowable deductions after applying the 2% limit that applies to miscellaneous itemized deductions. Use the smaller of:

1) The investment expenses included on line 23 of Schedule A (Form 1040), or
2) The amount on line 27 of Schedule A.

Losses from passive activities. Income or expenses that you used in computing income or loss from a passive activity are not included in determining your investment income or investment expenses (including investment interest expense). See Publication 925, *Passive Activity and At-Risk Rules,* for information about passive activities.

Form 4952

Use Form 4952, *Investment Interest Expense Deduction,* to figure your deduction for investment interest.

Exception to use of Form 4952. You do not have to complete Form 4952 or attach it to your return if you meet all of the following tests.

- Your investment interest expense is not more than your investment income from interest and ordinary dividends, minus any qualified dividends.
- You have no other deductible investment expenses.
- You have no carryover of investment interest expense from 2010.

If you meet all of these tests, you can deduct all of your investment interest.

V. Items You Cannot Deduct

Some interest payments are not deductible. Certain expenses similar to interest also are not deductible. Nondeductible expenses include the following items.

- Personal interest (discussed later).
- Service charges (however, see *Other Expenses* in chapter 28).
- Annual fees for credit cards.
- Loan fees.
- Credit investigation fees.
- Interest to purchase or carry tax-exempt securities.

Penalties. You cannot deduct fines and penalties paid to a government for violations of law, regardless of their nature.

PERSONAL INTEREST

Personal interest is not deductible. Personal interest is any interest that is not home mortgage interest, investment interest, business interest, or other deductible interest. It includes the following items.

- Interest on car loans (unless you use the car for business).
- Interest on federal, state, or local income tax.
- Finance charges on credit cards, retail installment contracts, and revolving charge accounts incurred for personal expenses.
- Late payment charges by a public utility.

VI. Allocation of Interest

If you use the proceeds of a loan for more than one purpose (for example, personal and business), you must allocate the interest on the loan to each use. However, you do not have to allocate home mortgage interest if it is fully deductible, regardless of how the funds are used.

You allocate interest (other than fully deductible home mortgage interest) on a loan in the same way as the loan itself is allocated. You do this by tracing disbursements of the debt proceeds to specific uses.

VII. How to Report

You must file Form 1040 to deduct any home mortgage interest expense on your tax return. Where you deduct your interest expense generally depends on how you use the loan proceeds. See Table 23-1 for a summary of where to deduct your interest expense.

Table 23-1. Where to Deduct Your Interest Expense

IF you have…	THEN deduct it on…	AND for more information go to…
Deductible student loan interest	Form 1040, line 33 or Form 1040A, line 18	Publication 970
Deductible home mortgage interest and points reported on Form 1098	Schedule A (Form 1040), line 10	Publication 936
Deductible home mortgage interest *not* reported on Form 1098	Schedule A (Form 1040), line 11	Publication 936
Deductible points *not* reported on Form 1098	Schedule A (Form 1040), line 12	Publication 936
Deductible mortgage insurance premiums	Schedule A (Form 1040), line 13	Publication 936
Deductible investment interest (other than interest incurred to produce rents or royalties)	Schedule A (Form 1040), line 14	Publication 550
Deductible business interest (non-farm)	Schedule C or C-EZ (Form 1040)	Publication 535
Deductible farm business interest	Schedule F (Form 1040)	Publications 225 and 535
Deductible interest incurred to produce rents or royalties	Schedule E (Form 1040)	Publications 527 and 535
Personal interest	Not Deductible	

Home mortgage interest and points. Deduct the home mortgage interest and points reported to you on Form 1098 on line 10 of Schedule A (Form 1040). If you paid more deductible interest to the financial institution than the amount shown on Form 1098, show the larger deductible amount on line 10. Attach a statement explaining the difference and print "See attached" next to line 10.

Deduct home mortgage interest that was ***not*** reported to you on Form 1098 on line 11 of Schedule A (Form 1040). If you paid home mortgage interest to the person from whom you bought your home, show that person's name, address, and taxpayer identification number (TIN) on the dotted lines next to line 11. The seller must give you this number and you must give the seller your TIN.

If you can take a deduction for points that were ***not*** reported to you on Form 1098, deduct those points on line 12 of Schedule A (Form 1040).

Deduct mortgage insurance premiums on Schedule A (Form 1040), line 13.

More than one borrower. If you and at least one other person (other than your spouse if you file a joint return) were liable for and paid interest on a mortgage that was for your home, and the other person received a Form 1098 showing the interest that was paid during the year, attach a statement to your return explaining this. Show how much of the interest each of you paid, and give the name and address of the person who received the form. Deduct your share of the interest on line 11 of Schedule A (Form 1040), and print "See attached" next to the line. Also, deduct your share of any qualified mortgage insurance premiums on Schedule A (Form 1040), line 13.

Similarly, if you are the payer of record on a mortgage on which there are other borrowers entitled to a deduction for the interest shown on the Form 1098 you received, deduct only your share of the interest on line 10 of Schedule A (Form 1040). You should let each of the other borrowers know what his or her share is.

Mortgage proceeds used for business or investment. If your home mortgage interest deduction is limited but all or part of the mortgage proceeds were used for business, investment, or other deductible activities, see *Table 23-1.* It shows where to deduct the part of your excess interest that is for those activities.

Investment interest. Deduct investment interest, subject to certain limits discussed in Publication 550, on Schedule A (Form 1040), line 14.

Amortization of bond premium. There are various ways to treat the premium you pay to buy taxable bonds.

Income-producing rental or royalty interest. Deduct interest on a loan for income-producing rental or royalty property that is not used in your business in Part I of Schedule E (Form 1040).

Example. You rent out part of your home and borrow money to make repairs. You can deduct only the interest payment for the rented part in Part I of Schedule E (Form 1040). Deduct the rest of the interest payment on Schedule A (Form 1040) if it is deductible home mortgage interest.

<u>CHAPTER 23 – REVIEW QUESTIONS</u>

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Home mortgage interest is fully deductible if all of the following conditions are met <u>except</u>:

   a) you must file Form 1040 and itemize deductions on Schedule A
   b) you must be legally liable for the loan
   c) the mortgage must be a secured debt on a qualified home
   d) the mortgage(s) have a combined balance exceeding $1 million

2. Points paid to obtain a home mortgage are generally <u>not</u> deductible in the year paid because points are:

   a) not an established business practice
   b) not computed as a percentage of the principal amount of the mortgage
   c) listed on the Uniform Settlement Statement
   d) prepaid interest and should be deducted over the life of the mortgage

3. Generally, your deduction for investment interest expense is limited to 50% of your net investment income.

   a) true
   b) false

CHAPTER 23 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. In most cases, you will be able to fully deduct home mortgage interest if certain conditions are met. Filing Form 1040 with itemized deductions is one of the necessary conditions.

   B: Incorrect. The condition of being legally liable for the home mortgage loan is a necessary condition for claiming the home mortgage interest deduction.

   C: Incorrect. The mortgage producing the intended interest expense to be deducted <u>must</u> be secured by a qualified home.

   D: Correct. Mortgage interest paid resulting from mortgage balances exceeding $1 million ($500,000 for married filing separately) do <u>not</u> qualify for full deductibility.

2. A: Incorrect. The deductibility of points is not directly related to a local business practice.

   B: Incorrect. Points are computed as a percentage of the principal amount of the borrowed funds, or mortgage. This calculation however has no relationship to the deductibility of these costs on a federal tax return.

   C: Incorrect. The listing of "points" on a standard closing statement (Form HUD-1) has no connection to their deductibility.

   D: Correct. The general rule is that points represent prepaid interest and therefore must be claimed over the life of the mortgage. However, a nine-point exception test exists that upon meeting all such conditions will allow a taxpayer to fully deduct all points paid in the same year as they were paid.

3. A: True is incorrect. Generally, your deduction for investment interest expense is limited to the amount of your net investment income. You can carry over the amount of investment interest that you could not deduct because of this limit to the next tax year.

   B: False is correct. The limit is usually the amount of your total net investment income. To determine the amount of your net investment income, subtract your investment expenses (other than interest expense) from your investment income.

Chapter 24: Contributions

I. Important Reminders

Extension of provision encouraging contributions of capital gain real property for conservation purposes. The 2010 Tax Act extends for two years (through 2011) the increased contribution limits and carryforward period for contributions of appreciated real property (including partial interests in real property) for conservation purposes.

II. Introduction

This chapter explains how to claim a deduction for your charitable contributions. It discusses:

- Organizations that are qualified to receive deductible charitable contributions,
- The types of contributions you can deduct,
- How much you can deduct,
- What records to keep, and
- How to report your charitable contributions.

A ***charitable contribution*** is a donation or gift to, or for the use of, a qualified organization. It is voluntary and is made without getting, or expecting to get, anything of equal value.

Form 1040 required. To deduct a charitable contribution, you must file Form 1040 and itemize deductions on Schedule A. The amount of your deduction may be limited if certain rules and limits explained in this chapter apply to you.

III. Organizations that Qualify to Receive Deductible Contributions

You can deduct your contributions only if you make them to a ***qualified organization.*** To become a qualified organization, most organizations other than churches and governments, as described below, must apply to the IRS.

TYPES OF QUALIFIED ORGANIZATIONS

Generally, only the five following types of organizations can be qualified organizations.

1) ***A community chest, corporation, trust, fund, or foundation*** organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the United States (including Puerto Rico). It must be organized and operated only for one or more of the following purposes.
   a) Religious.
   b) Charitable.
   c) Educational.
   d) Scientific.
   e) Literary.
   f) The prevention of cruelty to children or animals.

Certain organizations that foster national or international amateur sports competition also qualify.

2) ***War veterans' organizations,*** including posts, auxiliaries, trusts, or foundations, organized in the United States or any of its possessions.

3) ***Domestic fraternal societies,*** orders, and associations operating under the lodge system.
4) ***Certain nonprofit cemetery*** companies or corporations.
5) ***The United States*** or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions.

Examples. Qualified organizations include:

- Churches, a convention or association of churches, temples, synagogues, mosques, and other religious organizations.
- Most nonprofit charitable organizations such as the Red Cross and the United Way.
- Most nonprofit educational organizations, including the Girl and Boy Scouts of America, colleges, museums, and day-care centers if substantially all the child care provided is to enable individuals (the parents) to be gainfully employed and the services are available to the general public. However, if your contribution is a substitute for tuition or other enrollment fee, it is not deductible as a charitable contribution, as explained later under *Contributions You Cannot Deduct.*
- Nonprofit hospitals and medical research organizations.
- Utility company emergency energy programs, if the utility company is an agent for a charitable organization that assists individuals with emergency energy needs.
- Nonprofit volunteer fire companies.
- Public parks and recreation facilities (but not entry or usage fees).
- Civil defense organizations.

Certain foreign charitable organizations. Under income tax treaties with Canada, Israel, and Mexico, you may be able to deduct contributions to certain Canadian, Israeli, or Mexican charitable organizations. Generally, you must have income from sources in that country.

IV. Contributions You Can Deduct

Generally, you can deduct your contributions of money or property that you make to, or for the use of, a qualified organization. A gift or contribution is "for the use of" a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement. The contributions must be made to a qualified organization and not set aside for use by a specific person.

If you give property to a qualified organization, you generally can deduct the fair market value of the property at the time of the contribution. See *Contributions of Property,* later in this chapter.

Your deduction for charitable contributions is generally limited to 50% of your adjusted gross income, but in some cases 20% and 30% limits may apply.

In addition, the total of your charitable contributions deduction and certain other itemized deductions may be limited.

Table 24-1 lists some examples of contributions you can deduct and some that you cannot deduct.

Table 24-1. Examples of Charitable Contributions – A Quick Check

Use the following lists for a quick check of contributions you can or cannot deduct. See the rest of this chapter for more information and additional rules and limits that may apply.	
Deductible As Charitable Contributions	Not Deductible As Charitable Contributions
Money or property you give to: • Churches, synagogues, temples, mosques, and other religious organizations • Federal, state and local governments, if your contribution is solely for public purposes (for example, a gift to reduce the public debt) • Nonprofit schools and hospitals • Public parks and recreation facilities (but not entry or usage fees) • Salvation Army, Red Cross, CARE, Goodwill Industries, United Way, Boy Scouts, Girl Scouts, Boys and Girls Clubs of America, etc. • War veterans groups • Charitable organizations listed in Publication 78	Money or property you give to: • Civic leagues, social and sports clubs, labor unions, and chambers of commerce • Foreign organizations (except certain Canadian, Israeli, and Mexican charities) • Groups that are run for personal profit • Groups whose purpose is to lobby for law changes • Homeowners' associations • Individuals • Political groups or candidates for public office
Expenses paid for a student living with you, sponsored by a qualified organization Out-of-pocket expenses when you serve a qualified organization as a volunteer	Cost of raffle, bingo, or lottery tickets Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups Tuition Value of your time or services Value of blood given to a blood bank

CONTRIBUTIONS FROM WHICH YOU BENEFIT

If you receive a benefit as a result of making a contribution to a qualified organization, you can deduct only the amount of your contribution that is ***more than the value of the benefit*** you receive.

If you pay more than fair market value to a qualified organization for merchandise, goods, or services, the amount you pay that is more than the value of the item can be a charitable contribution. For the excess amount to qualify, you must pay it with the intent to make a charitable contribution.

Example 1. You pay $65 for a ticket to a dinner-dance at a church. All of the proceeds of the function go to the church. The ticket to the dinner-dance has a fair market value of $25. When you buy your ticket, you know that its value is less than your payment. To figure the amount of your charitable contribution, you subtract the value of the benefit you receive ($25) from your total payment ($65). You can deduct $40 as a contribution to the church.

Example 2. At a fund-raising auction conducted by a charity, you pay $600 for a week's stay at a beach house. The amount you pay is no more than the fair rental value. You have not made a deductible charitable contribution.

Athletic events. If you make a payment to, or for the benefit of, a college or university and, as a result, you receive the right to buy tickets to an athletic event in the athletic stadium of the college or university, you can deduct 80% of the payment as a charitable contribution.

If any part of your payment is for tickets (rather than the right to buy tickets), that part is not deductible. In that case, subtract the price of the tickets from your payment. 80% of the remaining amount is a charitable contribution.

Example 1. You pay $300 a year for membership in an athletic scholarship program maintained by a university (a qualified organization). The only benefit of membership is that you have the right to buy one season ticket for a seat in a designated area of the stadium at the university's home football games. You can deduct $240 (80% of $300) as a charitable contribution.

Example 2. The facts are the same as in Example 1 except that your $300 payment included the purchase of one season ticket for the stated ticket price of $120. You must subtract the usual price of a ticket ($120) from your $300 payment. The result is $180. Your deductible charitable contribution is $144 (80% of $180).

Charity benefit events. If you pay a qualified organization more than fair market value for the right to attend a charity ball, banquet, show, sporting event, or other benefit event, you can deduct only the amount that is more than the value of the privileges or other benefits you receive.

If there is an established charge for the event, that charge is the value of your benefit. If there is no established charge, your contribution is that part of your payment that is more than the reasonable value of the right to attend the event. Whether you use the tickets or other privileges has no effect on the amount you can deduct. However, if you return the ticket to the qualified organization for resale, you can deduct the entire amount you paid for the ticket.

Example. You pay $40 to see a special showing of a movie for the benefit of a qualified organization. Printed on the ticket is "Contribution – $40." If the regular price for the movie is $8, your contribution is $32 ($40 payment - $8 regular price).

Membership fees or dues. You may be able to deduct membership fees or dues you pay to a qualified organization. However, you can deduct only the amount that is more than the value of the benefits you receive. You cannot deduct dues, fees, or assessments paid to country clubs and other social organizations. They are not qualified organizations.

Certain membership benefits can be disregarded. Both you and the organization can disregard certain membership benefits you get in return for an annual payment of ***$75 or less*** to the qualified organization. You can pay more than $75 to the organization if the organization does not require a larger payment for you to get the benefits. The following benefits are covered under this rule.

1) Any rights or privileges, other than those discussed under *Athletic events,* earlier, that you can use frequently while you are a member, such as:
    a) Free or discounted admission to the organization's facilities or events,
    b) Free or discounted parking,
    c) Preferred access to goods or services, and
    d) Discounts on the purchase of goods and services.

2) Admission, while you are a member, to events that are open only to members of the organization, if the organization reasonably projects that the cost per person (excluding any allocated overhead) is not more than $9.50.

Token items. You can deduct your entire payment to a qualified organization as a charitable contribution if both of the following are true.

1) You get a small item or other benefit of token value.
2) The qualified organization correctly determines that the value of the item or benefit you received is not substantial and informs you that you can deduct your payment in full.

Written statement. A qualified organization must give you a written statement if you make a payment to it that is ***more than $75*** and is partly a contribution and partly for goods or services. The statement must tell you that you can deduct only the amount of your payment that is more than the value of the goods or services you received. It must also give you a good faith estimate of the value of those goods or services.

The organization can give you the statement either when it solicits or when it receives the payment from you.

Exception. An organization will not have to give you this statement if one of the following is true.

1) The organization is:
    a) The type of organization described in (5) under *Types of Qualified Organizations*, earlier, or
    b) Formed only for religious purposes, and the only benefit you receive is an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in commercial transactions outside the donative context.
2) You receive only items whose value is not substantial. See *Token items*, earlier.
3) You receive only membership benefits that can be disregarded, as described earlier.

EXPENSES PAID FOR STUDENT LIVING WITH YOU

You may be able to deduct some expenses of having a student live with you. You can deduct ***qualifying expenses*** for a foreign or American student who:

1) Lives in your home under a written agreement between you and a ***qualified organization*** as part of a program of the organization to provide educational opportunities for the student,
2) Is not your dependent or relative, and
3) Is a full-time student in the twelfth or any lower grade at a school in the United States.

You can deduct up to $50 a month for each full calendar month the student lives with you. Any month when conditions (1) through (3) above are not met for 15 days or more counts as a full month.

Mutual exchange program. You cannot deduct the costs of a foreign student living in your home under a mutual exchange program through which your child will live with a family in a foreign country.

OUT-OF-POCKET EXPENSES IN GIVING SERVICES

You may be able to deduct some amounts you pay in giving services to a qualified organization. The amounts must be:

- Unreimbursed,
- Directly connected with the services,
- Expenses you had only because of the services you gave, and
- Not personal, living, or family expenses.

Table 24-2 contains questions and answers that apply to some individuals who volunteer their services.

Table 24-2. Volunteers' Questions and Answers

If you do volunteer for a qualified organization, the following questions and answers may apply to you. All of the rules explained in this chapter also apply. See, in particular, *Out-of-Pocket Expenses* in *Giving Services*.	
Question	**Answer**
I do volunteer work 6 hours a week in the office of a qualified organization. The receptionist is paid $10 an hour to do the same work I do. Can I deduct $60 a week for my time?	No, you cannot deduct the value of your time or services.
The office is 30 miles from my home. Can I deduct any of my car expenses for these trips?	Yes, you can deduct the costs of gas and oil that are directly related to getting to and from the place where you are a volunteer. If you don't want to figure your actual costs, you can deduct 14 cents for each mile.
I volunteer as a Red Cross nurse's aide at a hospital. Can I deduct the cost of uniforms that I must wear?	Yes, you can deduct the cost of buying and cleaning your uniforms if the hospital is a qualified organization, the uniforms are not suitable for everyday use, and you must wear them when volunteering.
I pay a babysitter to watch my children while I do volunteer work for a qualified organization. Can I deduct these costs?	No, you cannot deduct payments for child care expenses as a charitable contribution, even if they are necessary so you can do volunteer work for a qualified organization. (If you have child care expenses so you can work for pay, see chapter 32.)

Conventions. If you are a ***chosen representative*** attending a convention of a qualified organization, you can deduct actual unreimbursed expenses for travel and transportation, including a reasonable amount for meals and lodging, while away from home overnight in connection with the convention. However, see *Travel,* later.

You cannot deduct personal expenses for sightseeing, fishing parties, theater tickets, or nightclubs. You also cannot deduct travel, meals and lodging, and other expenses for your spouse or children.

You cannot deduct your expenses in attending a church convention if you go only as a member of your church rather than as a chosen representative. You can deduct unreimbursed expenses that are directly connected with giving services for your church during the convention.

Uniforms. You can deduct the cost and upkeep of uniforms that are not suitable for everyday use and that you must wear while performing donated services for a charitable organization.

Foster parents. You may be able to deduct as a charitable contribution some of the costs of being a foster parent (foster care provider) if you have no profit motive in providing the foster care and are not, in fact, making a profit. A qualified organization must designate the individuals you take into your home for foster care.

You can deduct expenses that meet both of the following requirements.

1) They are unreimbursed out-of-pocket expenses to feed, clothe, and care for the foster child.
2) They are mainly to benefit the qualified organization.

Unreimbursed expenses that you cannot deduct as charitable contributions may be considered support provided by you in determining whether you can claim the foster child as a dependent. For details, see chapter 3.

Example. You cared for a foster child because you wanted to adopt her, not to benefit the agency that placed her in your home. Your unreimbursed expenses are not deductible as charitable contributions.

Car expenses. You can deduct unreimbursed out-of-pocket expenses, such as the cost of gas and oil, that are directly related to the use of your car in giving services to a charitable organization. You cannot deduct any part of general repair and maintenance expenses, depreciation, registration fees, or the costs of tires or insurance.

If you do not want to deduct your actual expenses, you can use a standard mileage rate of ***14 cents a mile*** to figure your contribution.

You can deduct parking fees and tolls whether you use your actual expenses or the standard mileage rate.

You must keep reliable written records of your car expenses. For more information, see *Car expenses* under *Records to Keep,* later.

Travel. Generally, you can claim a charitable contribution deduction for travel expenses necessarily incurred while you are away from home performing services for a charitable organization only if there is ***no significant element of personal pleasure,*** recreation, or vacation in the travel. This applies whether you pay the expenses directly or indirectly. You are paying the expenses indirectly if you make a payment to the charitable organization and the organization pays for your travel expenses.

The deduction for travel expenses will not be denied simply because you enjoy providing services to the charitable organization. Even if you enjoy the trip, you can take a charitable contribution deduction for your travel expenses if you are on duty in a genuine and substantial sense throughout the trip. However, if you have only nominal duties, or if for significant parts of the trip you do not have any duties, you cannot deduct your travel expenses.

Example 1. You are a troop leader for a tax-exempt youth group and take the group on a camping trip. You are responsible for overseeing the setup of the camp and for providing the adult supervision for the other activities during the entire trip. You participate in the activities of the group and really enjoy your time with them. You oversee the breaking of camp and you transport the group home. You can deduct your travel expenses.

Example 2. You sail from one island to another and spend 8 hours a day counting whales and other forms of marine life. The project is sponsored by a charitable organization. In most circumstances, you cannot deduct your expenses.

Example 3. You work for several hours each morning on an archaeological dig sponsored by a charitable organization. The rest of the day is free for recreation and sightseeing. You cannot take a charitable contribution deduction even though you work very hard during those few hours.

Example 4. You spend the entire day attending a charitable organization's regional meeting as a chosen representative. In the evening you go to the theater. You can claim your travel expenses as charitable contributions, but you cannot claim the cost of your evening at the theater.

Daily allowance (per diem). If you provide services for a charitable organization and receive a daily allowance to cover reasonable travel expenses, including meals and lodging while away from home overnight, you must include in income the amount of the allowance that is more than your deductible travel expenses. You can deduct your necessary travel expenses that are more than the allowance.

Deductible travel expenses. These include:

- Air, rail, and bus transportation,
- Out-of-pocket expenses for your car,
- Taxi fares or other costs of transportation between the airport or station and your hotel,
- Lodging costs, and
- The cost of meals.

Because these travel expenses are not business related, they are not subject to the same limits as business-related expenses. For information on business travel expenses, see *Travel Expenses* in chapter 26.

V. <u>Contributions You Cannot Deduct</u>

There are some contributions that you cannot deduct, such as those made to individuals and those made to nonqualified organizations. (See *Contributions to Individuals* and *Contributions to Nonqualified Organizations,* next). There are others that you can deduct only part of, as discussed later under *Contributions From Which You Benefit.*

CONTRIBUTIONS TO INDIVIDUALS

You cannot deduct contributions to specific individuals, including the following.

- Contributions to fraternal societies made for the purpose of paying medical or burial expenses of deceased members.
- Contributions to individuals who are needy or worthy. This includes contributions to a qualified organization if you indicate that your contribution is for a specific person. ***But*** you can deduct a contribution that you give to a qualified organization that in turn helps needy or worthy individuals if you do not indicate that your contribution is for a specific person.
- Payments to a member of the clergy that can be spent as he or she wishes, such as for personal expenses.
- Expenses you paid for another person who provided services to a qualified organization.

> ***Example.*** Your son does missionary work. You pay his expenses. You cannot claim a deduction for your son's unreimbursed expenses related to his contribution of services.

- Payments to a hospital that are for services for a specific patient. You cannot deduct these payments even if the hospital is operated by a city, a state, or other qualified organization.

CONTRIBUTIONS TO NONQUALIFIED ORGANIZATIONS

You cannot deduct contributions to organizations that are not qualified to receive tax-deductible contributions, including the following.

1) ***Certain state bar associations*** if:
   a) The state bar is not a political subdivision of a state,
   b) The bar has private, as well as public, purposes, such as promoting the professional interests of members, and
   c) Your contribution is unrestricted and can be used for private purposes.
2) ***Chambers of commerce*** and other business leagues or organizations (but see chapter 28.)
3) ***Civic leagues and associations.***
4) ***Communist organizations.***
5) ***Country clubs*** and other social clubs.
6) ***Foreign organizations*** other than:
   a) A U.S. organization that transfers funds to a charitable foreign organization if the U.S. organization controls the use of the funds or if the foreign organization is only an administrative arm of the U.S. organization, or
   b) Certain Canadian, Israeli, or Mexican charitable organizations. See *Certain foreign charitable organizations* under *Organizations That Qualify To Receive Deductible Contributions,* earlier.
7) ***Homeowners' associations.***
8) ***Labor unions.*** See chapter 28.
9) ***Political organizations and candidates.***

CONTRIBUTIONS FROM WHICH YOU BENEFIT

If you receive or expect to receive a financial or economic benefit as a result of making a contribution to a qualified organization, you cannot deduct the part of the contribution that represents the value of the benefit you receive or expect to receive. These contributions include the following.

- Contributions for ***lobbying.*** This includes amounts that you earmark for use in, or in connection with, influencing specific legislation.
- Contributions to a ***retirement home*** that are clearly for room, board, maintenance, or admittance. Also, if the amount of your contribution depends on the type or size of apartment you will occupy, it is not a charitable contribution.
- Costs of ***raffles, bingo, lottery, etc.*** You cannot deduct as a charitable contribution amounts you pay to buy raffle or lottery tickets or to play bingo or other games of chance. For information on how to report gambling winnings and losses, see chapter 12 and chapter 28.
- Dues to ***fraternal orders*** and similar groups. However, see *Membership fees or dues,* earlier, under *Contributions You Can Deduct.*
- ***Tuition,*** or amounts you pay instead of tuition, even if you pay them for children to attend parochial schools or qualifying nonprofit day-care centers. You also cannot deduct any fixed amount you may be required to pay in addition to the tuition fee to enroll in a private school, even if it is designated as a "donation."

VALUE OF TIME OR SERVICES

You cannot deduct the value of your time or services, including:

- ***Blood donations*** to the Red Cross or to blood banks, and
- ***The value of income lost*** while you work as an unpaid volunteer for a qualified organization.

PERSONAL EXPENSES

You cannot deduct personal, living, or family expenses, such as:

- ***The cost of meals*** you eat while you perform services for a qualified organization unless it is necessary for you to be away from home overnight while performing the services, or
- ***Adoption expenses,*** including fees paid to an adoption agency and the costs of keeping a child in your home before adoption is final. However, you may be able to claim a tax credit for these expenses and exclude from your gross income adoption expenses paid or reimbursed by your employer. See *Adoption Credit* in chapter 37 and the instructions for Form 8839, *Qualified Adoption Expenses*. You also may be able to claim an exemption for the child. See *Adoption* in chapter 3.

APPRAISAL FEES

Fees that you pay to find the fair market value of donated property are not deductible as contributions, (but see chapter 28).

VI. <u>Contributions of Property</u>

If you contribute property to a qualified organization, the amount of your charitable contribution is generally the fair market value of the property at the time of the contribution. However, if the property has increased in value, you may have to make some adjustments to the amount of your deduction. See *Giving Property That Has Increased in Value,* later.

For information about the records you must keep and the information you must furnish with your return if you donate property, see *Records To Keep* and *How To Report,* later.

Clothing and household items. You cannot take a deduction for clothing or household items you donate, unless the clothing or household items are in good used condition or better.

Exception. You can take a deduction for a contribution of an item of clothing or household item that is not in good used condition or better if you deduct more than $500 for it and include a qualified appraisal of it with your return.

Household items. Household items include:

- Furniture,
- Furnishings,
- Electronics,
- Appliances,
- Linens, and
- Other similar items.

Household items do not include:

- Food,
- Paintings, antiques, and other objects of art,
- Jewelry and gems, and
- Collections.

Cars, boats, and airplanes. The following rules apply to any donation of a qualified vehicle.

A qualified vehicle is:

- A car or any motor vehicle manufactured mainly for use on public streets, roads, and highways,
- A boat, or
- An airplane.

Deduction more than $500. If you donate a qualified vehicle to a qualified organization and you claim a deduction of more than $500, you can deduct the smaller of:

- The gross proceeds from the sale of the vehicle by the organization, or
- The vehicle's fair market value on the date of the contribution. If the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount, as described under *Giving Property That Has Increased in Value*, later.

Form 1098-C. You must attach to your return the copy of the Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes, (or other statement containing the same information as Form 1098-C) you received from the organization. The Form 1098-C (or other statement) will show the gross proceeds from the sale of the vehicle.

If you e-file your return, you must attach Copy B of Form 1098-C to Form 8453 and mail the forms to the IRS.

If you do not attach Form 1098-C (or other statement), you cannot deduct your contribution. You must get Form 1098-C (or other statement) within 30 days of the sale of the vehicle. But if exception 1 or 2 (described next) applies, you must get Form 1098-C (or other statement) within 30 days of your donation.

Exceptions. There are two exceptions to the rules just described for deductions of more than $500.

Exception 1 – vehicle used or improved by organization. If the qualified organization makes a significant intervening use of or material improvement to the vehicle before transferring it and you claim a deduction of more than $500, you generally can deduct the vehicle's fair market value at the time of the contribution. But if the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount, as described under *Giving Property That Has Increased in Value*, later. The Form 1098-C (or other statement) will show whether this exceptions applies.

Exception 2 – vehicle given or sold to needy individual. If the qualified organization will give the vehicle, or sell it for a price well below fair market value, to a needy individual to further the organization's charitable purpose, and you claim a deduction of more than $500, you generally can deduct the vehicle's fair market value at the time of the contribution. But if the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount, as described under *Giving Property That Has Increased in Value*, later. The Form 1098-C (or other statement) will show whether this exception applies.

This exception does not apply if the organization sells the vehicle at auction. In that case, you cannot deduct the vehicle's fair market value.

Example. Anita donates a used car to a qualified organization. She bought it 3 years ago for $9,000. A used car guide shows the fair market value for this type of car is $6,000. However, Anita gets a Form 1098-C from the organization showing the car was sold for $2,900. Neither exception 1 nor exception 2 applies. If Anita itemizes her deductions, she can deduct $2,900 for her donation. She must attach the Form 1098-C and Form 8283 to her return.

Deduction $500 or less. If the qualified organization sells the vehicle for $500 or less and exceptions 1 and 2 do not apply, you can deduct the smaller of:

- $500, or
- The vehicle's fair market value on the date of the contribution. But if the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount, as described under *Giving Property That Has Increased in Value*, later.

If the vehicle's fair market value is at least $250 but not more than $500, you must have a written statement from the qualified organization acknowledging your donation. The statement must contain the information and meet the tests for an acknowledgement described under *Deductions of At Least $250 But Not More Than $500* under *Records to Keep*, later.

Partial interest in property. Generally, you cannot deduct a charitable contribution (not made by a transfer in trust) of less than your entire interest in property.

Right to use property. A contribution of the right to use property is a contribution of less than your entire interest in that property and is not deductible. For exceptions and more information, see *Partial Interest in Property Not in Trust* in Publication 561.

Future interests in tangible personal property. You can deduct the value of a charitable contribution of a future interest in tangible personal property only after all intervening interests in and rights to the actual possession or enjoyment of the property have either expired or been turned over to someone other than yourself, a related person, or related organization.

Tangible personal property. This is any property, other than land or buildings, that can be seen or touched. It includes furniture, books, jewelry, paintings, and cars.

Future interest. This is any interest that is to begin at some future time, regardless of whether it is designated as a future interest under state law.

DETERMINING FAIR MARKET VALUE

This section discusses general guidelines for determining the fair market value of various types of donated property. Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the relevant facts.

Used clothing and household items. Generally, the fair market value of used clothing and household goods is far less than its original cost.

For used clothing, you should claim as the value the price that buyers of used items actually pay in used clothing stores, such as consignment or thrift shops. See *Household Goods* in Publication 561 for information on the valuation of household goods, such as furniture, appliances, and linens.

Example. Dawn Greene donated a coat to a thrift store operated by her church. She paid $300 for the coat 3 years ago. Similar coats in the thrift store sell for $50. The fair market value of the coat is reasonably determined to be $50. Dawn's donation is limited to $50.

Cars, boats, and airplane. If you contribute a car, boat, or airplane to a charitable organization, you must determine its fair market value.

Certain commercial firms and trade organizations publish guides, commonly called "blue books," containing complete dealer sale prices or dealer average prices for recent model years. The guides may be published monthly or seasonally and for different regions of the country. These guides also provide estimates for adjusting for unusual equipment, unusual mileage, and physical condition. The prices are not "official" and these publications are not considered an appraisal of any specific donated property. But they do provide clues for making an appraisal and suggest relative prices for comparison with current sales and offerings in your area.

Example. You donate a used car in poor condition to a local high school for use by students studying car repair. A used car guide shows the dealer retail value for this type of car in poor condition is $1,600. However, the guide shows the price for a private party sale of the car is only $750. The fair market value of the car is considered to be $750.

Large quantities. If you contribute a large number of the same item, fair market value is the price at which comparable numbers of the item are being sold.

GIVING PROPERTY THAT HAS DECREASED IN VALUE

If you contribute property with a fair market value that is less than your basis in it, your deduction is limited to its fair market value. You cannot claim a deduction for the difference between the property's basis and its fair market value.

GIVING PROPERTY THAT HAS INCREASED IN VALUE

If you contribute property with a fair market value that is more than your basis in it, you may have to reduce the fair market value by the amount of appreciation (increase in value) when you figure your deduction.

Your basis in property is generally what you paid for it. See chapter 13 if you need more information about basis.

Different rules apply to figuring your deduction, depending on whether the property is:

1) Ordinary income property, or
2) Capital gain property.

Ordinary income property. Property is ordinary income property if its sale at fair market value on the date it was contributed would have resulted in ordinary income or in short-term capital gain. Examples of ordinary income property are inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held 1 year or less.

Amount of deduction. The amount you can deduct for a contribution of ordinary income property is its fair market value less the amount that would be ordinary income or short-term capital gain if you sold the property for its fair market value. Generally, this rule limits the deduction to your basis in the property.

Example. You donate stock that you held for 5 months to your church. The fair market value of the stock on the day you donate it is $1,000, but you paid only $800 (your basis). Because the $200 of appreciation would be short-term capital gain if you sold the stock, your deduction is limited to $800 (fair market value less the appreciation).

Capital gain property. Property is capital gain property if its sale at fair market value on the date of the contribution would have resulted in long-term capital gain. It includes capital assets held more than 1 year, as well as certain real property and depreciable property used in your trade or business and, generally, held more than 1 year.

Amount of deduction – general rule. When figuring your deduction for a gift of capital gain property, you usually can use the ***fair market value*** of the gift.

Exceptions. In certain situations, you must reduce the fair market value by any amount that would have been long-term capital gain if you had sold the property for its fair market value. Generally, this means reducing the fair market value to the property's cost or other basis.

Bargain sales. A bargain sale of property to a qualified organization (a sale or exchange for less than the property's fair market value) is partly a charitable contribution and partly a sale or exchange. A bargain sale may result in a taxable gain.

VII. <u>When to Deduct</u>

You can deduct your contributions only in the year you actually make them in cash or other property (or in a later carryover year, as explained later under *Carryovers*). This applies whether you use the cash or an accrual method of accounting.

Time of making contribution. Usually, you make a contribution at the time of its unconditional delivery.

Checks. A check that you mail to a charity is considered delivered on the date you mail it.

Credit card. Contributions charged on your bank credit card are deductible in the year you make the charge.

Pay-by-phone account. If you use a pay-by-phone account, the date you make a contribution is the date the financial institution pays the amount. This date should be shown on the statement the financial institution sends to you.

Stock certificate. A gift to a charity of a properly endorsed stock certificate is completed on the date of mailing or other delivery to the charity or to the charity's agent. However, if you give a stock certificate to your agent or to the issuing corporation for transfer to the name of the charity, your gift is not completed until the date the stock is transferred on the books of the corporation.

Promissory note. If you issue and deliver a promissory note to a charitable organization as a contribution, it is not a contribution until you make the note payments.

Option. If you grant an option to buy real property at a bargain price to a charitable organization, you cannot take a deduction until the organization exercises the option.

Borrowed funds. If you make a contribution with borrowed funds, you can deduct the contribution in the year you make it, regardless of when you repay the loan.

VIII. <u>Limits on Deductions</u>

If your total contributions for the year are 20% or less of your adjusted gross income, you do not need to read this section. The limits discussed here do not apply to you.

The amount of your deduction may be limited to either ***20%, 30%, or 50%*** of your adjusted gross income, depending on the type of property you give and the type of organization you give it to. These limits are described below.

If your contributions are more than any of the limits that apply, see *Carryovers,* later.

<u>50% LIMIT</u>

This limit applies to the total of all charitable contributions you make during the year. This means that your deduction for charitable contributions cannot be more than 50% of your adjusted gross income for the year.

Generally, the 50% limit is the only limit that applies to gifts to organizations listed below under *50% limit organizations.* But there is one ***exception.*** The 30% limit also applies to such gifts if they are gifts of capital gain property for which you figure your deduction using fair market value without reduction for appreciation. (See *Special 30% Limit for Capital Gain Property*, later.)

50% limit organizations. You can ask any organization whether it is a 50% limit organization and most will be able to tell you. Or you can check IRS Publication 78 or call the Tax Exempt/Government Entities Customer Service at the number listed earlier under *Organizations that Qualify to Receive Deductible Contributions*. The following is a partial list of the types of organizations that are 50% limit organizations.

1) Churches and conventions or associations of churches.
2) Educational organizations with a regular faculty and curriculum that normally have a regularly enrolled student body attending classes on site.
3) Hospitals and certain medical research organizations associated with these hospitals.
4) Publicly supported charities.

30% LIMIT

A 30% limit applies to the following gifts:

- Gifts to all qualified organizations other than 50% limit organizations. This includes gifts to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations.
- Gifts for the use of any organization. However, if these gifts are of capital gain property, they are subject to the 20% limit, described later, rather than the 30% limit.

Student living with you. Amounts you spend on behalf of a student living with you are subject to the 30% limit. These amounts are considered a contribution for the use of a qualified organization. See *Expenses Paid for Student Living With You*, earlier.

SPECIAL 30% LIMIT FOR CAPITAL GAIN PROPERTY

A special 30% limit applies to gifts of capital gain property to 50% limit organizations. (For gifts of capital gain property to other organizations, see *20% Limit*, later.) However, the special 30% limit does not apply when you choose to reduce the fair market value of the property by the amount that would have been long-term capital gain if you had sold the property. Instead, only the 50% limit applies.

Two separate 30% limits. This special 30% limit for capital gain property is separate from the other 30% limit. Therefore, the deduction of a contribution subject to one 30% limit does not reduce the amount you can deduct for contributions subject to the other 30% limit. However, the total you deduct cannot be more than 50% of your adjusted gross income.

Example. Your adjusted gross income is $50,000. During the year, you gave capital gain property with a fair market value of $15,000 to a 50% limit organization. You do not choose to reduce the property's fair market value by its appreciation in value. You also gave $10,000 cash to a qualified organization that is not a 50% limit organization. The $15,000 gift of property is subject to the special 30% limit. The $10,000 cash gift is subject to the other 30% limit. Both gifts are fully deductible because neither is more than the 30% limit that applies ($15,000 in each case) and together they are not more than the 50% limit ($25,000).

20% LIMIT

This limit applies to all gifts of capital gain property to or for the use of qualified organizations (other than gifts of capital gain property to 50% limit organizations).

Qualified conservation contribution. The special 30% limit does not apply to qualified conservation contributions (QCCs). Instead, a 50% limit applies. For qualified farmers and ranchers, QCCs are deductible up to 100% of adjusted gross income.

CARRYOVERS

You can carry over your contributions that you are not able to deduct in the current year because they exceed your adjusted-gross-income limits. You can deduct the excess in each of the next 5 years until it is used up, but not beyond that time.

IX. Records to Keep

You must keep records to prove the amount of the contributions you make during the year. The kind of records you must keep depends on the amount of your contributions and whether they are:

- Cash contributions,
- Noncash contributions, or
- Out-of-pocket expenses when donating your services.

CASH CONTRIBUTIONS

Cash contributions include those paid by cash, check, credit card, or payroll deduction.

You cannot deduct a cash contribution, regardless of the amount, unless you keep one of the following.

1) A bank record that shows the name of the qualified organization, the date of the contribution, and the amount of the contribution. Bank records may include:
    a) A canceled check,
    b) A bank or credit union statement, or
    c) A credit card statement.
2) A receipt (or letter or other written communication) from the qualified organization showing the name of the organization, the date of the contribution, and the amount of the contribution.
3) The payroll deduction records described next.

Payroll deductions. If you can make a contribution by payroll deduction, you must keep:

1) A pay stub, Form W-2, or other document furnished by your employer that shows the date and amount of the contribution, and
2) A pledge or other document prepared by you for the qualified organization that shows the name of the organization.

If your employer withheld $250 or more from a single paycheck, see *Contributions of $250 or More*, next.

Contributions of $250 or More

You can claim a deduction for a contribution of $250 or more only if you have an acknowledgment of your contribution from the qualified organization or certain payroll deduction records.

If you made more than one contribution of $250 or more, you must have either a separate acknowledgment for each or one acknowledgment that lists each contribution and the date of each contribution and shows your total contributions.

Amount of contribution. In figuring whether your contribution is $250 or more, do not combine separate contributions. For example, if you gave your church $25 each week, your weekly payments do not have to be combined. Each payment is a separate contribution.

If contributions are made by payroll deduction, the deduction from each paycheck is treated as a separate contribution.

If you made a payment that is partly for goods and services, as described earlier under *Contributions From Which You Benefit*, your contribution is the amount of the payment that is more than the value of the goods and services.

Acknowledgment. The acknowledgment must meet these tests.

1) It must be written.
2) It must include:
   a) The amount of cash you contributed,
   b) Whether the qualified organization gave you any goods or services as a result of your contribution (other than certain token items and membership benefits),
   c) A description and good faith estimate of the value of any goods or services described in (b) (other than intangible religious benefits), and
   d) A statement that the only benefit you received was an intangible religious benefit, if that was the case. The acknowledgment does not need to describe or estimate the value of an intangible religious benefit. An intangible religious benefit is a benefit that generally is not sold in commercial transactions outside a donative (gift) context. An example is admission to a religious ceremony.
3) You must get it on or before the earlier of:
   a) The date you file your return for the year you make the contribution, or
   b) The due date, including extensions, for filing the return.

If the acknowledgment does not show the date of the contribution, you must also have a bank record or receipt, as described earlier, that does show the date of the contribution. If the acknowledgment does show the date of the contribution and meets the other tests just described, you do not need any other records.

Payroll deductions. If you make a contribution by payroll deduction and your employer withheld $250 or more from a single paycheck, you must keep:

1) A pay stub, Form W-2, or other document furnished by your employer that shows the amount withheld as a contribution, and
2) A pledge card or other document prepared by or for the qualified organization that shows the name of the organization and states the organization does not provide goods or services in return for any contribution made to it by payroll deduction.

A single pledge card may be kept for all contributions made by payroll deduction regardless of amount as long as it contains all the required information.

If the pay stub, Form W-2, pledge card, or other document does not show the date of the contribution, you must also have another document that does show the date of the contribution. If the pay stub, Form W-2, pledge card, or other document does show the date of the contribution, you do not need any other records except those just described in (1) and (2).

NONCASH CONTRIBUTIONS

For a contribution not made in cash, the records you must keep depend on whether your deduction for the contribution is:

1) Less than $250,
2) At least $250 but not more than $500,
3) Over $500 but not more than $5,000, or
4) Over $5,000.

Amount of deduction. In figuring whether your deduction is $500 or more, combine your claimed deductions for all similar items of property donated to any charitable organization during the year. If you received goods or services in return, as described earlier in *Contributions From Which You Benefit*, reduce your contribution by the value of those goods or services. If you figure your deduction by reducing the fair market value of the donated property by its appreciation, as described earlier in *Giving Property That Has Increased in Value,* your contribution is the reduced amount.

Deductions of Less Than $250

If you make any noncash contribution, you must get and keep a receipt from the charitable organization showing:

1) The name of the charitable organization,
2) The date and location of the charitable contribution, and
3) A reasonably detailed description of the property.

Additional records. You must also keep reliable written records for each item of donated property. Your written records must include the following information.

1) The name and address of the organization to which you contributed.
2) The date and location of the contribution.
3) A description of the property in detail reasonable under the circumstances. For a security, keep the name of the issuer, the type of security, and whether it is regularly traded on a stock exchange or in an over-the-counter market.

4) The fair market value of the property at the time of the contribution and how you figured the fair market value. If it was determined by appraisal, keep a signed copy of the appraisal.
5) The cost or other basis of the property if you must reduce its fair market value by appreciation. Your records should also include the amount of the reduction and how you figured it. If you choose the 50% limit instead of the special 30% limit on certain capital gain property, you must keep a record showing the years for which you made the choice, contributions for the current year to which the choice applies, and carryovers from preceding years to which the choice applies. See *How To Figure Your Deduction When Limits Apply* in Publication 526 for information on how to make the capital gain property election.
6) The amount you claim as a deduction for the tax year as a result of the contribution, if you contribute less than your entire interest in the property during the tax year. Your records must include the amount you claimed as a deduction in any earlier years for contributions of other interests in this property. They must also include the name and address of each organization to which you contributed the other interests, the place where any such tangible property is located or kept, and the name of any person in possession of the property, other than the organization to which you contributed.
7) The terms of any conditions attached to the gift of property.

Deductions of at Least $250 but Not More Than $500

If you claim a deduction of at least $250 but not more than $500 for a noncash charitable contribution, you must get and keep an acknowledgment of your contribution from the qualified organization. If you made more than one contribution of $250 or more, you must have either a separate acknowledgment for each or one acknowledgment that shows your total contribution.

The acknowledgment must contain the information in items (1) through (3) listed under *Deductions of Less Than $250,* earlier, and your written records must include the information listed in that discussion under *Additional records.*

The acknowledgment must also meet these tests.

1) It must be written.
2) It must include:
   a) A description (but not necessarily the value) of any property you contributed,
   b) Whether the qualified organization gave you any goods or services as a result of your contribution (other than certain token items and membership benefits), and
   c) A description and good faith estimate of the value of any goods or services described in (b). If the only benefit you received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgment must say so and does not need to describe or estimate the value of the benefit.
3) You must get it on or before the earlier of:
   a) The date you file your return for the year you make the contribution, or
   b) The due date, including extensions, for filing the return.

Deductions Over $500

You are required to give additional information if you claim a deduction over $500 for noncash charitable contributions. See *Records To Keep* in Publication 526 for more information.

Qualified Conservation Contribution

If the gift was a qualified conservation contribution, your records must also include the fair market value of the underlying property before and after the gift and the conservation purpose furthered by the gift. See *Qualified conservation contribution* in Publication 561 for more information.

<u>OUT-OF-POCKET EXPENSES</u>

If you render services to a qualified organization and have unreimbursed out-of-pocket expenses related to those services, the following three rules apply.

1) You must have adequate records to prove the amount of the expenses.
2) You must get an acknowledgment from the qualified organization that contains:
   a) A description of the services you provided,
   b) A statement of whether or not the organization provided you any goods or services to reimburse you for the expenses you incurred,
   c) A description and a good faith estimate of the value of any goods or services (other than intangible religious benefits) provided to reimburse you, and
   d) A statement that the only benefit you received was an intangible religious benefit, if that was the case. The acknowledgment does not need to describe or estimate the value of an intangible religious benefit (defined earlier under *Acknowledgment*).
3) You must get the acknowledgment on or before the earlier of:
   a) The date you file your return for the year you make the contribution, or
   b) The due date, including extensions, for filing the return.

Car expenses. If you claim expenses directly related to use of your car in giving services to a qualified organization, you must keep reliable written records of your expenses. Whether your records are considered reliable depends on all the facts and circumstances. Generally, they may be considered reliable if you made them regularly and at or near the time you had the expenses.

Your records must show the name of the organization you were serving and the date each time you used your car for a charitable purpose. If you use the standard mileage rate of 14 cents a mile, your records must show the miles you drove your car for the charitable purpose. If you deduct your actual expenses, your records must show the costs of operating the car that are directly related to a charitable purpose.

See *Car expenses* under *Out-of-Pocket Expenses in Giving Services*, earlier, for the expenses you can deduct.

X. <u>How to Report</u>

Report your charitable contributions on Schedule A (Form 1040). If your total deduction for all noncash contributions for the year is over $500, you must also file **Form 8283.** See *How To Report* in Publication 526 for more information.

CHAPTER 24 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Deductions to qualified charitable organizations are unlimited.

   a) true
   b) false

2. Claiming deductions for charitable contributions are generally limited to gifts given to qualifying organizations such as:

   a) country clubs and other social clubs
   b) churches and religious organizations
   c) homeowners' associations
   d) political organizations and candidates

3. If you contribute property with a fair market value that is less than your basis in it, your deduction is limited to the fair market value.

   a) true
   b) false

CHAPTER 24 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. Your deduction for charitable contributions is generally limited to 50% of your adjusted gross income, but in some cases 20% and 30% limits may apply.

   B: False is correct. Your deduction is generally limited to 50% of your adjusted gross income. If you give property to a qualified organization, you generally can deduct the fair market value of the property at the time of the contribution, subject to the total 50% limit.

2. A: Incorrect. You cannot deduct contributions to organizations that are not qualified to receive tax-deductible contributions such as country clubs or other social organizations.

   B: Correct. Churches and religious organizations are generally qualified organizations for accepting tax-deductible charitable contributions.

   C: Incorrect. Homeowners' associations are not qualified organizations with regard to accepting tax-deductible charitable contributions.

   D: Incorrect. Political organizations and candidates are generally not recognized as charitable organizations for tax deductibility purposes.

3. **A: True is correct.** You cannot claim a deduction for the difference between the property's basis and its fair market value.

   B: False is incorrect. Your basis in property is generally what you paid for it. You are generally limited to deduct the fair market value if it is less than your basis.

Chapter 25: Nonbusiness Casualty and Theft Losses

I. Important

New Schedule L (Form 1040A or 1040). If you claim a net disaster loss as part of your standard deduction, you must complete Schedule L (Form 1040A or 1040) and attach it to Form 1040.

II. Introduction

This chapter explains the tax treatment of personal (not business related) casualty losses, theft losses, and losses on deposits.

The chapter also explains the following topics.

- How to figure the amount of your loss.
- How to treat insurance and other reimbursements you receive.
- The deduction limits.
- When and how to report a casualty or theft.

Forms to file. When you have a casualty or theft, you have to file Form 4684. You will also have to file at least one of the following forms:

- Schedule A (Form 1040), Itemized Deductions
- Schedule D (Form 1040), Capital Gains and Losses
- Schedule L (Form 1040 or 1040A), Standard Deduction for Certain Filers.

III. Casualty

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

- A ***sudden*** event is one that is swift, not gradual or progressive.
- An ***unexpected*** event is one that is ordinarily unanticipated and unintended.
- An ***unusual*** event is one that is not a day-to-day occurrence and that is not typical of the activity in which you were engaged.

Deductible losses. Deductible casualty losses can result from a number of different causes, including the following.

- Car accidents (but see *Nondeductible losses,* next, for exceptions).
- Earthquakes.
- Fires (but see *Nondeductible losses,* next, for exceptions).
- Floods.
- Government-ordered demolition or relocation of a home that is unsafe to use because of a disaster as discussed under *Disaster Area Losses* in Publication 547.
- Mine cave-ins.
- Shipwrecks.
- Sonic booms.

- Storms, including hurricanes and tornadoes.
- Terrorist attacks.
- Vandalism.
- Volcanic eruptions.

Nondeductible losses. A casualty loss is not deductible if the damage or destruction is caused by the following.

- Accidentally breaking articles such as glassware or china under normal conditions.
- A family pet.
- A fire if you willfully set it or pay someone else to set it.
- A car accident if your willful negligence or willful act caused it. The same is true if the willful act or willful negligence of someone acting for you caused the accident.
- Progressive deterioration (explained next).

Progressive deterioration. Loss of property due to progressive deterioration is not deductible as a casualty loss. This is because the damage results from a steadily operating cause or a normal process, rather than from a sudden event. The following are examples of damage due to progressive deterioration.

- The steady weakening of a building due to normal wind and weather conditions.
- The deterioration and damage to a water heater that bursts. ***But*** the rust and water damage to rugs and drapes caused by the bursting of a water heater ***does qualify*** as a casualty.
- Most losses of property caused by droughts. To be deductible, a drought-related loss generally must be incurred in a trade or business or in a transaction entered into for profit.
- Termite or moth damage.
- The damage or destruction of trees, shrubs, or other plants by a fungus, disease, insects, worms, or similar pests. ***But,*** a sudden destruction due to an unexpected or unusual infestation of beetles or other insects may result in a casualty loss.

IV. Theft

A theft is the taking and removing of money or property with the intent to deprive the owner of it. The taking of property must be illegal under the laws of the state where it occurred and it must have been done with criminal intent. You do not need to show a conviction for theft.

Theft includes the taking of money or property by the following means.

- Blackmail.
- Burglary.
- Embezzlement.
- Extortion.
- Kidnapping for ransom.
- Larceny.
- Robbery.

The taking of money or property through fraud or misrepresentation is theft if it is illegal under state or local law.

Decline in market value of stock. You cannot deduct as a theft loss the decline in market value of stock acquired on the open market for investment if the decline is caused by disclosure of accounting fraud or other illegal misconduct by the officers or directors of the corporation that issued the stock. However, you can deduct as a capital loss the loss you sustain when you sell or exchange the stock or the stock becomes completely worthless. You report a capital loss on Schedule D (Form 1040). For more information about stock sales, worthless stock, and capital losses, see chapter 4 of Publication 550.

Mislaid or lost property. The simple disappearance of money or property is not a theft. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual. Sudden, unexpected, and unusual events are defined earlier.

Example. A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

Losses from Ponzi-type investment schemes. The IRS has issued the following guidance to assist taxpayers who are victims of losses from Ponzi-type investment schemes:

- Revenue Ruling 2009-9, 2009-14 I.R.B. 735 (available at www.irs.gov/irb/ 2009-14_IRB/ar07.html).
- Revenue Procedure 2009-20, 2009-14 I.R.B. 749 (available at www.irs.gov/irb/ 2009-14_IRB/ar11.html).

These losses are deductible as theft losses of income-producing property on your tax return for the year the loss was discovered. You figure the deductible loss in Section B of Form 4684. If you qualify to use Revenue Procedure 2009-20 and you choose to follow the procedures in Revenue Procedure 2009-20, you also must complete Appendix A of that procedure and write “Revenue Procedure 2009-20” across the top of Form 4684. For more information, see the above revenue ruling and revenue procedure.

V. Loss on Deposits

A loss on deposits can occur when a bank, credit union, or other financial institution becomes insolvent or bankrupt. If you incurred this type of loss, you can choose one of the following ways to deduct the loss.

- As a casualty loss.
- As an ordinary loss.
- As a nonbusiness bad debt.

Casualty loss or ordinary loss. You can choose to deduct a loss on deposits as a casualty loss or as an ordinary loss for any year in which you can reasonably estimate how much of your deposits you have lost in an insolvent or bankrupt financial institution. The choice is generally made on the return you file for that year and applies to all your losses on deposits for the year in that particular financial institution. If you treat the loss as a casualty or ordinary loss, you cannot treat the same amount of the loss as a nonbusiness bad debt when it actually becomes worthless. However, you can take a nonbusiness bad debt deduction for any amount of loss that is more than the estimated amount you deducted as a casualty or ordinary loss. Once you make this choice, you cannot change it without approval of the Internal Revenue Service.

If you claim an ordinary loss, report it as a miscellaneous itemized deduction on Schedule A (Form 1040), line 23. The maximum amount you can claim is $20,000 ($10,000 if you are married filing separately) reduced by any expected state insurance proceeds. Your loss is subject to the 2%-of-adjusted-gross-income limit. You cannot choose to claim an ordinary loss if any part of the deposit is federally insured.

Nonbusiness bad debt. If you do not choose to deduct the loss as a casualty loss or as an ordinary loss, you must wait until the actual loss is determined before you can deduct the loss as a nonbusiness bad debt in that year.

How to report. The kind of deduction you choose for your loss on deposits determines how you report your loss. If you choose:

- Casualty loss – report it on Form 4684 first and then on Schedule A (Form 1040).
- Ordinary loss – report it on Schedule A (Form 1040) as a miscellaneous itemized deduction.
- Nonbusiness bad debt – report it on Schedule D (Form 1040).

VI. <u>Proof of Loss</u>

To deduct a casualty or theft loss, you must be able to prove that you had a casualty or theft. You must be able to support the amount you claim for the loss as discussed next.

Casualty loss proof. For a casualty loss, your records should show all the following.

- The type of casualty (car accident, fire, storm, etc.) and when it occurred.
- That the loss was a direct result of the casualty.
- That you were the owner of the property or, if you leased the property from someone else, that you were contractually liable to the owner for the damage.
- Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

Theft loss proof. For a theft loss, your records should show all the following.

- When you discovered that your property was missing.
- That your property was stolen.
- That you were the owner of the property.
- Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

VII. <u>Figuring a Loss</u>

Figure the amount of your loss using the following steps.

1) Determine your adjusted basis in the property before the casualty or theft.
2) Determine the decrease in fair market value of the property as a result of the casualty or theft.
3) From the smaller of the amounts you determined in (1) and (2), subtract any insurance or other reimbursement you received or expect to receive.

For personal-use property and property used in performing services as an employee, apply the deduction limits, discussed later, to determine the amount of your deductible loss.

Leased property. If you are liable for casualty damage to property you lease, your loss is the amount you must pay to repair the property minus any insurance or other reimbursement you receive or expect to receive.

DECREASE IN FAIR MARKET VALUE

Fair market value (FMV) is the price for which you could sell your property to a willing buyer when neither of you has to sell or buy and both of you know all the relevant facts.

The decrease in FMV is the difference between the property's fair market value immediately before and immediately after the casualty or theft.

FMV of stolen property. The FMV of property immediately after a theft is considered to be zero, since you no longer have the property.

Example. Several years ago, you purchased silver dollars at face value for $150. This is your adjusted basis in the property. Your silver dollars were stolen this year. The FMV of the coins was $1,000 just before they were stolen, and insurance did not cover them. Your theft loss is $150.

Recovered stolen property. Recovered stolen property is your property that was stolen and later returned to you. If you recover property after you had already taken a theft loss deduction, you must refigure your loss using the smaller of the property's adjusted basis (explained later) or the decrease in FMV from the time just before it was stolen until the time it was recovered. Use this amount to refigure your total loss for the year in which the loss was deducted.

If your refigured loss is less than the loss you deducted, you generally have to report the difference as income in the recovery year. But report the difference only up to the amount of the loss that reduced your tax.

Figuring Decrease in FMV – Items to Consider

To figure the decrease in FMV because of a casualty or theft, you generally need a competent appraisal. But other measures can also be used to establish certain decreases.

Appraisal. An appraisal to determine the difference between the FMV of the property immediately before a casualty or theft and immediately afterward should be made by a competent appraiser. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This information is needed to limit any deduction to the actual loss resulting from damage to the property.

Several factors are important in evaluating the accuracy of an appraisal, including the following.

- The appraiser's familiarity with your property before and after the casualty or theft.
- The appraiser's knowledge of sales of comparable property in the area.
- The appraiser's knowledge of conditions in the area of the casualty.
- The appraiser's method of appraisal.

Cost of cleaning up or making repairs. The cost of repairing damaged property is not part of a casualty loss. Neither is the cost of cleaning up after a casualty. But you can use the cost of cleaning up or making repairs as a measure of the decrease in FMV if you meet all the following conditions.

- The repairs are actually made.
- The repairs are necessary to bring the property back to its condition before the casualty.
- The amount spent for repairs is not excessive.
- The repairs take care of the damage only.
- The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

Landscaping. The cost of restoring landscaping to its original condition after a casualty may indicate the decrease in FMV. You may be able to measure your loss by what you spend on the following.

- Removing destroyed or damaged trees and shrubs minus any salvage you receive.
- Pruning and other measures taken to preserve damaged trees and shrubs.
- Replanting necessary to restore the property to its approximate value before the casualty.

Car value. Books issued by various automobile organizations that list your car may be useful in figuring the value of your car. You can modify the book's retail value by such factors as mileage and the condition of your car to figure its value. The prices are ***not official***, but they may be useful in determining value and suggesting relative prices for comparison with current sales and offerings in your area. If your car is not listed in the books, determine its value from other sources. A dealer's offer for your car as a trade-in on a new car is not usually a measure of its true value.

Figuring Decrease in FMV – Items Not to Consider

The following items are generally not considered when establishing the decrease in the FMV of your property.

Cost of protection. The cost of protecting your property against a casualty or theft is not part of a casualty or theft loss. The amount you spend on insurance or to board up your house against a storm is not part of your loss.

If you make permanent improvements to your property to protect it against a casualty or theft, add the cost of these improvements to your basis in the property. An example would be the cost of a dike to prevent flooding.

Related expenses. Any incidental expenses you have due to a casualty or theft, such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not part of your casualty or theft loss.

Replacement cost. The cost of replacing stolen or destroyed property is not part of a casualty or theft loss.

Sentimental value. Do not consider sentimental value when determining your loss. If a family portrait, heirloom, or keepsake is damaged, destroyed, or stolen, you must base your loss only on its FMV.

Decline in market value of property in or near casualty area. A decrease in the value of your property because it is in or near an area that suffered a casualty, or that might again suffer a casualty, is not to be taken into consideration. You have a loss only for actual casualty damage to your property.

Costs of photographs and appraisals. Photographs taken after a casualty will be helpful in establishing the condition and value of the property after it was damaged. Photographs showing the condition of the property after it was repaired, restored, or replaced may also be helpful.

Appraisals are used to figure the decrease in FMV because of a casualty or theft. See *Appraisal*, earlier, under *Figuring Decrease in FMV – Items To Consider*, for more information about appraisals.

The cost of photographs and appraisals used as evidence of the value and condition of property damaged as a result of a casualty are not a part of the loss. You can claim these costs as a miscellaneous itemized deduction subject to the 2%-of-adjusted-gross-income limit on Schedule A (Form 1040). For information about miscellaneous deductions, see chapter 28.

ADJUSTED BASIS

Adjusted basis is your basis in the property (usually cost) increased or decreased by various events, such as improvements and casualty losses. For more information, see chapter 13.

INSURANCE AND OTHER REIMBURSEMENTS

If you receive an insurance payment or other type of reimbursement, you must subtract the reimbursement when you figure your loss. You do not have a casualty or theft loss to the extent you are reimbursed.

If you expect to be reimbursed for part or all of your loss, you must subtract the expected reimbursement when you figure your loss. You must reduce your loss even if you do not receive payment until a later tax year. See *Reimbursement Received After Deducting Loss,* later.

Failure to file a claim for reimbursement. If your property is covered by insurance, you must file a timely insurance claim for reimbursement of your loss. Otherwise, you cannot deduct this loss as a casualty or theft loss. However, this rule does not apply to the portion of the loss not covered by insurance (for example, a deductible).

Example. You have a car insurance policy with a $1,000 deductible. Because your insurance did not cover the first $1,000 of an auto collision, the $1,000 would be deductible (subject to the deduction limits discussed later). This is true even if you do not file an insurance claim, since your insurance policy would never have reimbursed you for the deductible.

Gain from reimbursement. If your reimbursement is more than your adjusted basis in the property, you have a gain. This is true even if the decrease in the FMV of the property is smaller than your adjusted basis. If you have a gain, you may have to pay tax on it, or you may be able to postpone reporting the gain.

Types of Reimbursements

The most common type of reimbursement is an insurance payment for your stolen or damaged property. Other types of reimbursements are discussed next. Also see the *Instructions for Form 4684.*

Employer's emergency disaster fund. If you receive money from your employer's emergency disaster fund and you must use that money to rehabilitate or replace property on which you are claiming a casualty loss deduction, you must take that money into consideration in computing the casualty loss deduction. Take into consideration only the amount you used to replace your destroyed or damaged property.

Example. Your home was extensively damaged by a tornado. Your loss after reimbursement from your insurance company was $10,000. Your employer set up a disaster relief fund for its employees. Employees receiving money from the fund had to use it to rehabilitate or replace their damaged or destroyed property. You received $4,000 from the fund and spent the entire amount on repairs to your home. In figuring your casualty loss, you must reduce your unreimbursed loss ($10,000) by the $4,000 you received from your employer's fund. Your casualty loss before applying the deduction limits discussed later is $6,000.

Cash gifts. If you receive excludable cash gifts as a disaster victim and there are no limits on how you can use the money, you do not reduce your casualty loss by these excludable cash gifts. This applies even if you use the money to pay for repairs to property damaged in the disaster.

Example. Your home was damaged by a hurricane. Relatives and neighbors made cash gifts to you which were excludable from your income. You used part of the cash gifts to pay for repairs to your home. There were no limits or restrictions on how you could use the cash gifts. Because it was an excludable gift, the money you received and used to pay for repairs to your home does not reduce your casualty loss on the damaged home.

Insurance payments for living expenses. You do not reduce your casualty loss by insurance payments you receive to cover living expenses in either of the following situations.

- You lose the use of your main home because of a casualty.
- Government authorities do not allow you access to your main home because of a casualty or threat of one.

Inclusion in income. If these insurance payments are more than the temporary increase in your living expenses, you must include the excess in your income. Report this amount on line 21 of Form 1040. However, if the casualty occurs in a federally declared disaster area, none of the insurance payments are taxable.

A temporary increase in your living expenses is the difference between the actual living expenses you and your family incurred during the period you could not use your home and your normal living expenses for that period. Actual living expenses are the reasonable and necessary expenses incurred because of the loss of your main home. Generally, these expenses include the amounts you pay for the following.

- Rent for suitable housing.
- Transportation.
- Food.
- Utilities.
- Miscellaneous services.

Normal living expenses consist of these same expenses that you would have incurred but did not because of the casualty or the threat of one.

Example. As a result of a fire, you vacated your apartment for a month and moved to a motel. You normally pay $525 a month for rent. None was charged for the month the apartment was vacated. Your motel rent for this month was $1,200. You normally pay $200 a month for food. Your food expenses for the month you lived in the motel were $400. You received $1,100 from your insurance company to cover your living expenses. You determine the payment you must include in income as follows.

1) Insurance payment for living expenses		$1,100
2) Actual expenses during the month you are unable to use your home because of the fire	$1,600	
3) Normal living expenses	725	
4) Temporary increase in living expenses: Subtract line 3 from line 2		875
5) Amount of payment includible in income: Subtract line 4 from line 1		$225

Tax year of inclusion. You include the taxable part of the insurance payment in income for the year you regain the use of your main home or, if later, for the year you receive the taxable part of the insurance payment.

Example. Your main home was destroyed by a tornado in August 2009. You regained use of your home in November 2010. The insurance payments you received in 2009 and 2010 were $1,500 more than the temporary increase in your living expenses during those years. You include this amount in income on your 2010 Form 1040. If, in 2011, you receive further payments to cover the living expenses you had in 2009 and 2010, you must include those payments in income on your 2011 Form 1040.

Disaster relief. Food, medical supplies, and other forms of assistance you receive do not reduce your casualty loss unless they are replacements for lost or destroyed property. These items are not taxable income to you.

Disaster unemployment assistance payments are unemployment benefits that are taxable.

Reimbursement Received After Deducting Loss

If you figured your casualty or theft loss using your expected reimbursement, you may have to adjust your tax return for the tax year in which you receive your actual reimbursement. This section explains the adjustment you may have to make.

Actual reimbursement less than expected. If you later receive less reimbursement than you expected, include that difference as a loss with your other losses (if any) on your return for the year in which you can reasonably expect no more reimbursement.

Example. Your personal car had an FMV of $2,000 when it was destroyed in a collision with another car last year. The accident was due to the negligence of the other driver. At the end of the year, there was a reasonable prospect that the owner of the other car would reimburse you in full. You subtracted the expected reimbursement when you figured your loss. You did not have a deductible loss last year.

This January, the court awarded you a judgment of $2,000. However, in July it became apparent that you will be unable to collect any amount from the other driver. You can deduct the loss this year subject to the limits discussed later.

Actual reimbursement more than expected. If you later receive more reimbursement than you expected after you claimed a deduction for the loss, you may have to include the extra reimbursement in your income for the year you receive it. However, if any part of the original deduction did not reduce your tax for the earlier year, do not include that part of the reimbursement in your income. You do not refigure your tax for the year you claimed the deduction. For more information, see *Recoveries* in chapter 12.

Actual reimbursement same as expected. If you receive exactly the reimbursement you expected, you do not have to include any of the reimbursement in your income and you cannot deduct any additional loss.

Example. Last December, you had a collision while driving your personal car. Repairs to the car cost $950. You had $100 deductible collision insurance. Your insurance company agreed to reimburse you for the rest of the damage. Because you expected a reimbursement from the insurance company, you did not have a casualty loss deduction last year.

Due to the $100 rule (discussed later under *Deduction Limits*), you cannot deduct the $100 deductible you paid. When you receive the $850 from the insurance company this year, do not report it as income.

SINGLE CASUALTY ON MULTIPLE PROPERTIES

Personal property. Personal property is any property that is not real property. If your personal property is stolen or is damaged or destroyed by a casualty, you must figure your loss separately for each item of property. Then combine these separate losses to determine your total loss from that casualty or theft.

Example. A fire in your home destroyed an upholstered chair, an oriental rug, and an antique table. You did not have fire insurance to cover your loss. (This was the only casualty or theft you had during the year.) You paid $750 for the chair and you established that it had an FMV of $500 just before the fire. The rug cost $3,000 and had an FMV of $2,500 just before the fire. You bought the table at an auction for $100 before discovering it was an antique. It had been appraised at $900 before the fire. You figure your loss on each of these items as follows:

	Chair	**Rug**	**Table**
1) Basis (cost)	$750	$3,000	$100
2) FMV before fire	$500	$2,500	$900
3) FMV after fire	-0-	-0-	-0-
4) Decrease in FMV	$500	$2,500	$900
5) Loss (smaller of (1) or (4))	$500	$2,500	$100
6) **Total loss**			**$3,100**

Real property. In figuring a casualty loss on personal-use real property, treat the entire property (including any improvements, such as buildings, trees, and shrubs) as one item. Figure the loss using the smaller of the adjusted basis or the decrease in FMV of the entire property.

Example. You bought your home a few years ago. You paid $160,000 ($20,000 for the land and $140,000 for the house). You also spent $2,000 for landscaping. This year a fire destroyed your home. The fire also damaged the shrubbery and trees in your yard. The fire was your only casualty or theft loss this year. Competent appraisers valued the property as a whole at $200,000 before the fire, but only $30,000 after the fire. (The loss to your household furnishings is not shown in this example. It would be figured separately on each item, as explained earlier under *Personal property.*) Shortly after the fire, the insurance company paid you $155,000 for the loss. You figure your casualty loss as follows:

1)Adjusted basis of the entire property (land, building, and landscaping)	$162,000
2) FMV of entire property before fire	$200,000
3) FMV of entire property after fire	30,000
4) Decrease in FMV of entire property	$170,000
5) Loss (smaller of (1) or (4))	$162,000
6) Subtract insurance	155,000
7) **Amount of loss after reimbursement**	**$7,000**

VIII. Deduction Limits

After you have figured your casualty or theft loss, you must figure how much of the loss you can deduct. If the loss was to property for your personal use or your family's use, there are ***two limits*** on the amount you can deduct for your casualty or theft loss.

1) You must reduce each casualty or theft loss by $100 ($100 rule) in 2011.
2) You must further reduce the total of all your casualty or theft losses by 10% of your adjusted gross income (10% rule).

You make these reductions on Form 4684.

These rules are explained next and *Table 25-1* summarizes how to apply the $100 rule and the 10% rule in various situations.

Table 25-1. How to Apply the Deduction Limits for Personal-Use Property

		$100 Rule	**10% Rule***
General Application		You must reduce each casualty or theft loss by $100 when figuring your deduction. Apply this rule after you have figured the amount of your loss	You must reduce your total casualty or theft loss by 10% of your adjusted gross income. Apply this rule after you reduce each loss by $100 (the $100 rule).
Single Event		Apply this rule only once, even if many pieces of property are affected.	Apply this rule only once, even if many pieces of property are affected.
More Than One Event		Apply to the loss from each event.	Apply to the total of all your losses from all events.
More Than One Person - With Loss From the Same Event (other than a married couple filing jointly)		Apply separately to each person.	Apply separately to each person.
Married Couple - With Loss From the Same Event	Filing Jointly	Apply as if you were one person.	Apply as if you were one person.
	Filing Separately	Apply separately to each spouse.	Apply separately to each spouse.

More Than One Owner (other than a married couple filing jointly).	Apply separately to each owner of jointly owned property.	Apply separately to each owner of jointly owned property.
* The 10% rule does not apply to a net disaster loss attributable to a federally declared disaster.		

Property used partly for business and partly for personal purposes. When property is used partly for personal purposes and partly for business or income-producing purposes, the casualty or theft loss deduction must be figured separately for the personal-use part and for the business or income-producing part. You must figure each loss separately because the $100 rule and the 10% rule apply only to the loss on the personal-use part of the property.

$100 RULE

After you have figured your casualty or theft loss on personal-use property, you must reduce that loss by $100. This reduction applies to each total casualty or theft loss. It does not matter how many pieces of property are involved in an event. Only a single $100 reduction applies.

Example. In 2011, a hailstorm damages your home and your car. Determine the amount of loss, as discussed earlier, for each of these items. Since the losses are due to a single event, you combine the losses and reduce the combined amount by $100.

Single event. Generally, events closely related in origin cause a single casualty. It is a single casualty when the damage is from two or more closely related causes, such as wind and flood damage caused by the same storm.

10% RULE

You must reduce the total of all your casualty or theft losses on personal-use property by 10% of your adjusted gross income. Apply this rule after you reduce each loss by $100. If you have both gains and losses from casualties or thefts, see *Gains and losses,* later in this discussion.

Example 1. In June, you discovered that your house had been burglarized. Your loss after insurance reimbursement was $2,000. Your adjusted gross income for the year you discovered the theft is $29,500. You first apply the $100 rule and then the 10% rule. Figure your theft loss deduction as follows.

1) Loss after insurance	$2,000
2) Subtract $100	100
3) Loss after $100 rule	$1,900
4) Subtract 10% x $29,500 AGI	2,950
5) Theft loss deduction	-0-

You do not have a theft loss deduction because your loss after you apply the $100 rule ($1,900) is less than 10% of your adjusted gross income ($2,950).

Example 2. In March, you had a car accident that totally destroyed your car. You did not have collision insurance on your car, so you did not receive any insurance reimbursement. Your loss on the car was $1,800. In November, a fire damaged your basement and totally destroyed the furniture, washer, dryer, and other items stored there. Your loss on the basement items after reimbursement was $2,100. Your adjusted gross income for the year that the accident and fire occurred is $25,000. You figure your casualty loss deduction as follows.

	Car	Basement
1) Loss	$1,800	$2,100
2) Subtract $100 per incident	100	100
3) Loss after $100 rule	$1,700	$2,000
4) Total loss		$3,700
5) Subtract 10% x $25,000 AGI		2,500
6) Casualty loss deduction		$1,200

Gains and losses. If you had both gains and losses from casualties or thefts to personal-use property, you must compare your total gains to your total losses. Do this after you have reduced each loss by any reimbursements and by $100, but before you have reduced the losses by 10% of your adjusted gross income.

Losses more than gains. If your losses are more than your recognized gains, subtract your gains from your losses and reduce the result by 10% of your adjusted gross income. The rest, if any, is your deductible loss.

Gains more than losses. If your recognized gains are more than your losses, subtract your losses from your gains. The difference is treated as capital gain and must be reported on Schedule D (Form 1040). The 10% rule does not apply to your gains.

IX. When to Report Gain or Loss

Gains. If you receive an insurance or other reimbursement that is more than your adjusted basis in the destroyed or stolen property, you have a gain from the casualty or theft. You must include this gain in your income in the year you receive the reimbursement, unless you choose to postpone reporting the gain as explained in Publication 547.

If you have a loss, see *Table 25-2.*

Table 25-2. When to Deduct a Loss

IF you have a loss…	**THEN deduct it in the year…**
from a casualty,	the loss occurred.
in a federally declared disaster area,	the disaster occurred or the year immediately before the disaster.
from a theft,	the theft was discovered.
on a deposit treated as a:	
• casualty,	• a reasonable estimate can be made.
• bad debt,	• deposits are totally worthless.
• ordinary loss,	• a reasonable estimate can be made.

Losses. Generally, you can deduct a casualty loss that is not reimbursable only in the tax year in which the casualty occurred. This is true even if you do not repair or replace the damaged property until a later year.

You can deduct theft losses that are not reimbursable only in the year you discover your property was stolen.

If you are not sure whether part of your casualty or theft loss will be reimbursed, do not deduct that part until the tax year when you become reasonably certain that it will not be reimbursed.

Loss on deposits. If your loss is a loss on deposits in an insolvent or bankrupt financial institution, see *Loss on Deposits,* earlier.

DISASTER AREA LOSS

You generally must deduct a casualty loss in the year it occurred. However, if you have a casualty loss from a federally declared disaster, you can choose to deduct the loss on your tax return or amended return for either of the following years.

- The year the disaster occurred.
- The year immediately preceding the year the disaster occurred.

Gains. Special rules apply if you choose to postpone reporting gain on property damaged or destroyed in a federally declared disaster area.

Postponed tax deadlines. The IRS may postpone for up to 1 year certain tax deadlines of taxpayers who are affected by a Presidentially declared disaster. The tax deadlines the IRS may postpone include those for filing income and employment tax returns, paying income and employment taxes, and making contributions to a traditional IRA or Roth IRA.

If any tax deadline is postponed, the IRS will publicize the postponement in your area by publishing a news release, revenue ruling, revenue procedure, notice, announcement, or other guidance in the Internal Revenue Bulletin (IRB).

Who is eligible. If the IRS postpones a tax deadline, the following taxpayers are eligible for the postponement.

- Any individual whose main home is located in a covered disaster area (defined next).
- Any business entity or sole proprietor whose principal place of business is located in a covered disaster area.
- Any relief worker affiliated with a recognized government or philanthropic organization who is assisting in a covered disaster area.
- Any individual, business entity, or sole proprietor whose records are needed to meet a postponed deadline, provided those records are maintained in a covered disaster area. The main home or principal place of business does ***not*** have to be located in the covered disaster area.
- Any estate or trust that has tax records necessary to meet a postponed tax deadline, provided those records are maintained in a covered disaster area.
- The spouse on a joint return with a taxpayer who is eligible for postponements.
- Any individual, business entity, or sole proprietorship not located in a covered disaster area, but whose records necessary to meet a postponed tax deadline are located in the covered disaster area.
- Any individual visiting the covered disaster area who was killed or injured as a result of the disaster.
- Any other person determined by the IRS to be affected by a Presidentially declared disaster.

Covered disaster area. This is an area of a Presidentially declared disaster area in which the IRS has decided to postpone tax deadlines for up to 1 year.

Abatement of interest and penalties. The IRS may abate the interest and penalties on underpaid income tax for the length of any postponement of tax deadlines.

X. How to Report Gains and Losses

Use Form 4684 to report a gain or a deductible loss from a casualty or theft. If you have more than one casualty or theft, use a separate Form 4684 to determine your gain or loss for each event. Combine the gains and losses on one Form 4684. Follow the form instructions as to which lines to fill out. In addition, you must use the appropriate schedule to report a gain or loss. The schedule you use depends on whether you have a gain or loss.

If you have a:	Report it on:
Gain…	Schedule D (Form 1040)
Loss…	Schedule A (Form 1040)

Note: Use Schedule L (Form 1040A or 1040) instead of Schedule A (Form 1040) if you are deducting a net disaster loss as part of your standard deduction.

Adjustments to basis. If you have a casualty or theft loss, you must decrease your basis in the property by any deductible loss and any insurance or other reimbursement. Amounts you spend to restore your property after a casualty increase your adjusted basis. See *Adjusted Basis* in chapter 13 for more information.

Net operating loss (NOL). If your casualty or theft loss deduction is more than your income, you may have an NOL. You can use an NOL to lower your tax in an earlier year, allowing you to get a refund for tax you have already paid. Or, you can use it to lower your tax in a later year. You do not have to be in business to have an NOL from a casualty or theft loss.

CHAPTER 25 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Nonbusiness losses caused by progressive deterioration are not deductible. Progressive deterioration includes all of the following situations except:

   a) termite or moth damage
   b) most losses of property caused by drought
   c) earthquakes
   d) a steady weakening of a building due to normal wind and weather conditions

2. In 2011, each casualty and theft loss must be reduced by $100 when calculating the amount of deductibility.

   a) true
   b) false

CHAPTER 25 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Loss of property due to the progressive deterioration is not deductible as a casualty loss. This loss situation was the result of a steadily operating cause rather than from a sudden event.

   B: Incorrect. Most drought caused damage is progressive in nature and therefore also not a casualty loss.

   C: Correct. An earthquake event meets all of the necessary tests for a casualty loss. Specifically, it is a sudden, unexpected, and unusual event.

   D: Incorrect. Building damage due to normal wind and weather conditions is an example of progressive deterioration.

2. **A: True is correct.** You must also further reduce the total of all your casualty and theft losses by 10% of your adjusted gross income. The 10% does not apply in federally declared disaster areas.

   B: False is incorrect. There are two limits on the amount you can deduct for your casualty or theft loss. First, you must reduce each casualty or theft loss by $100, and then you must further reduce the total of these losses by 10% of your adjusted gross income (except in federally declared disaster areas).

Chapter 26: Car Expenses and Other Employee Business Expenses

I. Important Change

Standard mileage rate. The standard mileage rate for the cost of operating your car is 51 cents a mile for all business miles in the first half of 2011, and 55.5 cents a mile for the second half of the year.

Car expenses and use of the standard mileage rate are explained under *Transportation Expenses*, later.

Depreciation limits on cars, trucks, and vans. For 2011, the first-year limit on the total section 179 deduction, special depreciation allowance, and depreciation deduction for cars is $11,060 ($3,060 if you elect not to claim the special depreciation allowance). For trucks and vans, the first-year limit is $11,260 ($3,260 if you elect not to claim the special depreciation allowance).

II. Introduction

You may be able to deduct the ordinary and necessary business-related expenses you have for:

- Travel,
- Entertainment,
- Gifts, or
- Transportation.

An ***ordinary expense*** is one that is common and accepted in your field of trade, business, or profession. A ***necessary expense*** is one that is helpful and appropriate for your business. An expense does not have to be required to be considered necessary.

This chapter explains:

- What expenses are deductible,
- How to report your expenses on your return,
- What records you need to prove your expenses, and
- How to treat any expense reimbursements you may receive.

III. Travel Expenses

If you temporarily travel away from your tax home, you can use this section to determine if you have deductible travel expenses. This section defines "travel expenses," "tax home," "temporary assignment," and the "standard meal allowance." It also discusses the rules for travel inside and outside the United States and deductible convention expenses.

Travel expenses defined. For tax purposes, travel expenses are the ordinary and necessary expenses (defined earlier) of traveling away from home for your business, profession, or job.

You will find examples of deductible travel expenses in *Table 26-1.*

TRAVELING AWAY FROM HOME

You are traveling away from home if:

1) Your duties require you to be away from the general area of your tax home (defined later) substantially longer than an ordinary day's work, and
2) You need to sleep or rest to meet the demands of your work while away from home.

This rest requirement is not satisfied by merely napping in your car. You do not have to be away from your tax home for a whole day or from dusk to dawn as long as your relief from duty is long enough to get necessary sleep or rest.

Example 1. You are a railroad conductor. You leave your home terminal on a regularly scheduled round-trip run between two cities and return home 16 hours later. During the run, you have 6 hours off at your turnaround point where you eat two meals and rent a hotel room to get necessary sleep before starting the return trip. You are considered to be away from home.

Example 2. You are a truck driver. You leave your terminal and return to it later the same day. You get an hour off at your turnaround point to eat. Because you are not off to get necessary sleep and the brief time off is not an adequate rest period, you are not traveling away from home.

Members of the Armed Forces. If you are a member of the U.S. Armed Forces on a permanent duty assignment overseas, you are not traveling away from home. You cannot deduct your expenses for meals and lodging. You cannot deduct these expenses even if you have to maintain a home in the United States for your family members who are not allowed to accompany you overseas. If you are transferred from one permanent duty station to another, you may have deductible moving expenses, which are explained in chapter 17.

A naval officer assigned to permanent duty aboard a ship that has regular eating and living facilities has a tax home aboard ship for travel expense purposes.

TAX HOME

To determine whether you are traveling away from home, you must first determine the location of your tax home.

Generally, your tax home is your regular place of business or post of duty, regardless of where you maintain your family home. It includes the ***entire city or general area*** in which your business or work is located.

If you have more than one regular place of business, your tax home is your main place of business. See *Main place of business or work,* later.

If you do not have a regular or a main place of business because of the nature of your work, then your tax home may be the place where you regularly live. See *No main place of business or work,* later.

If you do not have a regular place of business or post of duty and there is no place where you regularly live, you are considered a ***transient (an itinerant)*** and your tax home is wherever you work. As a transient, you cannot claim a travel expense deduction because you are never considered to be traveling away from home.

Main place of business or work. If you have more than one place of work, consider the following when determining which one is your main place of business or work.

1) The total time you ordinarily spend in each place.
2) The level of your business activity in each place.
3) Whether your income from each place is significant or insignificant.

Example. You live in Cincinnati where you have a seasonal job for 8 months each year and earn $40,000. You work the other 4 months in Miami, also at a seasonal job, and earn $15,000. Cincinnati is your main place of work because you spend most of your time there and earn most of your income there.

No main place of business or work. You may have a tax home even if you do not have a regular or main place of work. Your tax home may be the home where you regularly live.

Factors used to determine tax home. If you do not have a regular or main place of business or work, use the following three factors to determine where your tax home is.

1) You perform part of your business in the area of your main home and use that home for lodging while doing business in the area.
2) You have living expenses at your main home that you duplicate because your business requires you to be away from that home.
3) You have not abandoned the area in which both your historical place of lodging and your claimed main home are located; you have a member or members of your family living at your main home; or you often use that home for lodging.

If you satisfy all three factors, your tax home is the home where you regularly live. If you satisfy only two factors, you may have a tax home depending on all the facts and circumstances. If you satisfy only one factor, you are an itinerant; your tax home is wherever you work and you cannot deduct travel expenses.

Example. You are single and live in Boston in an apartment you rent. You have worked for your employer in Boston for a number of years. Your employer enrolls you in a 12-month executive training program. You do not expect to return to work in Boston after you complete your training.

During your training, you do not do any work in Boston. Instead, you receive classroom and on-the-job training throughout the United States. You keep your apartment in Boston and return to it frequently. You use your apartment to conduct your personal business. You also keep up your community contacts in Boston. When you complete your training, you are transferred to Los Angeles.

You do not satisfy factor (1) because you did not work in Boston. You satisfy factor (2) because you had duplicate living expenses. You also satisfy factor (3) because you did not abandon your apartment in Boston as your main home, you kept your community contacts, and you frequently returned to live in your apartment. You have a tax home in Boston.

Tax home different from family home. If you (and your family) do not live at your tax home, you cannot deduct the cost of traveling between your tax home and your family home. You also cannot deduct the cost of meals and lodging while at your tax home. See *Example 1* that follows.

If you are working temporarily in the same city where you and your family live, you may be considered as traveling away from home. See *Example 2,* below.

Example 1. You are a truck driver and you and your family live in Tucson. You are employed by a trucking firm that has its terminal in Phoenix. At the end of your long runs, you return to your home terminal in Phoenix and spend one night there before returning home. You cannot deduct any expenses you have for meals and lodging in Phoenix or the cost of traveling from Phoenix to Tucson. This is because Phoenix is your tax home.

Example 2. Your family home is in Pittsburgh, where you work 12 weeks a year. The rest of the year you work for the same employer in Baltimore. In Baltimore, you eat in restaurants and sleep in a rooming house. Your salary is the same whether you are in Pittsburgh or Baltimore.

Because you spend most of your working time and earn most of your salary in Baltimore, that city is your tax home. You cannot deduct any expenses you have for meals and lodging there. However, when you return to work in Pittsburgh, you are away from your tax home even though you stay at your family home. You can deduct the cost of your round trip between Baltimore and Pittsburgh. You can also deduct your part of your family's living expenses for meals and lodging while you are living and working in Pittsburgh.

TEMPORARY ASSIGNMENT OR JOB

You may regularly work at your tax home and another location. It may not be practical to return home from this other location at the end of each work day.

Temporary assignment vs. indefinite assignment. If your assignment or job away from your main place of work is ***temporary,*** your tax home does not change. You are considered to be away from home for the whole period you are away from your main place of work. You can deduct your travel expenses, if they otherwise qualify for deduction. Generally, a temporary assignment in a single location is one that is realistically expected to last (and does in fact last) for one year or less.

However, if your assignment or job is ***indefinite,*** the location of the assignment or job becomes your new tax home and you cannot deduct your travel expenses while there. An assignment or job in a single location is considered indefinite if it is realistically expected to last for more than one year, whether or not it actually lasts for more than one year.

If your assignment is indefinite, you must include in your income any amounts you receive from your employer for living expenses, even if they are called travel allowances and you account to your employer for them. You may be able to deduct the cost of relocating to your new tax home as a moving expense. See chapter 17 for more information.

Exception for federal crime investigations or prosecutions. If you are a federal employee participating in a federal crime investigation or prosecution, you are not subject to the one-year rule. This means you may be able to deduct travel expenses even if you are away from your tax home for more than one year, provided you meet the other requirements for deductibility.

For you to qualify, the Attorney General (or his or her designee) must certify that you are traveling:

1) For the federal government,
2) In a temporary duty status, and
3) To investigate or prosecute, or provide support services for the investigation or prosecution of, a federal crime.

Determining temporary or indefinite. You must determine whether your assignment is temporary or indefinite when you start work. If you expect an assignment or job to last for one year or less, it is temporary unless there are facts and circumstances that indicate otherwise. An assignment or job that is initially temporary may become indefinite due to changed circumstances. A series of assignments to the same location, all for short periods but that together cover a long period, may be considered an indefinite assignment.

Going home on days off. If you go back to your tax home from a temporary assignment on your days off, you are not considered away from home while you are in your hometown. You cannot deduct the cost of your meals and lodging there. However, you can deduct your travel expenses, including meals and lodging, while traveling between your temporary place of work and your tax home. You can claim these expenses up to the amount it would have cost you to stay at your temporary place of work.

If you keep your hotel room during your visit home, you can deduct the cost of your hotel room. In addition, you can deduct your expenses of returning home up to the amount you would have spent for meals had you stayed at your temporary place of work.

Probationary work period. If you take a job that requires you to move, with the understanding that you will keep the job if your work is satisfactory during a probationary period, the job is indefinite. You cannot deduct any of your expenses for meals and lodging during the probationary period.

WHAT TRAVEL EXPENSES ARE DEDUCTIBLE?

Once you have determined that you are traveling away from your tax home, you can determine what travel expenses are deductible.

You can deduct ordinary and necessary expenses you have when you travel away from home on business. The type of expense you can deduct depends on the facts and your circumstances.

Table 26-1 summarizes travel expenses you may be able to deduct. You may have other deductible travel expenses that are not covered there, depending on the facts and your circumstances.

Table 26-1. Travel Expenses You Can Deduct
This chart summarizes expenses you can deduct when you travel away from home for business purposes.

IF you have expenses for…	THEN you can deduct the cost of…
transportation	travel by airplane, train, bus, or car between your home and your business destination. If you were provided with a ticket or you are riding free as a result of a frequent traveler or similar program, your cost is zero. If you travel by ship, see *Luxury Water Travel* and *Cruise ships* (under *Conventions*) in Publication 463 for additional rules and limits.
taxi, commuter bus, and airport limousine	fares for these and other types of transportation that take you between: • The airport or station and your hotel, and • The hotel and the work location of your customers or clients, your business meeting place, or your temporary work location.
baggage and shipping	sending baggage and sample or display material between your regular and temporary work locations.
car	operating and maintaining your car when traveling away from home on business. You can deduct actual expenses or the standard mileage rate as well as business-related tolls and parking. If you rent a car while away from home on business, you can deduct only the business-use portion of the expenses.
lodging and meals	your lodging and meals if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties. Meals include amounts spent for food, beverages, taxes, and related tips. See *Meals and incidental expenses* for additional rules and limits.
cleaning	dry cleaning and laundry.
telephone	business calls while on your business trip. This includes business communication by fax machine or other communication devices.
tips	tips you pay for any expenses in this chart.
other	other similar ordinary and necessary expenses related to your business travel. These expenses might include transportation to or from a business meal, public stenographer's fees, computer rental fees, and operating and maintaining a house trailer.

Records. When you travel away from home on business, you should keep records of all the expenses you have and any advances you receive from your employer. You can use a log, diary, notebook, or any other written record to keep track of your expenses. The types of expenses you need to record, along with supporting documentation, are described in *Table 26-2* later.

Separating costs. If you have one expense that includes the costs of meals, entertainment, and other services (such as lodging or transportation), you must allocate that expense between the cost of meals and entertainment and the cost of other services. You must have a reasonable basis for making this allocation. For example, you must allocate your expenses if a hotel includes one or more meals in its room charge.

Travel expenses for another individual. If a spouse, dependent, or other individual goes with you (or your employee) on a business trip or to a business convention, you generally cannot deduct his or her travel expenses.

Employee. You can deduct the travel expenses of someone who goes with you if that person:

1) Is your employee,
2) Has a bona fide business purpose for the travel, and

3) Would otherwise be allowed to deduct the travel expenses.

Business associate. If a business associate travels with you and meets the conditions in (2) and (3) above, you can deduct the travel expenses you have for that person. A business associate is someone with whom you could reasonably expect to actively conduct business. A business associate can be a current or prospective (likely to become) customer, client, supplier, employee, agent, partner, or professional advisor.

Bona fide business purpose. A bona fide business purpose exists if you can prove a real business purpose for the individual's presence. Incidental services, such as typing notes or assisting in entertaining customers, are not enough to make the expenses deductible.

Example. Jerry drives to Chicago on business and takes his wife, Linda, with him. Linda is not Jerry's employee. Linda occasionally types notes, performs similar services, and accompanies Jerry to luncheons and dinners. The performance of these services does not establish that her presence on the trip is necessary to the conduct of Jerry's business. Her expenses are not deductible.

Jerry pays $199 a day for a double room. A single room costs $149 a day. He can deduct the total cost of driving his car to and from Chicago, but only $149 a day for his hotel room. If he uses public transportation, he can deduct only his fare.

Meals and incidental expenses

You can deduct the cost of meals in either of the following two situations.

1) It is necessary for you to stop for substantial sleep or rest to properly perform your duties while traveling away from home on business.
2) The meal is business-related entertainment.

Business-related entertainment is discussed under *Entertainment Expenses,* later. The following discussion deals only with meals that are not business-related entertainment.

Lavish or extravagant. You cannot deduct expenses for meals that are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable based on the facts and circumstances. Expenses will not be disallowed merely because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, nightclubs, or resorts.

50% limit on meals. You can figure your meal expenses using either of the following two methods.

1) Actual cost.
2) The standard meal allowance.

Both of these methods are explained below. But, regardless of the method you use, you generally can deduct only 50% of the unreimbursed cost of your meals.

If you are reimbursed for the cost of your meals, how you apply the 50% limit depends on whether your employer's reimbursement plan was accountable or nonaccountable. If you are not reimbursed, the 50% limit applies whether the unreimbursed meal expense is for business travel or business entertainment. The 50% limit is explained later under *Entertainment Expenses.* Accountable and nonaccountable plans are discussed later under *Reimbursements.*

Actual cost. You can use the actual cost of your meals to figure the amount of your expense before reimbursement and application of the 50% deduction limit. If you use this method, you must keep records of your actual cost.

Standard meal allowance. Generally, you can use the "standard meal allowance" method as an alternative to the actual cost method. It allows you to use a set amount for your daily **meals and incidental expenses (M&IE)**, instead of keeping records of your actual costs. The set amount varies depending on where and when you travel. In this chapter, "standard meal allowance" refers to the federal rate for M&IE, discussed later under *Amount of standard meal allowance*. If you use the standard meal allowance, you still must keep records to prove the time, place, and business purpose of your travel.

Incidental expenses. The term “incidental expenses” means:

- Fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries,
- Transportation between places of lodging or business and places where meals are taken, if suitable meals can be obtained at the temporary duty site, and
- Mailing costs associated with filing travel vouchers and payment of employer-sponsored charge card billings.

Incidental expenses do not include expenses for laundry, cleaning and pressing of clothing, lodging taxes, or the cost of telegrams or telephone calls.

Incidental expenses only method. You can use an optional method (instead of actual cost) for deducting incidental expenses only. The amount of the deduction is $5 a day for 2011. You can use this method only if you did not pay or incur any meal expenses. You cannot use this method on any day that you use the standard meal allowance.

Caution. *Federal employees should refer to the Federal Travel Regulations at www.gsa.gov. Click on “Federal Travel Regulation (FTR) for changes affecting claims for reimbursement of these expenses.*

50% limit may apply. If you use this method for meal expenses and you are not reimbursed or you are reimbursed under a nonaccountable plan, you can generally deduct only 50% of the standard meal allowance. If you are reimbursed under an accountable plan and you are deducting amounts that are more than your reimbursements, you can deduct only 50% of the excess amount. The 50% limit is explained later under *Entertainment Expenses.* Accountable and nonaccountable plans are discussed later under *Reimbursements.*

Caution. *There is no optional standard lodging amount similar to the standard meal allowance. Your allowable lodging expense deduction is your actual cost.*

Who can use the standard meal allowance. You can use the standard meal allowance whether you are an employee or self-employed, and whether or not you are reimbursed for your traveling expenses.

Use of the standard meal allowance for other travel. You can use the standard meal allowance to figure your meal expenses when you travel in connection with investment and other income-producing property. You can also use it to figure your meal expenses when you travel for qualifying educational purposes. You ***cannot*** use the standard meal allowance to figure the cost of your meals when you travel for medical or charitable purposes.

Amount of standard meal allowance. The standard meal allowance is the federal M&IE rate. For travel in 2011, the rate for most small localities in the United States is $46 a day for 2011.

Most major cities and many other localities in the United States are designated as high-cost areas, qualifying for higher standard meal allowances. Locations qualifying for these rates are listed in Publication 1542 which is available on the Internet at www.irs.gov.

Standard meal allowance for areas outside the continental United States. The standard meal allowance rates do not apply to travel in Alaska, Hawaii, or any other locations outside the continental United States. The Department of Defense establishes per diem rates for Alaska, Hawaii, Puerto Rico, American Samoa, Guam, Midway, the Northern Mariana Islands, the U.S. Virgin Islands, Wake Island and other non-foreign areas outside the continental United States. The Department of State establishes per diem rates for all other foreign areas. You can access per diem rates for non-foreign areas outside the continental United States at:

http://perdiem.hqda.pentagon.mil/perdiem/perdiemrates.html.

You can access all other foreign per diem rates at: www.state.gov/travel/.

Special rate for transportation workers. You can use a special standard meal allowance if you work in the transportation industry. You are in the transportation industry if your work:

1) Directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and
2) Regularly requires you to travel away from home and, during any single trip, usually involves travel to areas eligible for different standard meal allowance rates.

If this applies to you, you can claim a ***$59 a day*** standard meal allowance ($65 for travel outside the continental United States) in 2011.

Using the special rate for transportation workers eliminates the need for you to determine the standard meal allowance for every area where you stop for sleep or rest. If you choose to use the special rate for any trip, you must use the special rate (and not use the regular standard meal allowance rates) for all trips you take that year.

Travel for days you depart and return. For both the day you depart for and the day you return from a business trip, you must prorate the standard meal allowance (figure a reduced amount for each day). You can do so by one of two methods.

1) ***Method 1:*** You can claim 3/4 of the standard meal allowance, or
2) ***Method 2:*** You can prorate using any method that you consistently apply and that is in accordance with reasonable business practice.

Example. Jen is employed in New Orleans as a convention planner. In March, her employer sent her on a 3-day trip to Washington, DC, to attend a planning seminar. She left her home in New Orleans at 10 a.m. on Wednesday and arrived in Washington, DC, at 5:30 p.m. After spending two nights there, she flew back to New Orleans on Friday and arrived back home at 8:00 p.m. Jen's employer gave her a flat amount to cover her expenses and included it with her wages.

Under Method 1, Jen can claim 2½ days of the standard meal allowance for Washington, DC: ¾ of the daily rate for Wednesday and Friday (the days she departed and returned), and the full daily rate for Thursday.

Under Method 2, Jen could also use any method that she applies consistently and that is in accordance with reasonable business practice. For example, she could claim 3 days of the standard meal allowance even though a federal employee would have to use method 1 and be limited to only 2½ days.

TRAVEL IN THE UNITED STATES

The following discussion applies to travel in the United States. For this purpose, the United States includes the 50 states and the District of Columbia. The treatment of your travel expenses depends on how much of your trip was business related and on how much of your trip occurred within the United States.

Trip Primarily for Business

You can deduct all your travel expenses if your trip was entirely business related. If your trip was primarily for business and, while at your business destination, you extended your stay for a vacation, made a personal side trip, or had other personal activities, you can deduct your business-related travel expenses. These expenses include the travel costs of getting to and from your business destination and any business-related expenses at your business destination.

Example. You work in Atlanta and take a business trip to New Orleans. On your way home, you stop in Mobile to visit your parents. You spend $2,012 for the 9 days you are away from home for travel, meals, lodging, and other travel expenses. If you had not stopped in Mobile, you would have been gone only 6 days, and your total cost would have been $1,712. You can deduct $1,712 for your trip, including the round-trip transportation to and from New Orleans. The deduction for your meals is subject to the 50% limit on meals mentioned earlier.

Trip Primarily for Personal Reasons

If your trip was primarily for personal reasons, such as a vacation, the entire cost of the trip is a nondeductible personal expense. However, you can deduct any expenses you have while at your destination that are directly related to your business.

A trip to a resort or on a cruise ship may be a vacation even if the promoter advertises that it is primarily for business. The scheduling of incidental business activities during a trip, such as viewing videotapes or attending lectures dealing with general subjects, will not change what is really a vacation into a business trip.

Part of Trip Outside the United States

If part of your trip is outside the United States, use the rules described later under *Travel Outside the United States* for that part of the trip. For the part of your trip that is inside the United States, use the rules for travel in the United States. Travel outside the United States does not include travel from one point in the United States to another point in the United States. The following discussion can help you determine whether your trip was entirely within the United States.

Public transportation. If you travel by public transportation, any place in the United States where that vehicle makes a scheduled stop is a point in the United States. Once the vehicle leaves the last scheduled stop in the United States on its way to a point outside the United States, you apply the rules under *Travel Outside the United States.*

Example. You fly from New York to Puerto Rico with a scheduled stop in Miami. You return to New York nonstop. The flight from New York to Miami is in the United States, so only the flight from Miami to Puerto Rico is outside the United States. Because there are no scheduled stops between Puerto Rico and New York, all of the return trip is outside the United States.

Private car. Travel by private car in the United States is travel between points in the United States, even when you are on your way to a destination outside the United States.

Example. You travel by car from Denver to Mexico City and return. Your travel from Denver to the border and from the border back to Denver is travel in the United States, and the rules in this section apply. The rules under *Travel Outside the United States* apply to your trip from the border to Mexico City and back to the border.

TRAVEL OUTSIDE THE UNITED STATES

If any part of your business travel is outside the United States, some of your deductions for the cost of getting to and from your destination may be limited. For this purpose, the United States includes the 50 states and the District of Columbia.

How much of your travel expenses you can deduct depends in part upon how much of your trip outside the United States was business related.

Travel Entirely for Business or Considered Entirely for Business

You can deduct all your travel expenses of getting to and from your business destination if your trip is entirely for business or considered entirely for business.

Travel entirely for business. If you travel outside the United States and you spend the entire time on business activities, you can deduct all of your travel expenses.

Travel considered entirely for business. Even if you did not spend your entire time on business activities, your trip is considered entirely for business if you meet at least one of the following four exceptions.

Exception 1 - No substantial control. Your trip is considered entirely for business if you did not have substantial control over arranging the trip. The fact that you control the timing of your trip does not, by itself, mean that you have substantial control over arranging your trip. You do not have substantial control over your trip if you:

1) Are an employee who was reimbursed or paid a travel expense allowance,
2) Are not related to your employer, and
3) Are not a managing executive.

"Related to your employer" is defined later in this chapter under *Per Diem and Car Allowances.*

A "managing executive" is an employee who has the authority and responsibility, without being subject to the veto of another, to decide on the need for the business travel.

A self-employed person generally has substantial control over arranging business trips.

Exception 2 - Outside United States no more than a week. Your trip is considered entirely for business if you were outside the United States for a week or less, combining business and nonbusiness activities. One week means seven consecutive days. In counting the days, do not count the day you leave the United States, but do count the day you return to the United States.

Exception 3 - Less than 25% of time on personal activities. Your trip is considered entirely for business if:

1) You were outside the United States for more than a week, and
2) You spent less than 25% of the total time you were outside the United States on nonbusiness activities.

For this purpose, count both the day your trip began and the day it ended.

Exception 4 - Vacation not a major consideration. Your trip is considered entirely for business if you can establish that a personal vacation was not a major consideration, even if you have substantial control over arranging the trip.

Travel Primarily for Business

If you travel outside the United States primarily for business but spend some of your time on nonbusiness activities, you generally cannot deduct all of your travel expenses. You can only deduct the business portion of your cost of getting to and from your destination. You must make an allocation between your business and nonbusiness activities to determine your deductible amount.

Travel Primarily for Personal Reasons

If you travel outside the United States primarily for vacation or for ***investment*** purposes, the entire cost of the trip is a nondeductible ***personal expense***. If you spend some time attending brief professional seminars or a continuing education program, you can deduct your registration fees and other expenses you have that are directly related to your business.

CONVENTIONS

You can deduct your travel expenses when you attend a convention if you can show that your attendance benefits your trade or business. You cannot deduct the travel expenses for your family.

If the convention is for ***investment***, political, social, or other nonbusiness purposes, you cannot deduct the expenses.

Convention agenda. The convention agenda or program generally shows the purpose of the convention. You can show your attendance at the convention benefits your trade or business by comparing the agenda with the official duties and responsibilities of your position. The agenda does not have to deal specifically with your official duties and responsibilities; it will be enough if the agenda is so related to your position that it shows your attendance was for business purposes.

IV. Entertainment Expenses

You may be able to deduct business-related entertainment expenses you have for entertaining a client, customer, or employee.

You can deduct entertainment expenses only if they are both ordinary and necessary (defined earlier) and meet one of the following two tests.

1) Directly-related test.
2) Associated test.

50% LIMIT

In general, you can deduct only 50% of your business-related meal and entertainment expenses. (If you are subject to the Department of Transportation's "hours of service" limits, you can deduct 80% of your business-related meal and entertainment expenses. See *Individuals subject to "hours of service" limits,* later.)

The 50% limit applies to employees or their employers, and to self-employed persons (including independent contractors) or their clients, depending on whether the expenses are reimbursed.

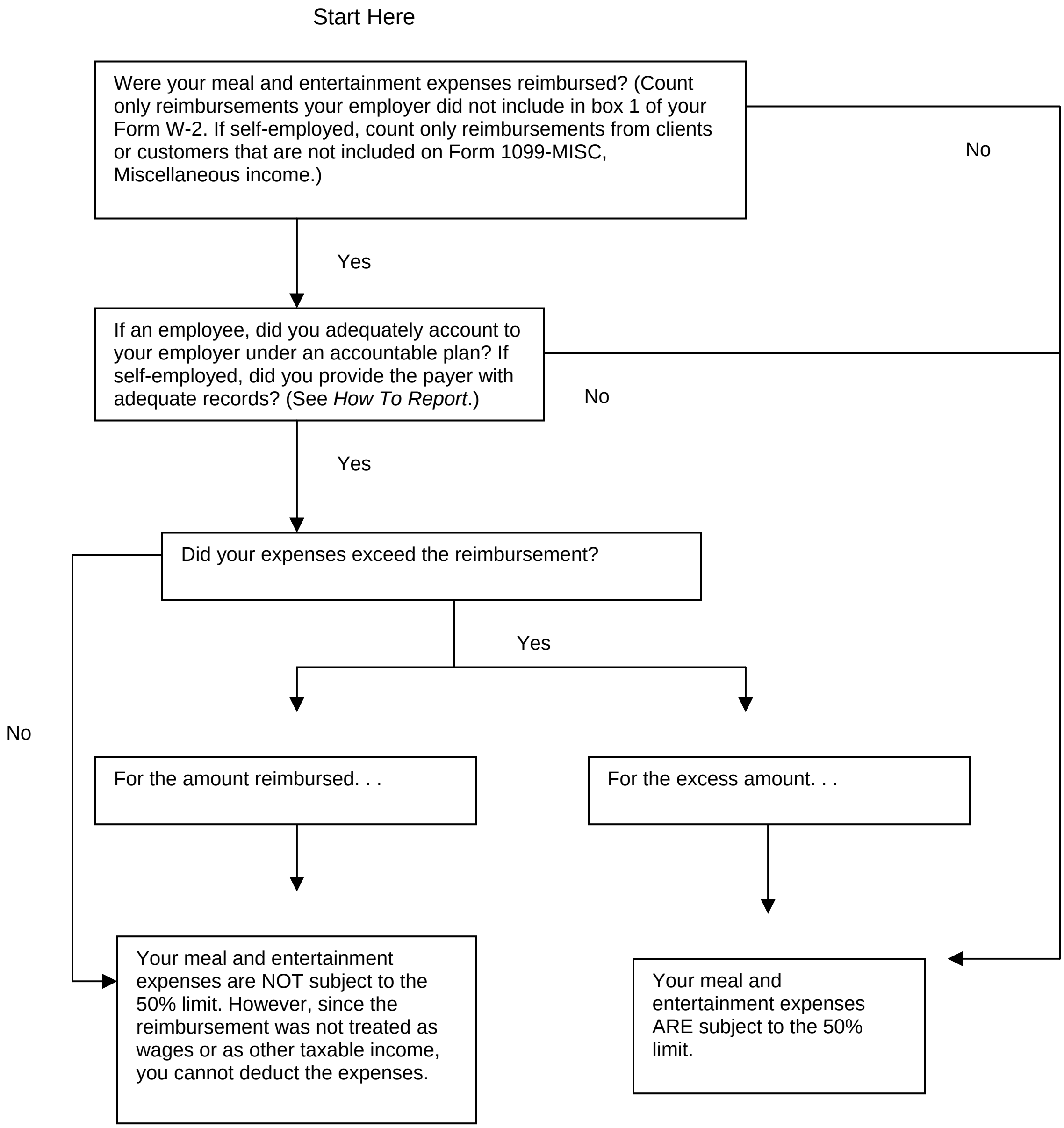
Figure 26-A summarizes the general rules explained in this section.

The 50% limit applies to business meals or entertainment expenses you have while:

1) Traveling away from home (whether eating alone or with others) on business,
2) Entertaining customers at your place of business, a restaurant, or other location, or
3) Attending a business convention or reception, business meeting, or business luncheon at a club.

Figure 26-A. **Does the 50% Limit Apply to Your Expenses?**
There are exceptions to these rules. See Exceptions to the 50% Limit.

All employees and self-employed persons can use this chart. For more information, see 50% limit.



Included expenses. Expenses subject to the 50% limit include:

- Taxes and tips relating to a business meal or entertainment activity,
- Cover charges for admission to a nightclub,
- Rent paid for a room in which you hold a dinner or cocktail party, and
- Amounts paid for parking at a sports arena.

However, the cost of transportation to and from a business meal or a business-related entertainment activity is not subject to the 50% limit.

Application of 50% limit. The 50% limit on meal and entertainment expenses applies if the expense is otherwise deductible and is not covered by one of the exceptions discussed later in this section.

The 50% limit also applies to certain meal and entertainment expenses that are not business-related. It applies to meal and entertainment expenses incurred for the production of income, including rental or royalty income. It also applies to the cost of meals included in deductible educational expenses.

When to apply the 50% limit. You apply the 50% limit after determining the amount that would otherwise qualify for a deduction. You first determine the amount of meal and entertainment expenses that would be deductible under the other rules discussed in this chapter.

Example 1. You spend $200 for a business-related meal. If $110 of that amount is not allowable because it is lavish and extravagant, the remaining $90 is subject to the 50% limit. Your deduction cannot be more than $45 (.50 X $90).

Example 2. You purchase two tickets to a concert and give them to a client. You purchased the tickets through a ticket agent. You paid $200 for the two tickets, which had a face value of $80 each ($160 total). Your deduction cannot be more than $80 (.50 X $160).

Exceptions to the 50% Limit

Generally, business-related meal and entertainment expenses are subject to the 50% limit. *Figure 26-A* can help you determine if the 50% limit applies to you.

Your meal or entertainment expense is ***not*** subject to the 50% limit if the expense meets either of the following exceptions.

Employee's reimbursed expenses. If you are an employee, you are not subject to the 50% limit on the amount of expenses for which your employer reimburses you under an accountable plan. Accountable plans are discussed later under *Reimbursements.*

Individuals subject to "hours of service" limits. You can deduct a higher percentage of your meal expenses if the meals take place during or incident to any period subject to the Department of Transportation's "hours of service" limits. The percentage is 80% for 2011.

Individuals subject to the Department of Transportation's "hours of service" limits include the following persons.

1) Certain air transportation workers (such as pilots, crew, dispatchers, mechanics, and control tower operators) who are under Federal Aviation Administration regulations.
2) Interstate truck operators and bus drivers who are under Department of Transportation regulations.
3) Certain railroad employees (such as engineers, conductors, train crews, dispatchers, and control operations personnel) who are under Federal Railroad Administration regulations.
4) Certain merchant mariners who are under Coast Guard regulations.

WHAT ENTERTAINMENT EXPENSES ARE DEDUCTIBLE

This section explains different types of entertainment expenses that you may be able to deduct.

Entertainment. Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. Examples include entertaining guests at nightclubs; at social, athletic, and sporting clubs; at theaters; at sporting events; on yachts, or on hunting, fishing, vacation, and similar trips.

A meal as a form of entertainment. Entertainment includes the cost of a meal you provide to a customer or client, whether the meal is a part of other entertainment or by itself. A meal expense includes the cost of food, beverages, taxes, and tips for the meal. To deduct an entertainment-related meal, you or your employee must be present when the food or beverages are provided.

Caution. *You cannot claim the cost of your meal both as an entertainment expense and as a travel expense.*

Separating costs. If you have one expense that includes the costs of entertainment, and other services (such as lodging or transportation), you must allocate that expense between the cost of entertainment and the cost of other services. You must have a reasonable basis for making this allocation. For example, you must allocate your expenses if a hotel includes entertainment in its lounge on the same bill with your room charge.

Taking turns paying for meals or entertainment. If a group of business acquaintances take turns picking up each others' meal or entertainment checks without regard to whether any business purposes are served, no member of the group can deduct any part of the expense.

Lavish or extravagant expenses. You cannot deduct expenses for entertainment that are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable considering the facts and circumstances. Expenses will not be disallowed just because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, nightclubs, or resorts.

Trade association meetings. You can deduct entertainment expenses that are directly related to, and necessary for, attending business meetings or conventions of certain exempt organizations if the expenses of your attendance are related to your active trade or business. These organizations include business leagues, chambers of commerce, real estate boards, trade associations, and professional associations.

Entertainment tickets. Generally, you cannot deduct more than the face value of an entertainment ticket, even if you paid a higher price. For example, you cannot deduct service fees you pay to ticket agencies or brokers or any amount over the face value of the tickets you pay to scalpers.

WHAT ENTERTAINMENT EXPENSES ARE NOT DEDUCTIBLE?

This section explains different types of entertainment expenses that you generally may not be able to deduct.

Club dues and membership fees. You cannot deduct dues (including initiation fees) for membership in any club organized for:

- Business,
- Pleasure
- Recreation, or
- Other social purpose.

This rule applies to any membership organization if one of its principal purposes is either:

- To conduct entertainment activities for members or their guests, or
- To provide members or their guests with access to entertainment facilities.

The purposes and activities of a club, not its name, will determine whether or not you can deduct the dues. You cannot deduct dues paid to:

- Country clubs,
- Golf and athletic clubs,
- Airline clubs,
- Hotel clubs, and
- Clubs operated to provide meals under circumstances generally considered to be conducive to business discussions.

Entertainment facilities. Generally, you cannot deduct any expense for the use of an entertainment facility. This includes expenses for depreciation and operating costs such as rent, utilities, maintenance, and protection.

An entertainment facility is any property you own, rent, or use for entertainment. Examples include a yacht, hunting lodge, fishing camp, swimming pool, tennis court, bowling alley, car, airplane, apartment, hotel suite, or home in a vacation resort.

Out-of-pocket expenses. You can deduct out-of-pocket expenses, such as food and beverages, catering, gas, and fishing bait, that you provided during entertainment at a facility. These are not expenses for the use of an entertainment facility. However, these expenses are subject to the directly-related and associated tests and to the 50% limit discussed earlier.

V. Gift Expenses

If you give gifts in the course of your trade or business, you can deduct all or part of the cost. This section explains the limits and rules for deducting the costs of gifts.

$25 limit. You can deduct no more than $25 for business gifts you give directly or indirectly to any one person during your tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift.

If you give a gift to a member of a customer's family, the gift is generally considered to be an indirect gift to the customer. This rule does not apply if you have a bona fide, independent business connection with that family member and the gift is not intended for the customer's eventual use.

If you and your spouse both give gifts, both of you are treated as one taxpayer. It does not matter whether you have separate businesses, are separately employed, or whether each of you has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer.

Incidental costs. Incidental costs, such as engraving on jewelry, or packaging, insuring, and mailing, are generally not included in determining the cost of a gift for purposes of the $25 limit.

A cost is incidental only if it does not add substantial value to the gift. For example, the cost of gift wrapping is an incidental cost. However, the purchase of an ornamental basket for packaging fruit is not an incidental cost if the value of the basket is substantial compared to the value of the fruit.

Exceptions. The following items are not considered gifts for purposes of the $25 limit.

1) An item that costs $4 or less and:
   a) Has your name clearly and permanently imprinted on the gift, and
   b) Is one of a number of identical items you widely distribute. Examples include pens, desk sets, and plastic bags and cases.
2) Signs, display racks, or other promotional material to be used on the business premises of the recipient.

Gift or entertainment. Any item that might be considered either a gift or entertainment generally will be considered entertainment. However, if you give a customer packaged food or beverages that you intend the customer to use at a later date, treat it as a gift.

If you give a customer tickets to a theater performance or sporting event and you do not go with the customer to the performance or event, you have a choice. You can treat the cost of the tickets as either a gift expense or an entertainment expense, whichever is to your advantage.

If you go with the customer to the event, you must treat the cost of the tickets as an entertainment expense. You cannot choose, in this case, to treat the cost of the tickets as a gift expense.

VI. <u>Transportation Expenses</u>

This section discusses expenses you can deduct for business transportation when you are not traveling away from home as defined earlier. These expenses include the cost of transportation by air, rail, bus, taxi, etc., and the cost of driving and maintaining your car.

Transportation expenses include the ordinary and necessary costs of all of the following.

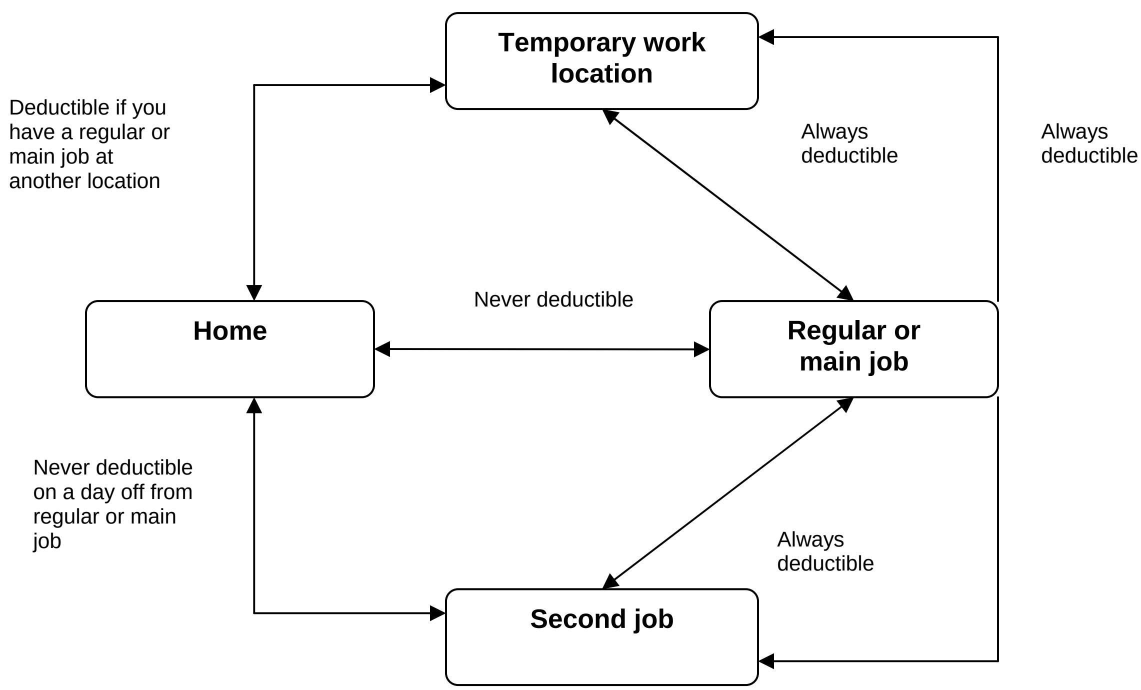
- Getting from one workplace to another in the course of your business or profession when you are traveling within your tax home. (Tax home is defined earlier under *Travel Expenses.*)
- Visiting clients or customers.
- Going to a business meeting away from your regular workplace.
- Getting from your home to a temporary workplace when you have one or more regular places of work. These temporary workplaces can be either within the area of your tax home or outside that area.

Transportation expenses do ***not*** include expenses you have while traveling away from home overnight. Those expenses are travel expenses, which are discussed earlier. However, if you use your car while traveling away from home overnight, use the rules in this section to figure your car expense deduction. See *Car Expenses,* later.

Illustration of transportation expenses. *Figure 26-B* illustrates the rules for when you can deduct transportation expenses when you have a regular or main job away from your home. You may want to refer to it when deciding whether you can deduct your transportation expenses.

Figure 26-B. **<u>When Are Transportation Expenses Deductible?</u>**

Most employees and self-employed persons can use this chart. (Do not use this chart if your home is your principal place of business. See *Office in the home*.)



Home: The place where you reside. Transportation expenses between your home and your main or regular place of work are personal commuting expenses.

Regular or main job: Your principal place of business. If you have more than one job, you must determine which one is your regular or main job. Consider the time you spend at each, the activity you have at each, and the income you earn at each.

Temporary work location: A place where your work assignment is realistically expected to last (and does in fact last) one year or less. Unless you have a regular place of business, you can only deduct your transportation expenses to a temporary work location <u>outside</u> your metropolitan area.

Second job: If you regularly work at two or more places in one day, whether or not for the same employer, you can deduct your transportation expenses of getting from one workplace to another. You cannot deduct your transportation costs between your home and a second job on a day off from your main job.

Temporary work location. If you have one or more regular work locations away from your home and you commute to a temporary work location in the same trade or business, you can deduct the expenses of the daily round-trip transportation between your home and the temporary location, regardless of distance.

If your employment at a work location is realistically expected to last (and does in fact last) for one year or less, the employment is temporary unless there are facts and circumstances that would indicate otherwise.

If your employment at a work location is realistically expected to last for more than 1 year or if there is no realistic expectation that the employment will last for 1 year or less, the employment is not temporary, regardless of whether it actually lasts for more than 1 year.

If employment at a work location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to last more than 1 year, that employment will be treated as temporary (unless there are facts and circumstances that would indicate otherwise) until your expectation changes. It will not be treated as temporary after the date you determine it will last more than 1 year.

If the temporary work location is beyond the general area of your regular place of work and you stay overnight, you are traveling away from home. You may have deductible travel expenses as discussed earlier in this chapter.

No regular place of work. If you have no regular place of work but ordinarily work in the metropolitan area where you live, you can deduct daily transportation costs between home and a temporary work site ***outside*** that metropolitan area.

Generally, a metropolitan area includes the area within the city limits and the suburbs that are considered part of that metropolitan area.

You cannot deduct daily transportation costs between your home and temporary work sites ***within*** your metropolitan area. These are nondeductible commuting expenses.

Two places of work. If you work at two places in one day, whether or not for the same employer, you can deduct the expense of getting from one workplace to the other. However, if for some personal reason you do not go directly from one location to the other, you cannot deduct more than the amount it would have cost you to go directly from the first location to the second.

Transportation expenses you have in going between home and a part-time job on a day off from your main job are commuting expenses. You cannot deduct them.

Armed Forces reservists. A meeting of an Armed Forces reserve unit is a second place of business if the meeting is held on a day on which you work at your regular job. You can deduct the expense of getting from one workplace to the other as just discussed under *Two places of work.*

You usually cannot deduct the expense if the reserve meeting is held on a day on which you do not work at your regular job. In this case, your transportation generally is considered a nondeductible commuting expense. However, you can deduct your transportation expenses if the location of the meeting is temporary and you have one or more regular places of work.

If you ordinarily work in a particular metropolitan area but not at any specific location and the reserve meeting is held at a temporary location outside that metropolitan area, you can deduct your transportation expenses.

If you travel away from home overnight to attend a guard or reserve meeting, you can deduct your travel expenses. These expenses are discussed earlier under *Travel Expenses.*

If you travel more than 100 miles away from home in connection with your performance of services as a member of the reserves, you may be able to deduct some of your reserve-related travel costs as an adjustment to income rather than as an itemized deduction. See *Armed Forces reservists traveling more than 100 miles from home* under *Special Rules*, later.

Commuting expenses. You cannot deduct the costs of taking a bus, trolley, subway, or taxi, or of driving a car between ***your home*** and your main or regular place of work. These costs are personal commuting expenses. You cannot deduct commuting expenses no matter how far your home is from your regular place of work. You cannot deduct commuting expenses even if you work during the commuting trip.

Example. You sometimes use your cell phone to make business calls while commuting to and from work. Sometimes business associates ride with you to and from work, and you have a business discussion in the car. These activities do not change the trip from personal to business. You cannot deduct your commuting expenses.

Parking fees. Fees you pay to park your car at your place of business are nondeductible commuting expenses. You can, however, deduct business-related parking fees when visiting a customer or client.

Advertising display on car. Putting display material that advertises your business on your car does not change the use of your car from personal use to business use. If you use this car for commuting or other personal uses, you still cannot deduct your expenses for those uses.

Car pools. You cannot deduct the cost of using your car in a nonprofit car pool. Do not include payments you receive from the passengers in your income. These payments are considered reimbursements of your expenses. However, if you operate a car pool for a profit, you must include payments from passengers in your income. You can then deduct your car expenses (using the rules in this chapter).

Hauling tools or instruments. Hauling tools or instruments in your car while commuting to and from work does not make your car expenses deductible. However, you can deduct any additional costs you have for hauling tools or instruments (such as for renting a trailer you tow with your car).

Union members' trips from a union hall. If you get your work assignments at a union hall and then go to your place of work, the costs of getting from the union hall to your place of work are nondeductible commuting expenses. Although you need the union to get your work assignments, you are employed where you work, not where the union hall is located.

Office in the home. If you have an office in your home that qualifies as a ***principal place of business,*** you can deduct your daily transportation costs between your home and another work location in the same trade or business.

Examples of deductible transportation expenses. The following examples show when you can deduct transportation expenses based on the location of your work and your home.

Example 1. You regularly work in an office in the city where you live. Your employer sends you to a one-week training session at a different office in the same city. You travel directly from your home to the training location and return each day. You can deduct the cost of your daily round-trip transportation between your home and the training location.

Example 2. Your principal place of business is in your home. You can deduct the cost of round-trip transportation between your qualifying home office and your client's or customer's place of business.

Example 3. You have no regular office, and you do not have an office in your home. In this case, the location of your first business contact is considered your office. Transportation expenses between your home and this first contact are nondeductible commuting expenses. Transportation expenses between your last business contact and your home are also nondeductible commuting expenses. Although you cannot deduct the costs of these first and last trips, you can deduct the costs of going from one client or customer to another.

CAR EXPENSES

If you use your car for business purposes, you may be able to deduct car expenses. You generally can use one of the two following methods to figure your deductible expenses.

- Actual car expenses.
- Standard mileage rate.

If you use actual car expenses to figure your deduction for a car you lease, there are rules that affect the amount of your lease payments that you can deduct. See *Leasing a car* under *Actual Car Expenses,* later.

In this chapter, "car" includes a van, pickup, or panel truck.

Rural mail carriers. If you are a rural mail carrier, you may be able to treat the amount of qualified reimbursement you received as the amount of your allowable expense. Because the qualified reimbursement is treated as paid under an accountable plan, your employer should not include the amount of reimbursement in your income.

If your vehicle expenses are more than the amount of your reimbursement, you can deduct the unreimbursed expenses as an itemized deduction on Schedule A (Form 1040). You must complete Form 2106 and attach it to your Form 1040.

A "qualified reimbursement" is the amount of reimbursement you receive that meets both of the following conditions.

1) It is given as an equipment maintenance allowance (EMA) to employees of the U.S. Postal Service.
2) It is at the rate contained in the 1991 collective bargaining agreement. Any later agreement cannot increase the qualified reimbursement amount by more than the rate of inflation.

See your employer for information on your reimbursement.

STANDARD MILEAGE RATE

You may be able to use the standard mileage rate to figure the deductible costs of operating your car for business purposes. The standard mileage rate is ***51 cents*** a mile for all business miles during the first half of 2011, and 55.5 cents during the second half of 2011.

Choosing the standard mileage rate. If you want to use the standard mileage rate for a car you own, you must choose to use it in the first year the car is available for use in your business. Then in later years, you can choose to use either the standard mileage rate or actual expenses.

If you want to use the standard mileage rate for a car you lease, you must use it for the entire lease period. For leases that began on or before December 31, 1997, the standard mileage rate must be used for the entire portion of the lease period (including renewals) that is after 1997.

You must make the choice to use the standard mileage rate by the due date (including extensions) of your return. You cannot revoke the choice. However, in a later year, you can switch from the standard mileage rate to the actual expenses method. If you change to the actual expense method in a later year, but before your car is fully depreciated, you have to estimate the remaining useful life of the car and use straight line depreciation.

Standard mileage rate not allowed. You cannot use the standard mileage rate if you:

1) Use the car for hire (such as a taxi),
2) Use five or more cars at the same time (as in fleet operations),
3) Claimed a depreciation deduction for the car using any method other than straight line depreciation,
4) Claimed a section 179 deduction on the car,
5) Claimed the special depreciation allowance on the car,
6) Claimed actual car expenses after 1997 for a car you leased, or
7) Are a rural mail carrier who received a qualified reimbursement. (See *Rural mail carriers,* earlier.)

Five or more cars. If you own or lease five or more cars that are used for business at the same time, you cannot use the standard mileage rate for the business use of any car. However, you may be able to deduct your actual expenses for operating each of the cars in your business.

You are ***not*** using five or more cars for business at the same time if you alternate using (use at different times) the cars for business.

Parking fees and tolls. In addition to using the standard mileage rate, you can deduct any business-related parking fees and tolls. (Parking fees that you pay to park your car at your place of work are nondeductible commuting expenses.)

Actual Car Expenses

If you do not use the standard mileage rate, you may be able to deduct your actual car expenses.

Actual car expenses include: depreciation, garage rent, gas, insurance, lease payments, licenses, oil, parking fees, registration fees, repairs, tires, and tolls.

Business and personal use. If you use your car for both business and personal purposes, you must divide your expenses between business and personal use. You can divide your expense based on the miles driven for each purpose.

Example. You are a contractor and drive your car 20,000 miles during the year: 12,000 miles for business use and 8,000 miles for personal use. You can claim only 60% (12,000 / 20,000) of the cost of operating your car as a business expense.

Interest on car loans. If you are an employee, you cannot deduct any interest paid on a car loan. This interest is treated as personal interest and is not deductible.

Tip. *If you use a home equity loan to purchase your car, you may be able to deduct the interest.*

Taxes paid on your car. If you are an employee, you can deduct personal property taxes paid on your car if you itemize deductions. Enter the amount paid on line 7 of Schedule A (Form 1040). (See chapter 22 for more information on taxes.) If you are not an employee, see your form instructions for information on how to deduct personal property taxes paid on your car.

Sales taxes. Generally, sales taxes on your car are part of your car's basis and are recovered through depreciation, discussed later.

Fines and collateral. You cannot deduct fines and collateral you pay for traffic violations.

Depreciation and section 179 deductions. Generally, the cost of a car, plus sales tax and improvements, is a capital expense. Because the benefits last longer than one year, you generally cannot deduct a capital expense. However, you can recover this cost through the section 179 deduction (the deduction allowed by section 179 of the Internal Revenue Code) and depreciation deductions. By using depreciation, you recover the cost over more than one year by deducting part of it each year.

Generally, there are limits on these deductions. Special rules apply if you use your car 50% or less in your work or business.

Leasing a car. If you lease a car that you use in your business, you can use the standard mileage rate or actual expenses to figure your deductible car expense.

Deductible payments. If you choose to use actual expenses, you can deduct the part of each lease payment that is for the use of the car in your business. You cannot deduct any part of a lease payment that is for personal use of the car, such as commuting.

You must spread any advance payments over the entire lease period. You cannot deduct any payments you make to buy a car, even if the payments are called lease payments.

If you lease a car for 30 days or more, you may have to reduce your lease payment deduction by an "inclusion amount." For information on reporting lease inclusion amounts, see *Leasing a Car* in chapter 4 of Publication 463.

Sale, Trade-in, or Other Disposition

If you sell, trade in, or otherwise dispose of your car, you may have a taxable gain or a deductible loss. This is true whether you used the standard mileage rate or actual car expenses to deduct the business use of your car.

VII. Recordkeeping

HOW TO PROVE EXPENSES

Table 26-2 is a summary of records you need to prove each expense discussed in this chapter. You must be able to prove the elements listed across the top portion of the chart. You prove them by having the information and receipts (where needed) for the expenses listed in the first column.

You should keep adequate records to prove your expenses or have sufficient evidence that will support your own statement. You must generally prepare a written record for it to be considered adequate. This is because written evidence is more reliable than oral evidence alone. However, if you prepare a record in a computer memory device with the aid of a logging program, it is considered an adequate record.

Table 26-2. How to Prove Certain Business Expenses

<table>
<tr><th rowspan="2">IF you have expenses for…</th><th colspan="4">THEN you must keep records that show details of the following elements…</th></tr>
<tr><th>Amount</th><th>Time</th><th>Place or Description</th><th>Business Purpose and Business Relationship</th></tr>
<tr><td>Travel</td><td>Cost of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories such as taxis, daily meals for traveler, etc.</td><td>Dates you left and returned for each trip and number of days spent on business.</td><td>Destination or area of your travel (name of city, town, or other designation).</td><td><u>Purpose</u>: Business purpose for the expense or the business benefit gained or expected to be gained.

<u>Relationship</u>: N/A</td></tr>
<tr><td>Entertainment</td><td>Cost of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.</td><td>Date of entertainment. (Also see Business Purpose.)</td><td>Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. (Also see Business Purpose.)</td><td rowspan="2"><u>Purpose</u>: Business purpose for the expense or the business benefit gained, or expected to be gained. For entertainment, the nature of the business discussion or activity. If the entertainment was directly before or after a business discussion: the date, place, nature, and duration of the business discussion, and the identities of the persons who took part in both the business discussion and the entertainment activity.

<u>Relationship</u>: Occupations or other information (such as names, titles, or other designations) about the recipients that shows their business relationship to you. For entertainment, you must also prove that you or your employee was present if the entertainment was a business meal.</td></tr>
<tr><td>Gifts</td><td>Cost of the gift.</td><td>Date of the gift.</td><td>Description of the gift.</td></tr>
</table>

Transportation	Cost of each separate expense. For car expenses, the cost of the car and any improvements, the date you started using it for business, the mileage for each business use, and the total miles for the year.	Date of the expense. For car expenses, the date of the use of the car	Your business destination.	Purpose: Business purpose for the expense. Relationship: N/A

What are Adequate Records?

You should keep the proof you need in an account book, diary, statement of expense, or similar record. You should also keep documentary evidence that, together with your records, will support each element of an expense.

Documentary evidence. You generally must have documentary evidence, such as receipts, canceled checks, or bills, to support your expenses.

Exception. Documentary evidence is not needed if any of the following conditions apply.

1) You have meals or lodging expenses while traveling away from home for which you account to your employer under an accountable plan and you use a per diem allowance method that includes meals and/or lodging. (Accountable plans and per diem allowances are discussed later under *Reimbursements.*)
2) Your expense, other than lodging, is less than $75.
3) You have a transportation expense for which a receipt is not readily available.

Adequate evidence. Documentary evidence ordinarily will be considered adequate if it shows the amount, date, place, and essential character of the expense.

For example, a hotel receipt is enough to support expenses for business travel if it has all of the following information.

1) The name and location of the hotel.
2) The dates you stayed there.
3) Separate amounts for charges such as lodging, meals, and telephone calls.

A restaurant receipt is enough to prove an expense for a business meal if it has all of the following information.

1) The name and location of the restaurant.
2) The number of people served.
3) The date and amount of the expense.

If a charge is made for items other than food and beverages, the receipt must show that this is the case.

Canceled check. A canceled check, together with a bill from the payee, ordinarily establishes the cost. However, a canceled check by itself does not prove a business expense without other evidence to show that it was for a business purpose.

Duplicate information. You do not have to record information in your account book or other record that duplicates information shown on a receipt as long as your records and receipts complement each other in an orderly manner.

You do not have to record amounts your employer pays directly for any ticket or other travel item. However, if you charge these items to your employer, through a credit card or otherwise, you must keep a record of the amounts you spend.

Timely-kept records. You should record the elements of an expense or of a business use at or near the time of the expense or use and support it with sufficient documentary evidence. A timely-kept record has more value than a statement prepared later when generally there is a lack of accurate recall.

You do not need to write down the elements of every expense on the day of the expense. If you maintain a log on a weekly basis which accounts for use during the week, the log is considered a timely-kept record.

If you give your employer, client, or customer an expense account statement, it can also be considered a timely-kept record. This is true if you copy it from your account book, diary, statement of expense, or similar record.

Proving business purpose. You must generally provide a written statement of the business purpose of an expense. However, the degree of proof varies according to the circumstances in each case. If the business purpose of an expense is clear from the surrounding circumstances, then you do not need to give a written explanation.

Confidential information. You do not need to put confidential information relating to an element of a deductible expense (such as the place, business purpose, or business relationship) in your account book, diary, or other record. However, you do have to record the information elsewhere at or near the time of the expense and have it available to fully prove that element of the expense.

What If I Have Incomplete Records?

If you do not have complete records to prove an element of an expense, then you must prove the element with:

1) Your own written or oral statement, containing specific information about the element, and
2) Other supporting evidence that is sufficient to establish the element.

Destroyed records. If you cannot produce a receipt because of reasons beyond your control, you can prove a deduction by reconstructing your records or expenses. Reasons beyond your control include fire, flood, and other casualty.

Separating and Combining Expenses

This section explains when expenses must be kept separate and when expenses can be combined.

Separating expenses. Each separate payment is generally considered a separate expense. For example, if you entertain a customer or client at dinner and then go to the theater, the dinner expense and the cost of the theater tickets are two separate expenses. You must record them separately in your records.

Combining items. You can make one daily entry in your record for reasonable categories of expenses. Examples are taxi fares, telephone calls, or other incidental travel costs. Meals should be in a separate category. You can include tips for meal-related services with the costs of the meals.

Expenses of a similar nature occurring during the course of a single event are considered a single expense. For example, if during entertainment at a cocktail lounge, you pay separately for each serving of refreshments, the total expense for the refreshments is treated as a single expense.

Allocating total cost. If you can prove the total cost of travel or entertainment but you cannot prove how much it cost for each person who participated in the event, you may have to allocate the total cost among you and your guests on a pro rata basis. An allocation would be needed, for example, if you did not have a business relationship with all of your guests.

If your return is examined. If your return is examined, you may have to provide additional information to the IRS. This information could be needed to clarify or to establish the accuracy or reliability of information contained in your records, statements, testimony, or documentary evidence before a deduction is allowed.

HOW LONG TO KEEP RECORDS AND RECEIPTS

You must keep records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, this means you must keep your records that support your deduction (or an item of income) for 3 years from the date you file the income tax return on which the deduction is claimed. A return filed early is considered filed on the due date.

Reimbursed for expenses. Employees who give their records and documentation to their employers and are reimbursed for their expenses generally do not have to keep copies of this information. However, you may have to prove your expenses if any of the following conditions apply.

1) You claim deductions for expenses that are more than reimbursements.
2) Your expenses are reimbursed under a nonaccountable plan.
3) Your employer does not use adequate accounting procedures to verify expense accounts.

4) You are related to your employer, as defined later under *Related to employer.*

See the next section, *How To Report,* for a discussion of reimbursements, adequate accounting, and nonaccountable plans.

VIII. How to Report

Self-employed. You must report your income and expenses on Schedule C or C-EZ (Form 1040) if you are a sole proprietor, or on Schedule F (Form 1040) if you are a farmer. You do not use Form 2106 or 2106-EZ. See your form instructions for information on how to complete your tax return.

Both self-employed and an employee. If you are both self-employed and an employee, you must keep separate records for each business activity. Report your business expenses for self-employment on Schedule C, C-EZ, or F (Form 1040), as discussed earlier. Report your business expenses for your work as an employee on Form 2106 or 2106-EZ, as discussed next.

Employees. If you are an employee, you generally must complete Form 2106 to deduct your travel, transportation, and entertainment expenses. However, you can use the shorter Form 2106-EZ instead of Form 2106 if you meet all of the following conditions.

1) You are an employee deducting expenses attributable to your job.
2) You were not reimbursed by your employer for your expenses (amounts included in box 1 of your Form W-2 are not considered reimbursements).
3) If you are claiming car expenses, you use the standard mileage rate.

Gifts. If you did not receive any reimbursements (or the reimbursements were all included in box 1 of your Form W-2), the only business expense you are claiming is for gifts, and the rules for certain individuals (such as performing artists), discussed later under *Special Rules*, do not apply to you, do not complete Form 2106 or 2106-EZ. Instead, claim the amount of your deductible gifts directly on line 21 of Schedule A (Form 1040).

Statutory employees. If you received a Form W-2 and the "Statutory employee" box in box 13 was checked, you report your income and expenses related to that income on Schedule C or C-EZ (Form 1040). Do not complete Form 2106 or 2106-EZ.

Statutory employees include full-time life insurance salespersons, certain agent or commission drivers, traveling salespersons, and certain homeworkers.

Reimbursement for personal expenses. If your employer reimburses you for nondeductible personal expenses, such as for vacation trips, your employer must report the reimbursement as wage income in box 1 of your Form W-2. You cannot deduct personal expenses.

REIMBURSEMENTS

This section explains what to do when you receive an advance or are reimbursed for any of the employee business expenses discussed in this chapter.

If you received an advance, allowance, or reimbursement for your expenses, how you report this amount and your expenses depends on whether the reimbursement was paid to you under an accountable plan or a nonaccountable plan.

This section explains the two types of plans, how per diem and car allowances simplify proving the amount of your expenses, and the tax treatment of your reimbursements and expenses.

No reimbursement. You are not reimbursed or given an allowance for your expenses if you are paid a salary or commission with the understanding that you will pay your own expenses. In this situation, you have no reimbursement or allowance arrangement, and you do not have to read this section on reimbursements. Instead, see *Completing Forms 2106 and 2106-EZ,* later, for information on completing your tax return.

Reimbursement, allowance, or advance. A reimbursement or other expense allowance arrangement is a system or plan that an employer uses to pay, substantiate, and recover the expenses, advances, reimbursements, and amounts charged to the employer for employee business expenses. Arrangements include per diem and car allowances.

A per diem allowance is a fixed amount of daily reimbursement your employer gives you for your lodging, meal, and incidental expenses when you are away from home on business. (The term "incidental expenses" is defined earlier under *Meals and Incidental Expenses.*) A car allowance is an amount your employer gives you for the business use of your car.

Your employer should tell you what method of reimbursement is used and what records you must provide.

Accountable Plans

To be an accountable plan, your employer's reimbursement or allowance arrangement must include all three of the following rules.

1) Your expenses must have a business connection – that is, you must have paid or incurred deductible expenses while performing services as an employee of your employer.
2) You must adequately account to your employer for these expenses within a reasonable period of time.
3) You must return any excess reimbursement or allowance within a reasonable period of time.

See *Adequate Accounting* and *Returning Excess Reimbursements*, later.

An ***excess reimbursement or allowance*** is any amount you are paid that is more than the business-related expenses that you adequately accounted for to your employer.

The definition of ***reasonable period of time*** depends on the facts and circumstances of your situation. However, regardless of the facts and circumstances of your situation, actions that take place within the times specified in the following list will be treated as taking place within a reasonable period of time.

1) You receive an advance within 30 days of the time you have an expense.
2) You adequately account for your expenses within 60 days after they were paid or incurred.
3) You return any excess reimbursement within 120 days after the expense was paid or incurred.

4) You are given a periodic statement (at least quarterly) that asks you to either return or adequately account for outstanding advances ***and*** you comply within 120 days of the statement.

Employee meets accountable plan rules. If you meet the three rules for accountable plans, your employer should not include any reimbursements in your income in box 1 of your Form W-2. If your expenses equal your reimbursement, you do not complete Form 2106. You have no deduction since your expenses and reimbursement are equal.

Accountable plan rules not met. Even though you are reimbursed under an accountable plan, some of your expenses may not meet all three rules. Those expenses that fail to meet all three rules for accountable plans are treated as having been reimbursed under a nonaccountable plan (discussed later).

Reimbursement of nondeductible expenses. You may be reimbursed under your employer's accountable plan for expenses related to that employer's business, some of which are deductible as employee business expenses and some of which are not deductible. The reimbursements you receive for the nondeductible expenses do not meet rule (1) for accountable plans, and they are treated as paid under a nonaccountable plan.

Example. Your employer's plan reimburses you for travel expenses while away from home on business and also for meals when you work late at the office, even though you are not away from home. The part of the arrangement that reimburses you for the nondeductible meals when you work late at the office is treated as paid under a nonaccountable plan.

Adequate Accounting

One of the rules for an accountable plan is that you must adequately account to your employer for your expenses. You adequately account by giving your employer a statement of expense, an account book, a diary, or a similar record in which you entered each expense at or near the time you had it, along with documentary evidence (such as receipts) of your travel, mileage, and other employee business expenses. (See Table 26-2, earlier, for details you need to enter in your record and documents you need to prove certain expenses.) A per diem or car allowance satisfies the adequate accounting requirement under certain conditions.

You must account for ***all*** amounts you received from your employer during the year as advances, reimbursements, or allowances. This includes amounts you charged to your employer by credit card or other method. You must give your employer the same type of records and supporting information that you would have to give to the IRS if the IRS questioned a deduction on your return. You must pay back the amount of any reimbursement or other expense allowance for which you do not adequately account or that is more than the amount for which you accounted.

Per Diem and Car Allowances

If your employer reimburses you for your expenses using a per diem or car allowance, you can generally use the allowance as proof of the amount of your expenses. A per diem or car allowance satisfies the adequate accounting requirements for the amount of your expenses only if all four of the following conditions apply.

1) Your employer reasonably limits payments of your expenses to those that are ordinary and necessary in the conduct of the trade or business.
2) The allowance is similar in form to and not more than the federal rate (discussed later).
3) You prove the time (dates), place, and business purpose of your expenses to your employer (as explained in *Table 26-2*) within a reasonable period of time.
4) You are not related to your employer (as defined earlier under *Who cannot use the standard meal allowance*). If you are related to your employer, you must be able to prove your expenses to the IRS even if you have already adequately accounted to your employer and returned any excess reimbursement.

If the IRS finds that an employer's travel allowance practices are not based on reasonably accurate estimates of travel costs (including recognition of cost differences in different areas for per diem amounts), you will not be considered to have accounted to your employer. In this case, you must be able to prove your expenses to the IRS.

Related to employer. You are related to your employer if:

1) Your employer is your brother or sister, half brother or half sister, spouse, ancestor, or lineal descendant,
2) Your employer is a corporation in which you own, directly or indirectly, more than 10% in value of the outstanding stock, or
3) Certain relationships (such as grantor, fiduciary, or beneficiary) exist between you, a trust, and your employer.

You may be considered to indirectly own stock, for purposes of (2), if you have an interest in a corporation, partnership, estate, or trust that owns the stock or if a member of your family or your partner owns the stock.

The federal rate. The federal rate can be figured using any one of the following methods.

1) For per diem amounts:
   a) The regular federal per diem rate.
   b) The standard meal allowance.
   c) The high-low rate.
2) For car expenses:
   a) The standard mileage rate.
   b) A fixed and variable rate (FAVR).

Regular federal per diem rate. The regular federal per diem rate is the highest amount that the federal government will pay to its employees for lodging, meal, and incidental expenses (or meal and incidental expenses only) while they are traveling away from home in a particular area. The rates are different for different locations.

The standard meal allowance. The standard meal allowance (discussed earlier) is the federal rate for meals and incidental expenses (M&IE). The rate for most small localities in the United States is $46 a day for 2011. Most major cities and many other localities qualify for higher rates.

You receive an allowance only for meals and incidental expenses when your employer does one of the following.

1) Provides you with lodging (furnishes it in kind).
2) Reimburses you, based on your receipts, for the actual cost of your lodging.
3) Pays the hotel, motel, etc., directly for your lodging.
4) Does not have a reasonable belief that you had (or will have) lodging expenses, such as when you stay with friends or relatives or sleep in the cab of your truck.
5) Figures the allowance on a basis similar to that used in computing your compensation, such as number of hours worked or miles traveled.

High-low rate. This is a simplified method of computing the federal per diem rate for travel within the continental United States. It eliminates the need to keep a current list of the per diem rate for each city.

Under the high-low method, the per diem amount for travel during 2011 is $233 (including $65 for M&IE) for certain high-cost locations. All other areas have a per diem amount of $160 (including $52 for M&IE). (Employers can get Publication 1542, which gives the areas eligible for the $233 per diem amount under the high-low method for all or part of this period.)

Caution. *Effective October 1, 2011, the per diem rate for certain high-cost locations increased to $242 (including $65 for M&IE). The rate for all other locations increased to $163 (including $52 for M&IE). However, an employer can continue to use the rates described in the preceding paragraph for the remainder of 2011 if those rates and locations are used consistently during October, November, and December for all employees. Employers who did not use the high-low method during the first 9 months of 2011 cannot begin to use it before 2012.*

Note: The high-low method may be discontinued. *In Rev Proc 2010-39, the IRS asked for comments on whether the high-low method was still needed. Having received no comments, the IRS says it intends to discontinue this method. However, there's no indication of when the high-low method will be discontinued, so employers currently using it should continue to do so until the IRS says otherwise.*

Prorating the standard meal allowance on partial days of travel. The standard meal allowance is for a full 24-hour day of travel. If you travel for part of a day, such as on the days you depart and return, you must prorate the full-day M&IE rate. This rule also applies if your employer uses the regular federal per diem rate or the high-low rate.

You can use either of the following methods to figure the federal M&IE for that day.

1) *Method 1:*
   a) For the day you depart, add 3/4 of the standard meal allowance amount for that day.
   b) For the day you return, add 3/4 of the standard meal allowance amount for the preceding day
2) *Method 2:* Prorate the standard meal allowance using any method that you consistently apply and that is in accordance with reasonable business practice.

The standard mileage rate. This is a set rate per mile that you can use to compute your deductible car expenses. The standard mileage rate is ***51 cents a mile*** for all business miles in the first half of 2011, and 55.5 cents during the second half of 2011.

Fixed and variable rate (FAVR). This is an allowance your employer may use to reimburse your car expenses. Under this method, your employer pays an allowance that includes a combination of payments covering fixed and variable costs, such as a cents-per-mile rate to cover your variable operating costs (such as gas, oil, etc.) plus a flat amount to cover your fixed costs (such as depreciation (or lease payments), insurance, etc.). If your employer chooses to use this method, your employer will request the necessary records from you.

Reporting your expenses with a per diem or car allowance. If your reimbursement is in the form of an allowance received under an accountable plan, the following two facts affect your reporting.

1) The federal rate.
2) Whether the allowance or your actual expenses were more than the federal rate.

The following discussions explain where to report your expenses depending upon how the amount of your allowance compares to the federal rate.

Allowance LESS than or EQUAL to the federal rate. If your allowance is less than or equal to the federal rate, the allowance will not be included in box 1 of your Form W-2. You do not need to report the related expenses or the allowance on your return if your expenses are equal to or less than the allowance.

However, if your actual expenses are more than your allowance, you can complete Form 2106 and deduct the excess amount on Schedule A (Form 1040). If you are using actual expenses, you must be able to prove to the IRS the total amount of your expenses and reimbursements for the entire year. If you are using the standard meal allowance or the standard mileage rate, you do not have to prove that amount.

Example. Nicole drives 10,000 miles during the first half of 2011 for business. Under her employer's accountable plan, she accounts for the time (dates), place, and business purpose of each trip. Her employer pays her a mileage allowance of 40 cents a mile.

Since Nicole's $5,100 expense computed under the standard mileage rate is more than her $4,000 reimbursement (10,000 miles × 40 cents), she itemizes her deductions to claim the excess expense. Nicole completes Form 2106 (showing all of her expenses and reimbursements) and enters $1,100 ($5,100 − $4,000) as an itemized deduction.

Allowance MORE than the federal rate. If your allowance is more than the federal rate, your employer must include the allowance amount up to the federal rate in box 12 of your Form W-2. This amount is not taxable. However, the excess allowance will be included in box 1 of your Form W-2. You must report this part of your allowance as if it were wage income.

If your actual expenses are less than or equal to the federal rate, you do not complete Form 2106 or claim any of your expenses on your return.

However, if your actual expenses are more than the federal rate, you can complete Form 2106 and, generally, deduct those excess expenses. You must report on Form 2106 your reimbursements up to the federal rate (as shown in box 12 of your Form W-2) and all your expenses. You should be able to prove these amounts to the IRS.

Example. Joe lives and works in Austin. His employer sent him to San Diego for 4 days and paid the hotel directly for Joe's hotel bill. The employer reimbursed Joe $75 a day for his meals and incidental expenses. The federal rate for San Diego is $71 a day.

Joe can prove that his actual meal expenses totaled $380. His employer's accountable plan will not pay more than $75 a day for travel to San Diego, so Joe does not give his employer the records that prove that he actually spent $380. However, he does account for the time, place, and business purpose of the trip. This is Joe's only business trip this year.

Joe was reimbursed $300 ($75 X 4 days), which is $16 more than the federal rate of $284 ($71 X 4 days). The employer includes the $16 as income on Joe's Form W-2 in box 1. The employer also enters $284 in box 12 of Joe's Form W-2.

Joe completes Form 2106 to figure his deductible expenses. He enters the total of his actual expenses for the year ($380) on Form 2106. He also enters the reimbursements that were not included in his income ($284). His total deductible expense, before the 50% limit, is $96. After he figures the 50% limit on his unreimbursed meals and entertainment, he will include the balance, $48, as an itemized deduction.

Returning Excess Reimbursements

Under an accountable plan, you are required to return any excess reimbursement for your business expenses to the person paying the reimbursement or allowance. ***Excess reimbursement*** means any amount for which you did not adequately account within a reasonable period of time. For example, if you received a travel advance and you did not spend all the money on business-related expenses, or if you do not have proof of all your expenses, you have an excess reimbursement.

"Adequate accounting" and "reasonable period of time" were discussed earlier.

Travel advance. You receive a travel advance if your employer provides you with an expense allowance before you actually have the expense, and the allowance is reasonably expected to be no more than your expense. Under an accountable plan, you are required to adequately account to your employer for this advance and to return any excess within a reasonable period of time.

If you do not adequately account for or do not return any excess advance within a reasonable period of time, the amount you do not account for or return will be treated as having been paid under a nonaccountable plan (discussed later).

Unproved amounts. If you do not prove that you actually traveled on each day for which you received a per diem or car allowance (proving the elements described in *Table 26-2*), you must return this unproved amount of the travel advance within a reasonable period of time. If you do not do this, the unproved amount is considered paid under a nonaccountable plan (discussed later).

Per diem allowance MORE than federal rate. If your employer's accountable plan pays you an allowance that is higher than the federal rate, you do not have to return the difference between the two rates for the period you can prove business-related travel expenses. However, the difference will be reported as wages on your Form W-2. This excess amount is considered paid under a nonaccountable plan (discussed later).

Example. Your employer sends you on a 5-day business trip to Phoenix in March 2011 and gives you a $400 ($80 X 5 days) advance to cover your meals and incidental expenses. The federal per diem for meals and incidental expenses for Phoenix is $71. Your trip lasts only 3 days. Under your employer's accountable plan, you must return the $160 ($80 X 2 days) advance for the 2 days you did not travel. You do not have to return the $27 difference between the allowance you received and the federal rate for Phoenix [($80 - $71) X 3 days]. However, the $27 will be reported on your Form W-2 as wages.

Nonaccountable Plans

A nonaccountable plan is a reimbursement or expense allowance arrangement that does not meet one or more of the three rules listed earlier under *Accountable Plans.*

In addition, even if your employer has an accountable plan, the following payments will be treated as being paid under a nonaccountable plan.

1) Excess reimbursements you fail to return to your employer.
2) Reimbursement of nondeductible expenses related to your employer's business. See *Reimbursement of nondeductible expenses* earlier under *Accountable Plans.*

If you are not sure if the reimbursement or expense allowance arrangement is an accountable or nonaccountable plan, ask your employer.

Reporting your expenses under a nonaccountable plan. Your employer will combine the amount of any reimbursement or other expense allowance paid to you under a nonaccountable plan with your wages, salary, or other pay. Your employer will report the total in box 1 of your Form W-2.

You must complete Form 2106 or 2106-EZ and itemize your deductions to deduct your expenses for travel, transportation, meals, or entertainment. Your meal and entertainment expenses will be subject to the 50% limit discussed earlier under *Entertainment Expenses.* Also, your total expenses will be subject to the 2%-of-adjusted-gross-income limit that applies to most miscellaneous itemized deductions on Schedule A (Form 1040).

Example. Kim's employer gives her $1,000 a month ($12,000 for the year) for her business expenses. Kim does not have to provide any proof of her expenses to her employer, and Kim can keep any funds that she does not spend.

Kim is being reimbursed under a nonaccountable plan. Her employer will include the $12,000 on Kim's Form W-2 as if it were wages. If Kim wants to deduct her business expenses, she must complete Form 2106 or 2106-EZ and itemize her deductions.

COMPLETING FORMS 2106 AND 2106-EZ

This section briefly describes how employees complete Forms 2106 and 2106-EZ. *Table 26-3* explains what the employer reports on Form W-2 and what the employee reports on Form 2106. The instructions for the forms have more information on completing them.

Table 26-3. <u>Reporting Travel, Entertainment, Gift, and Car Expenses and Reimbursements</u>

IF the type of reimbursement (or other expense allowance) arrangement is under:	THEN the employer reports on Form W-2:	AND the employee reports on Form 2106:*
An accountable plan with:		
Actual expense reimbursement: Adequate accounting made <u>and</u> excess returned.	No amount.	No amount.
Actual expense reimbursement: Adequate accounting and return of excess both required <u>but</u> excess not returned.	The excess amount as wages in box 1.	No amount.
Per diem or mileage allowance up to the federal rate. Adequate accounting made <u>and</u> excess returned.	No amount.	All expenses and reimbursements only if excess expenses are claimed. Otherwise, form is not filed.
Per diem or mileage allowance up to the federal rate. Adequate accounting and return of excess both required <u>but</u> excess not returned.	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 12 – it is not reported in box 1	No amount.
Per diem or mileage allowance exceeds the federal rate. Adequate accounting up to the federal rate only <u>and</u> excess not returned.	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 12 – it is not reported in box 1.	All expenses (and reimbursement reported on Form W-2 box 12) only if expenses in excess of the federal rate are claimed. Otherwise, form is not required.
A nonaccountable plan with:		
Either adequate accounting or return of excess, or both, not required by plan.	The entire amount as wages in box 1.	All expenses.
No reimbursement plan:	The entire amount as wages in box 1.	All expenses.
*You may be able to use Form 2106-EZ. See *Completing Forms 2106 and 2106-EZ.*		

Form 2106-EZ. You may be able to use the shorter Form 2106-EZ to claim your employee business expenses. You can use this form if you meet all of the following conditions.

1) You are an employee deducting expenses attributable to your job.
2) You were not reimbursed by your employer for your expenses (amounts included in box 1 of your Form W-2 are not considered reimbursements).
3) If you claim car expenses, you use the standard mileage rate.

Car expenses. If you used a car to perform your job as an employee, you may be able to deduct certain car expenses. These are generally figured in Part II of Form 2106, and then claimed on line 1, Column A, of Part I of Form 2106. Car expenses using the standard mileage rate can also be figured on Form 2106-EZ by completing Part II and line 1 of Part I.

Transportation expenses. Show your transportation expenses that did not involve overnight travel on line 2, Column A, of Form 2106 or on line 2, Part I, of Form 2106-EZ. Also include on this line business expenses you have for parking fees and tolls. Do not include expenses of operating your car or expenses of commuting between your home and work.

Employee business expenses other than meals and entertainment. Show your other employee business expenses on lines 3 and 4, Column A, of Form 2106 or lines 3 and 4 of Form 2106-EZ. Do not include expenses for meals and entertainment on those lines. Line 4 is for expenses such as gifts, educational expenses (tuition and books), office-in-the-home expenses, and trade and professional publications.

Meal and entertainment expenses. Show the full amount of your expenses for business-related meals and entertainment on line 5, Column B, of Form 2106. Include meals while away from your tax home overnight and other business meals and entertainment. Enter 50% of the line 8 meal and entertainment expenses on line 9, Column B, of Form 2106.

If you file Form 2106-EZ, enter the full amount of your meals and entertainment on the line to the left of line 5 and multiply the total by 50%. Enter the result on line 5.

Hours of service limits. If you are subject to the Department of Transportation's "hours of service" limits, use 80% instead of 50% for meals while away from your tax home.

Reimbursements. Enter on line 7 of Form 2106 the amounts your employer (or third party) reimbursed you that were ***not*** included in box 1 of your Form W-2. (You cannot use Form 2106-EZ.) This includes any reimbursement reported under code L in box 12 of Form W-2.

Allocating your reimbursement. If you were reimbursed under an accountable plan and want to deduct excess expenses that were not reimbursed, you may have to allocate your reimbursement. This is necessary if your employer pays your reimbursement in the following manner:

1) Pays you a single amount that covers meals and/or entertainment, as well as other business expenses, and
2) Does not clearly identify how much is for deductible meals and/or entertainment.

You must allocate the reimbursement so that you know how much to enter in Column A and Column B of line 7 of Form 2106.

Example. Rob's employer paid him an expense allowance of $12,000 this year under an accountable plan. The $12,000 payment consisted of $5,000 for airfare and $7,000 for entertainment and car expenses. The employer did not clearly show how much of the $7,000 was for the cost of deductible entertainment. Rob actually spent $14,000 during the year ($5,500 for airfare, $4,500 for entertainment, and $4,000 for car expenses).

Since the airfare allowance was clearly identified, Rob knows that $5,000 of the payment goes in Column A, line 7 of Form 2106. To allocate the remaining $7,000, Rob uses the worksheet from the instructions for Form 2106. His completed worksheet follows.

1. Enter the total amount of reimbursements your employer gave you that **were not** reported to you in box 1 of Form W-2	$7,000
2. Enter the total amount of your expenses for the periods covered by this reimbursement.	8,500
3. Of the amount on line 2, enter your total expense for meals and entertainment	4,500
4. Divide line 3 by line 2. Enter the result as a decimal (rounded to at least three places)	.529
5. Multiply line 1 by line 4. Enter the result here and in Column B, line 7	3,703
6. Subtract line 5 from line 1. Enter the result here and in Column A, line 7	$3,297

On line 7 of Form 2106, Rob enters $8,297 ($5,000 airfare and $3,297 of the $7,000) in Column A and $3,703 (of the $7,000) in Column B.

After you complete the form. After you have completed your Form 2106 or 2106-EZ, follow the directions on that form to deduct your expenses on the appropriate line of your tax return. For most taxpayers, this is line 21 of Schedule A (Form 1040). However, if you are a government official paid on a fee basis, a performing artist, an Armed Forces reservist, or a disabled employee with impairment-related work expenses, see *Special Rules,* later.

Limits on employee business expenses. Your employee business expenses may be subject to any of the two limits described next. These limits are figured in the following order on the specified form.

1) ***Limit on meals and entertainment.*** Certain meal and entertainment expenses are subject to a 50% limit. Employees figure this limit on line 9 of Form 2106 or line 5 of Form 2106-EZ. See *50% Limit* under *Entertainment Expenses,* earlier.

2) ***Limit on miscellaneous itemized deductions.*** Employees deduct employee business expenses (as figured on Form 2106 or 2106-EZ) on line 21 of Schedule A (Form 1040). Most miscellaneous itemized deductions, including employee business expenses, are subject to a 2%-of-adjusted-gross-income limit. This limit is figured on line 26 of Schedule A (Form 1040).

SPECIAL RULES

This section discusses special rules that apply only to government officials who are paid on a fee basis, Armed Forces reservists, performing artists, and disabled employees with impairment-related work expenses.

Armed Forces reservists traveling more than 100 miles from home. If you are a member of a reserve component of the Armed Forces of the United States and you travel more than 100 miles away from home in connection with your performance of services as a member of the reserves, you can deduct your travel expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. The amount of expenses you can deduct as an adjustment to gross income is limited to the regular federal per diem rate (for lodging, meals, and incidental expenses) and the standard mileage rate (for car expenses) plus any parking fees, ferry fees, and tolls.

Officials paid on a fee basis. Certain fee-basis officials can claim their employee business expenses whether or not they itemize their other deductions on Schedule A (Form 1040).

Fee-basis officials are persons who are employed by a state or local government and who are paid in whole or in part on a fee basis. They can deduct their business expenses in performing services in that job as an adjustment to gross income rather than as a miscellaneous itemized deduction.

If you are a fee-basis official, include your employee business expenses from line 10 of Form 2106 or line 6 of Form 2106-EZ in the total on line 24 of Form 1040.

Expenses of certain performing artists. If you are a performing artist, you may qualify to deduct your employee business expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. To qualify, you must meet ***all*** of the following requirements.

1) During the tax year, you perform services in the performing arts for at least two employers.
2) You receive at least $200 each from any two of these employers.
3) Your related performing-arts business expenses are more than 10% of your gross income from the performance of those services.
4) Your adjusted gross income is not more than $16,000 before deducting these business expenses.

Special rules for married persons. If you are married, you must file a joint return unless you lived apart from your spouse at all times during the tax year.

If you file a joint return, you must figure requirements (1), (2), and (3) separately for both you and your spouse. However, requirement (4) applies to your and your spouse's combined adjusted gross income.

Where to report. If you meet all of the above requirements, you should first complete Form 2106 or 2106-EZ. Then you include your performing-arts-related expenses from line 10 of Form 2106 or line 6 of Form 2106-EZ in the total on line 24 of Form 1040.

If you do not meet all of the above requirements, you do not qualify to deduct your expenses as an adjustment to gross income. Instead, you must complete Form 2106 or 2106-EZ and deduct your employee business expenses as an itemized deduction on line 21 of Schedule A (Form 1040).

Impairment-related work expenses of disabled employees. If you are an employee with a physical or mental disability, your impairment-related work expenses are not subject to the 2%-of-adjusted-gross-income limit that applies to most other employee business expenses. After you complete Form 2106 or 2106-EZ, enter your impairment-related work expenses from line 10 of Form 2106 or line 6 of Form 2106-EZ on line 28 of Schedule A (Form 1040), and identify the type and amount of this expense on the dotted line next to line 28. Enter your employee business expenses that are ***unrelated*** to your disability from line 10 of Form 2106 or line 6 of Form 2106-EZ on line 21 of Schedule A.

Impairment-related work expenses are your allowable expenses for attendant care at your workplace and other expenses you have in connection with your workplace that are necessary for you to be able to work. For more information, see chapter 21.

ILLUSTRATED EXAMPLE

Bill Wilson is an employee of Fashion Clothing Co. in Manhattan, NY. In a typical week, Bill leaves his home on Long Island on Monday morning and drives to Albany to exhibit the Fashion line for 3 days to prospective customers. Then he drives to Troy to show Fashion's new line of merchandise to Town Department Store, an old customer. While in Troy, he talks with Tom Brown, purchasing agent for Town Department Store, to discuss the new line. He later takes John Smith of Attire Co. out to dinner to discuss Attire Co.'s buying Fashion's new line of clothing.

Bill purchased his car on January 3, 2008. He uses the standard mileage rate for car expense purposes. He records his total mileage, business mileage, parking fees, and tolls for the year. Bill timely records his expenses and other pertinent information in a travel expense log (not shown). He obtains receipts for his expenses for lodging and for any other expenses of $75 or more.

During the year, Bill drove a total of 25,000 miles during the first half of 2011 of which 20,000 miles were for business. He answers all the questions in Part II of Form 2106-EZ and figures his car expense to be $10,200 (20,000 x 51 cents).

His total employee business expenses are shown in the following table.

Type of Expense	Amount
Parking fees and tolls	$520
Car expenses	10,200
Meals	3,861
Lodging, laundry, dry cleaning	18,318
Entertainment	3,250
Gifts, education, etc.	650
Total	**$36,799**

Bill received an allowance of $33,000 ($2,750 per month) to help offset his expenses. Bill did not have to account to his employer for the reimbursement, and the $33,000 was included as income in box 1 of his Form W-2.

Because Bill's reimbursement was included in his income and he is using the standard mileage rate for his car expenses, he files **Form 2106-EZ** with his tax return.

Form **2106-EZ**

Department of the Treasury
Internal Revenue Service (99)

Unreimbursed Employee Business Expenses

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2011

Attachment Sequence No. **129A**

Your name	Occupation in which you incurred expenses	Social security number
Bill Wilson	Sales	555 00 5555

You Can Use This Form Only if All of the Following Apply.

• You are an employee deducting ordinary and necessary expenses attributable to your job. An ordinary expense is one that is common and accepted in your field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be required to be considered necessary.

• You **do not** get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements for this purpose).

• If you are claiming vehicle expense, you are using the standard mileage rate for 2011.

Caution: *You can use the standard mileage rate for 2011* ***only if: (a)*** *you owned the vehicle and used the standard mileage rate for the first year you placed the vehicle in service,* ***or (b)*** *you leased the vehicle and used the standard mileage rate for the portion of the lease period after 1997.*

Part I Figure Your Expenses

1	Complete Part II. Multiply line 8a by 51¢ (.51) for miles driven **before** July 1, 2011, and by 55.5¢ (.555) for miles driven **after** June 30, 2011. Add the amounts , then enter the result here . . .	1	10,200
2	Parking fees, tolls, and transportation, including train, bus, etc., that **did not** involve overnight travel or commuting to and from work	2	520
3	Travel expense while away from home overnight, including lodging, airplane, car rental, etc. **Do not** include meals and entertainment	3	18,318
4	Business expenses not included on lines 1 through 3. **Do not** include meals and entertainment	4	650
5	Meals and entertainment expenses: $ 7,111 × 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 80% (.80) instead of 50%. For details, see instructions.)	5	3,556
6	**Total expenses.** Add lines 1 through 5. Enter here and on **Schedule A (Form 1040), line 21** (or on **Schedule A (Form 1040NR), line 7**). (Armed Forces reservists, fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter this amount.)	6	33,244

Part II Information on Your Vehicle. Complete this part **only** if you are claiming vehicle expense on line 1.

7 When did you place your vehicle in service for business use? (month, day, year) ▶ 1 / 3 / 2008

8 Of the total number of miles you drove your vehicle during 2011, enter the number of miles you used your vehicle for:

a Business 20,000 b Commuting (see instructions) 2,600 c Other 2,400

9 Was your vehicle available for personal use during off-duty hours? . . . . . ☑ Yes ☐ No

10 Do you (or your spouse) have another vehicle available for personal use? . . . . . ☑ Yes ☐ No

11a Do you have evidence to support your deduction? . . . . . ☑ Yes ☐ No

b If "Yes," is the evidence written? . . . . . ☑ Yes ☐ No

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 20604Q Form **2106-EZ** (2011)

CHAPTER 26 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. When determining your tax home, an assignment is considered temporary if it is expected to last:

   a) 6 months or less
   b) 12 months or less
   c) 18 months or less
   d) 24 months or less

2. You can generally deduct the travel expenses of a spouse that travels with you on a business trip.

   a) true
   b) false

3. Business related meal and entertainment expenses can be deducted up to which limit:

   a) 50% of the total costs
   b) 60% of the total costs
   c) 75% of the total costs
   d) 100% of the business related total costs

4. The maximum deductible amount allowed for business gifts provided to any one person during the tax year is:

   a) $10
   b) $25
   c) $50
   d) $100

5. You are not required to keep documentary evidence of any business expense if it is less than $75.

   a) true
   b) false

6. The regular federal per diem rate is the highest amount that the federal government will pay to its employees for lodging, meal, and incidental expenses while they are traveling away from home in a particular area.

   a) true
   b) false

CHAPTER 26 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A work assignment can last for more time than this period without affecting the taxpayer's tax home.

   B: Correct. An assignment is considered temporary if it is expected to last 12 months or less. You must determine whether your assignment is temporary or indefinite when you start work. If your assignment is temporary, your tax home does not change.

   C: Incorrect. A work assignment that is realistically expected to last more than 12 months at a single location is considered indefinite. In such a case, your tax home becomes the same as your new location.

   D: Incorrect. This time period is too long.

2. A: True is incorrect. Generally, you cannot deduct travel expenses incurred for the benefit of a spouse, dependent, or other individual who attends a business trip with the taxpayer.

   B: False is correct. To deduct travel expenses for someone who travels with you, that person must be an employee, have a bona fide business purpose for the travel, and would otherwise be allowed to deduct the travel expenses.

3. **A: Correct.** The 50% limit applies to employees or their employers, and to self-employed persons or their clients, depending on whether the expenses are reimbursed.

   B: Incorrect. The limit of deductibility of business-related meal and entertainment expenses is not 60%.

   C: Incorrect. The deductibility limit for business-related meal and entertainment expenses is not 75%.

   D: Incorrect. The correct percentage is less than 100%.

4. A: Incorrect. This amount is below the maximum amount allowed as a deductible business expense.

   B: Correct. You can deduct no more than $25 for business gifts that you give directly or indirectly to any one person during your tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive that gift.

   C: Incorrect. This amount exceeds the maximum amount deductible as a business gift.

   D: Incorrect. This amount is significantly higher than the allowable amount.

5. A: True is incorrect. Lodging expenses should be documented regardless of their amount unless you are under an accountable plan and you use the per diem allowance method.

   B: False is correct. You generally must have documentary evidence, such as receipts, canceled checks, or bills, to support your expenses. Your expenses, other than lodging, do not require documentary evidence if less than $75.

6. **A: True is correct.** The rates are different for different locations.

   B: False is incorrect. The other methods that can be used for per diems include the standard meal allowance method and the high-low rate method.

Chapter 27: Tax Benefits for Work-Related Education

I. Important Changes

Standard mileage rate. Generally, if you claim a business deduction for work-related education and you drive your car to and from school, the amount you can deduct for miles driven during 2011 is 51 cents a mile for the first half of the year, and 55.5 cents for the second half of 2011. See *Transportation Expenses* under *What Expenses Can Be Deducted*, for more information.

Temporarily extend the expanded exclusion for employer-provided educational assistance. An employee may exclude from gross income up to $5,250 for income and employment tax purposes per year of employer-provided education assistance. Prior to 2001, this incentive was temporary and only applied to undergraduate courses. The EGTRRA expanded this provision to graduate education and extended the provision for undergraduate and graduate education to the end of 2010. The 2010 Act extended the changes of this provision for an additional two years, through 2012.

II. Introduction

This chapter discusses work-related education expenses that you may be able to deduct as business expenses.

To claim such a deduction, you must:

- Be working,
- Itemize your deductions on Schedule A (Form 1040) if you are an employee,
- File Schedule C (Form 1040) or Schedule F (Form 1040) if you are self-employed, and
- Have expenses for education that meet the requirements discussed under *Qualifying Work-Related Education*.

If you are an employee and able to itemize your deductions, you may be able to claim a deduction for the expenses you pay for your work-related education. Your deduction will be the amount by which your qualifying work-related education expenses plus other job and certain miscellaneous expenses is greater than 2% of your adjusted gross income. See chapter 28.

If you are self-employed, you deduct your expenses for qualifying work-related education directly from your self-employment income.

Your work-related educational expenses may also qualify you for other tax benefits, such as the tuition and fees deduction and the American opportunity and lifetime learning credits. You may qualify for these other benefits even if you do not meet the requirements listed above.

Also, keep in mind that your work-related educational expenses may qualify you to claim more than one tax benefit. Generally, you may claim any number of benefits as long as you use different expenses to figure each one.

III. Qualifying Work-Related Education

You can deduct the costs of qualifying work-related education as business expenses. This is education that meets ***at least one*** of the following two tests.

1) The education is ***required by your employer or the law*** to keep your present salary, status, or job. The required education must serve a bona fide business purpose of your employer.
2) The education ***maintains or improves skills*** needed in your present work.

However, even if the education meets one or both of the above tests, it is not qualifying work-related education if it:

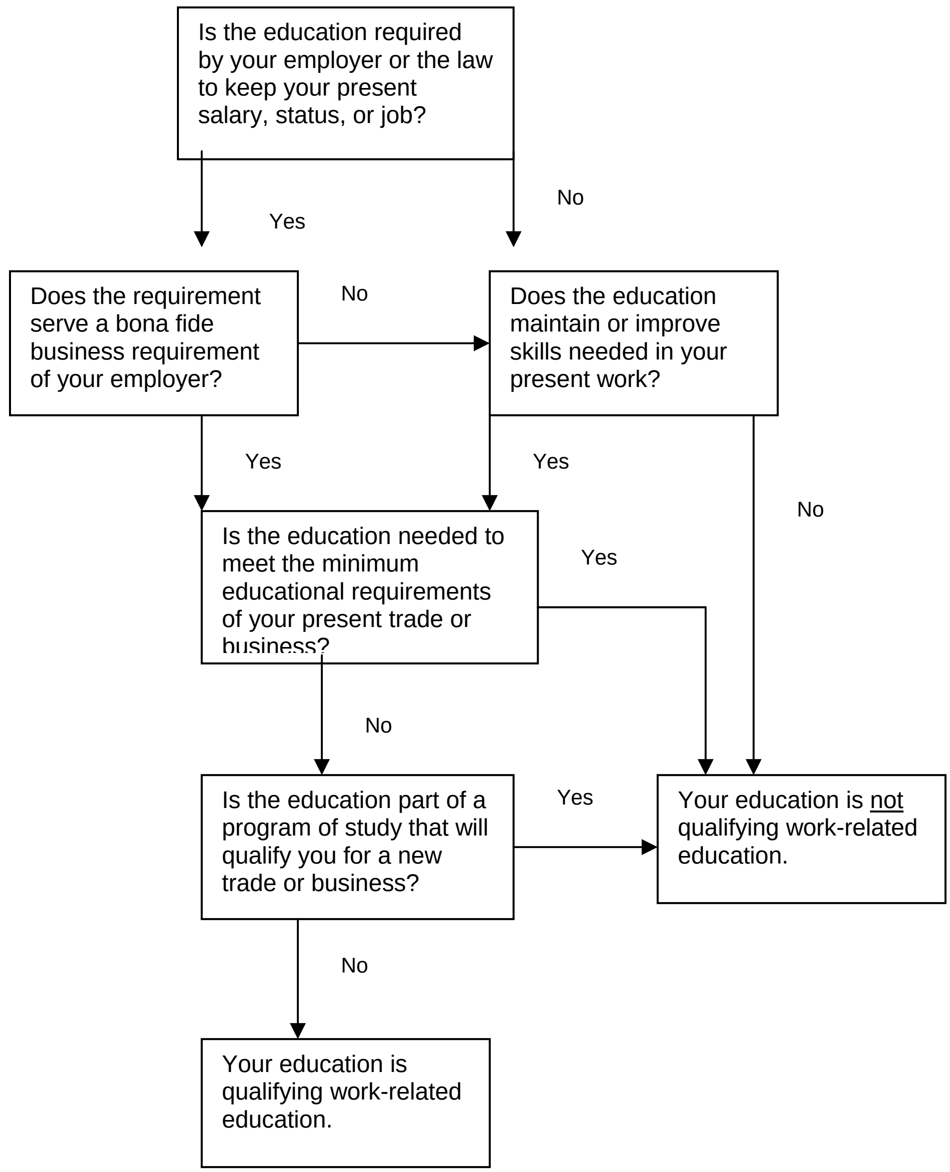
1) Is needed to meet the ***minimum educational requirements*** of your present trade or business, or
2) Is part of a program of study that will ***qualify you for a new trade or business***.

You can deduct the costs of qualifying work-related education as a business expense even if the education could lead to a degree.

You can use *Figure 27-A* as a quick check to see if your education qualifies.

Figure 27-A. Does Your Work-Related Education Qualify?

Start Here



EDUCATION REQUIRED BY EMPLOYER OR BY LAW

Once you have met the minimum educational requirements for your job, your employer or the law may require you to get more education. This additional education is qualifying education if all three of the following requirements are met.

1) It is required for you to keep your present salary, status, or job,
2) The requirement serves a business purpose of your employer, and
3) The education is not part of a program that will qualify you for a new trade or business.

When you get more education than your employer or the law requires, the additional education can be qualifying education only if it maintains or improves skills required in your present work. See *Education To Maintain or Improve Skills.*

Example. You are a teacher who has satisfied the minimum requirements for teaching. Your employer requires you to take an additional college course each year to keep your teaching job. If the courses will not qualify you for a new trade or business, they are qualifying education even if you eventually receive a master's degree and an increase in salary because of this extra education.

EDUCATION TO MAINTAIN OR IMPROVE SKILLS

If your education is not required by your employer or the law, it can be qualifying work-related education only if it maintains or improves skills needed in your present work. This could include refresher courses, courses on current developments, and academic or vocational courses.

Example. You repair televisions, radios, and stereo systems for XYZ Store. To keep up with the latest changes, you take special courses in radio and stereo service. These courses maintain and improve skills required in your work.

Maintaining skills vs. qualifying for new job. Education to maintain or improve skills needed in your present work is not qualifying education if it will also qualify you for a new trade or business.

Temporary absence. If you stop working for a year or less in order to get education to maintain or improve skills needed in your present work and then return to the same general type of work, your absence is considered temporary. Education that you get during a temporary absence is qualifying education if it maintains or improves skills needed in your present work.

Example. You quit your biology research job to become a full-time biology graduate student for one year. If you return to work in biology research after completing the courses, the education is related to your present work even if you do not go back to work with the same employer.

Indefinite absence. If you stop work for more than a year, your absence from your job is considered indefinite. Education during an indefinite absence, even if it maintains or improves skills needed in the work from which you are absent, is considered to qualify you for a new trade or business. Therefore, it is not qualifying work-related education.

EDUCATION TO MEET MINIMUM REQUIREMENTS

Education you need to meet the minimum educational requirements for your present trade or business is not qualifying work-related education. The minimum educational requirements are determined by:

1) Laws and regulations,
2) Standards of your profession, trade, or business, and
3) Your employer.

Once you have met the minimum educational requirements that were in effect when you were hired, you do not have to meet any new minimum educational requirements. This means that if the minimum requirements change after you were hired, any education you need to meet the new requirements can be qualifying education.

Example 1. You are a full-time engineering student. Although you have not received your degree or certification, you work part time as an engineer for a firm that will employ you as a full-time engineer after you finish college. Although your college engineering courses improve your skills in your present job, they are also needed to meet the minimum job requirements for a full-time engineer. The education is not qualifying work-related education.

Example 2. You are an accountant and you have met the minimum educational requirements of your employer. Your employer later changes the minimum educational requirements and requires you to take college courses to keep your job. These additional courses can be qualifying work-related education because you have already satisfied the minimum requirements that were in effect when you were hired.

Requirements for Teachers

States or school districts usually set the minimum educational requirements for teachers. The requirement is the college degree or the minimum number of college hours usually required of a person hired for that position.

If there are no requirements, you will have met the minimum educational requirements when you become a faculty member. You generally will be considered a faculty member when ***one or more*** of the following occurs.

1) You have tenure.
2) Your years of service count toward obtaining tenure.
3) You have a vote in faculty decisions.
4) Your school makes contributions for you to a retirement plan other than social security or a similar program.

Example 1. The law in your state requires beginning secondary school teachers to have a bachelor's degree, including 10 professional education courses. In addition, to keep the job, a teacher must complete a fifth year of training within 10 years from the date of hire. If the employing school certifies to the state Department of Education that qualified teachers cannot be found, the school can hire persons with only 3 years of college. However, to keep their jobs, these teachers must get a bachelor's degree and the required professional education courses within 3 years.

Under these facts, the bachelor's degree, whether or not it includes the 10 professional education courses, is considered the minimum educational requirement for qualification as a teacher in your state.

If you have all the required education except the fifth year, you have met the minimum educational requirements. The fifth year of training is qualifying work-related education unless it is part of a program of study that will qualify you for a new trade or business.

Example 2. Assume the same facts as in *Example 1* except that you have a bachelor's degree and only six professional education courses. The additional four education courses can be qualifying work-related education. Although you do not have all the required courses, you have already met the minimum educational requirements.

Example 3. Assume the same facts as in *Example 1* except that you are hired with only 3 years of college. The courses you take that lead to a bachelor's degree (including those in education) are not qualifying work-related education. They are needed to meet the minimum educational requirements for employment as a teacher.

Example 4. You have a bachelor's degree and you work as a temporary instructor at a university. At the same time, you take graduate courses toward an advanced degree. The rules of the university state that you can become a faculty member only if you get a graduate degree. Also, you can keep your job as an instructor only as long as you show satisfactory progress toward getting this degree. You have not met the minimum educational requirements to qualify you as a faculty member. The graduate courses are not qualifying work-related education.

Certification in a new state. Once you have met the minimum educational requirements for teachers for your state, you are considered to have met the minimum educational requirements in all states. This is true even if you must get additional education to be certified in another state. Any additional education you need is qualifying work-related education. You have already met the minimum requirements for teaching. Teaching in another state is not a new trade or business.

Example. You hold a permanent teaching certificate in State A and are employed as a teacher in that state for several years. You move to State B and are promptly hired as a teacher. You are required, however, to complete certain prescribed courses to get a permanent teaching certificate in State B. These additional courses are qualifying work-related education because the teaching position in State B involves the same general kind of work for which you were qualified in State A.

EDUCATION THAT QUALIFIES YOU FOR A NEW TRADE OR BUSINESS

Education that is part of a program of study that will qualify you for a new trade or business is not qualifying work-related education. This is true even if you do not plan to enter that trade or business.

If you are an employee, a change of duties that involves the same general kind of work is not a new trade or business.

Example 1. You are an accountant. Your employer requires you to get a law degree at your own expense. You register at a law school for the regular curriculum that leads to a law degree. Even if you do not intend to become a lawyer, the education is not qualifying because the law degree will qualify you for a new trade or business.

Example 2. You are a general practitioner of medicine. You take a 2-week course to review developments in several specialized fields of medicine. The course does not qualify you for a new profession. It is qualifying work-related education because it maintains or improves skills required in your present profession.

Example 3. While working in the private practice of psychiatry, you enter a program to study and train at an accredited psychoanalytic institute. The program will lead to qualifying you to practice psychoanalysis. The psychoanalytic training does not qualify you for a new profession. It is qualifying work-related education because it maintains or improves skills required in your present profession.

Bar or CPA Review Course

Review courses to prepare for the bar examination or the certified public accountant (CPA) examination are not qualifying work-related education. They are part of a program of study that can qualify you for a new profession.

Teaching and Related Duties

All teaching and related duties are considered the same general kind of work. A change in duties in any of the following ways is not considered a change to a new business.

1) Elementary school teacher to secondary school teacher.
2) Teacher of one subject, such as biology, to teacher of another subject, such as art.
3) Classroom teacher to guidance counselor.
4) Classroom teacher to school administrator.

IV. What Expenses Can Be Deducted?

If your education meets the requirements described earlier under *Qualifying Work-Related Education,* you can generally deduct your education expenses as business expenses. If you are not self-employed, you can deduct business expenses only if you itemize your deductions.

You cannot deduct expenses related to tax-exempt and excluded income.

Deductible expenses. The following educational expenses can be deducted.

- Tuition, books, supplies, lab fees, and similar items.
- Certain transportation and travel costs.
- Other educational expenses, such as costs of research and typing when writing a paper as part of an educational program.

Nondeductible expenses. Educational expenses do not include personal or capital expenses. For example, you cannot deduct the dollar value of vacation time or annual leave you take to attend classes. This amount is a personal expense.

Unclaimed reimbursement. If you do not claim reimbursement that you are entitled to receive from your employer, you cannot deduct the expenses that apply to the reimbursement.

Example. Your employer agrees to pay your educational expenses if you file a voucher showing your expenses. You do not file a voucher, and you do not get reimbursed. Because you did not file a voucher, you cannot deduct the expenses on your tax return.

TRANSPORTATION EXPENSES

If your education qualifies, you can deduct local transportation costs of going directly from work to school. If you are regularly employed and go to school on a ***temporary basis***, you can also deduct the costs of returning from school to home.

Attendance on a temporary basis. You go to school on a temporary basis if either of the following situations applies to you.

1) Your attendance at school is realistically expected to last 1 year or less and does indeed last for 1 year or less.
2) Initially, your attendance at school is realistically expected to last 1 year or less, but at a later date your attendance is reasonably expected to last more than 1 year. Your attendance will be considered temporary up to the date you determine it will last more than 1 year.

Note. If you are in either situation (1) or (2) above, your attendance is not temporary if facts and circumstances indicate otherwise.

Attendance not on a temporary basis. You do not go to school on a temporary basis if either of the following situations apply to you.

1) Your attendance at school is realistically expected to last more than 1 year. It does not matter how long you actually attend.
2) Initially, your attendance at school is realistically expected to last 1 year or less, but at a later date your attendance is reasonably expected to last more than 1 year. Your attendance is not temporary after the date you determine it will last more than 1 year.

Deductible Transportation Expenses

If you are regularly employed and go directly from home to school on a temporary basis, you can deduct the round-trip costs of transportation between your home and school. This is true regardless of the location of the school, the distance traveled, or whether you attend school on nonwork days.

Transportation expenses include the actual costs of bus, subway, cab, or other fares, as well as the costs of using your car. Transportation expenses do not include amounts spent for travel, meals, or lodging while you are away from home overnight.

Example 1. You regularly work in a nearby town, and go directly from work to home. You also attend school every work night for 3 months to take a course that improves your job skills. Since you are attending school on a temporary basis, you can deduct your daily round-trip transportation expenses in going between home and school. This is true regardless of the distance traveled.

Example 2. Assume the same facts as in *Example 1* except that on certain nights you go directly from work to school and then home. You can deduct your transportation expenses from your regular work site to school and then home.

Example 3. Assume the same facts as in *Example 1* except that you attend the school for 9 months on Saturdays, nonwork days. Since you are attending school on a temporary basis, you can deduct your round-trip transportation expenses in going between home and school.

Example 4. Assume the same facts as in *Example 1* except that you attend classes twice a week for 15 months. Since your attendance in school is not considered temporary, you cannot deduct your transportation expenses in going between home and school. If you go directly from work to school, you can deduct the one-way transportation expenses of going from work to school. If you go from work to home to school and return home, your transportation expenses cannot be more than if you had gone directly from work to school.

Using your car. If you use your car (whether you own or lease it) for transportation to school, you can deduct your actual expenses or use the standard mileage rate to figure the amount you can deduct. Whichever method you use, you can also deduct parking fees and tolls. See *Car Expenses* in chapter 26 for information on deducting your actual expenses of using a car.

TRAVEL EXPENSES

You can deduct expenses for travel, meals (see *50% Limit on Meals*, later), and lodging if you travel overnight to obtain qualified work-related education.

Travel expenses for qualifying work-related education are treated the same as travel expenses for other employee business purposes. For more information, see chapter 26.

Caution. *You cannot deduct expenses for personal activities, such as sightseeing, visiting, or entertaining.*

Mainly personal travel. If your travel away from home is mainly personal, you cannot deduct all of your expenses for travel, meals, and lodging. You can deduct only your expenses for lodging and 50% of your expenses for meals during the time you attend the qualified educational activities.

Whether a trip's purpose is mainly personal or educational depends upon the facts and circumstances. An important factor is the comparison of time spent on personal activities with time spent on educational activities. If you spend more time on personal activities, the trip is considered mainly educational only if you can show a substantial nonpersonal reason for traveling to a particular location.

Example 1. John works in Newark, New Jersey. He traveled to Chicago to take a deductible 1-week course at the request of his employer. His main reason for going to Chicago was to take the course.

While there, he took a sightseeing trip, entertained some friends, and took a side trip to Pleasantville for a day.

Since the trip was mainly for business, John can deduct his round-trip airfare to Chicago. He cannot deduct his transportation expenses of going to Pleasantville. He can deduct only the meals (subject to the 50% limit) and lodging connected with his educational activities.

Example 2. Sue works in Boston. She went to a university in Michigan to take a course for work. The course is qualifying work-related education.

She took one course, which is one-fourth of a full course load of study. She spent the rest of the time on personal activities. Her reasons for taking the course in Michigan were all personal.

Sue's trip is mainly personal because three-fourths of her time is considered personal time. She cannot deduct the cost of her round-trip train ticket to Michigan. She can deduct one-fourth of the meals (subject to the 50% limit) and lodging costs for the time she attended the university.

Example 3. Dave works in Nashville and recently traveled to California to take a 2-week seminar. The seminar is qualifying work-related education.

While there, he spent an extra 8 weeks on personal activities. The facts, including the extra 8-week stay, show that his main purpose was to take a vacation.

Dave cannot deduct his round-trip airfare or his meals and lodging for the 8 weeks. He can deduct only his expenses for meals (subject to the 50% limit) and lodging for the 2 weeks he attended the seminar.

Cruises and conventions. Certain cruises and conventions offer seminars or courses as part of their itinerary. Even if the seminars or courses are work related, your deduction for travel may be limited. This applies to:

1) Travel by ocean liner, cruise ship, or other form of luxury water transportation, and
2) Conventions outside the North American area.

For a discussion of the limits on travel expense deductions that apply to cruises and conventions, see *Luxury Water Travel* and *Conventions* in Publication 463.

50% limit on meals. You can deduct only 50% of the cost of your qualifying meals while traveling away from home to obtain education. You cannot have been reimbursed for the meals.

Employees must use Form 2106 or Form 2106-EZ to apply the 50% limit.

Travel as Education

You cannot deduct the cost of travel as a form of education even if it is directly related to your duties in your work or business.

Example. You are a French language teacher. While on sabbatical leave granted for travel, you traveled through France to improve your knowledge of the French language. You chose your itinerary and most of your activities to improve your French language skills. You cannot deduct your travel expenses as educational expenses. This is true even if you spent most of your time learning French by visiting French schools and families, attending movies or plays, and engaging in similar activities.

NO DOUBLE BENEFIT ALLOWED

You cannot do either of the following.

- Deduct work-related education expenses as business expenses if you benefit from these expenses under any other provision of the law, for example, as a tuition and fees deduction, or an education credit.
- Deduct work-related education expenses paid with tax-free scholarship, grant, or employer-provided educational assistance. See *Adjustments to Qualifying Work-Related Education Expenses*, below.

Adjustments to Qualifying Work-Related Education Expenses

If you pay qualifying work-related education expenses with certain tax-free funds, you cannot claim a deduction for those amounts. You must reduce the qualifying expenses by the amount of any tax-free education assistance you received.

Tax-free educational assistance includes:

- The tax-free part of scholarships and fellowships (see chapter 1 of Publication 970),
- Pell grants (see chapter 1 of Publication 970),
- Employer-provided educational assistance (see chapter 11 of Publication 970),
- Veterans' educational assistance (see chapter 1 of Publication 970), and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received for education assistance.

Amounts that do not reduce qualifying work-related education expenses. Do not reduce the qualifying work-related education expenses by amounts paid with funds the student receives as:

- Payment for services, such as wages,
- A loan,
- A gift,
- An inheritance, or
- A withdrawal from the student's personal savings.

Also, do not reduce the qualifying work-related education expenses by any scholarship or fellowship reported as income on the student's return or any scholarship which, by its terms, cannot be applied to qualifying work-related education expenses.

V. Reimbursements

How you treat reimbursements depends on the arrangement you have with your employer.

There are two basic types of reimbursement arrangements – accountable plans and nonaccountable plans. You can tell the type of plan you are reimbursed under by the way the reimbursement is reported on your Form W-2.

For information about how to treat reimbursements under both accountable and nonaccountable plans, see *Reimbursements* in chapter 26.

VI. Deducting Business Expenses

Self-employed persons and employees report business expenses differently.

The following information explains what forms you must use to deduct the cost of your qualifying work-related education as a business expense.

SELF-EMPLOYED PERSONS

If you are self-employed, you must report the cost of your qualifying work-related education on the appropriate form used to report your business income and expenses (Schedule C, C-EZ, or F). If your educational expenses include expenses for a car or truck, travel, or meals, report them the same way you report other business expenses for those items. See the instructions for the form you file for information on how to complete it.

EMPLOYEES

If you are an employee, you can deduct the cost of qualifying work-related education only if you:

1) Did not receive any reimbursement from your employer,
2) Were reimbursed under a nonaccountable plan (amount is included in box 1 of Form W-2), or
3) Received reimbursement under an accountable plan, but the amount received was less than your expenses.

If either (1) or (2) applies, you can deduct the total qualifying cost. If (3) applies, you can deduct only the qualifying costs that were more than your reimbursement.

In order to deduct the cost of your qualifying work-related education as a business expense, include the amount with your deduction for any other employee business expenses on line 21 of Schedule A (Form 1040). (Special rules for expenses of certain performing artists and fee-basis officials and for impairment-related work expenses are explained later in this chapter.) This deduction is subject to the 2%-of-adjusted-gross-income limit that applies to most miscellaneous itemized deductions.

Form 2106 or 2106-EZ. To figure your deduction for employee business expenses, including qualifying work-related education, you generally must complete Form 2106 or Form 2106-EZ.

Form not required. Do not complete either Form 2106 or Form 2106-EZ if:

- All reimbursements, if any, were included in box 1 of your Form W-2, and
- You are not claiming travel, transportation, meal, or entertainment expenses.

If you meet both of these requirements, enter the expenses directly on line 21 of Schedule A (Form 1040). (Special rules for expenses of certain performing artists and fee-basis officials and for impairment-related work expenses are explained later.)

Using Form 2106-EZ. This form is shorter and easier to use than Form 2106. Generally, you can use this form if:

- All reimbursements, if any, are included in box 1 of your Form W-2, and
- You are using the standard mileage rate if you are claiming vehicle expenses.

If you do not meet both of these requirements, use Form 2106.

PERFORMING ARTISTS AND FEE-BASIS OFFICIALS

If you are a qualified performing artist, or a state (or local) government official who is paid in whole or in part on a fee basis, you can deduct the cost of your qualifying work-related education as an adjustment to gross income rather than as an itemized deduction.

Include the cost of your qualifying work-related education with any other employee business expenses on Form 1040, line 24. You do not have to itemize your deductions on Schedule A (Form 1040), and, therefore, the deduction is not subject to the 2%-of-adjusted-gross-income limit. You must complete Form 2106 or 2106-EZ to figure your deduction, even if you meet the requirements described earlier under *Form not required*.

IMPAIRMENT-RELATED WORK EXPENSES

If you are disabled and have impairment-related work expenses that are necessary for you to be able to get qualifying work-related education, you can deduct these expenses on line 28 of Schedule A (Form 1040). They are not subject to the 2%-of-adjusted-gross-income limit. To deduct these expenses, you must complete Form 2106 or 2106-EZ, even if you meet the requirements described earlier under *Form not required*.

CHAPTER 27 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. You can deduct the costs of qualifying work-related education as business expenses if it is needed to meet the minimum educational requirements of your present trade or business.

   a) true
   b) false

CHAPTER 27 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. Even if education is required by your employer or by law or the education maintains or improves skills needed in your present work, if it is needed to meet the minimum educational requirements of your present trade or business it is not qualifying work-related education.

   B: False is correct. It is also not qualifying work-related education if it is part of a program of study that will qualify you for a new trade or business.

Chapter 28: Miscellaneous Deductions

I. What's New

Losses from Ponzi-type investments. Special rules apply to theft losses from Ponzi-type investment arrangements. See Form 4684 and Instructions for more information.

Standard mileage rate. The 2011 rate for business use of a vehicle is 51 cents per mile for the first half of 2011, and 55.5 cents during the second half.

II. Introduction

This chapter explains which expenses you can claim as miscellaneous itemized deductions on **Schedule A** (Form 1040). You must reduce the total of most miscellaneous itemized deductions by 2% of your adjusted gross income. This chapter covers the following topics.

- Deductions subject to the 2% limit.
- Deductions not subject to the 2% limit.
- Expenses you cannot deduct.

III. Deductions Subject to the 2% Limit

You can deduct certain expenses as miscellaneous itemized deductions on Schedule A (Form 1040). You can claim the amount of expenses that is more than 2% of your adjusted gross income. You figure your deduction on Schedule A by subtracting 2% of your adjusted gross income from the total amount of these expenses. Your adjusted gross income is the amount on line 38, Form 1040.

Generally, you apply the 2% limit after you apply any other deduction limit. For example, you apply the 50% (or 80%) limit on business-related meals and entertainment (discussed in chapter 26) before you apply the 2% limit.

Deductions subject to the 2% limit are discussed in the three categories in which you report them on Schedule A.

1) ***Unreimbursed employee expenses (line 21).***
2) ***Tax preparation fees (line 22).***
3) ***Other expenses (line 23).***

UNREIMBURSED EMPLOYEE EXPENSES (LINE 21)

You can deduct only unreimbursed employee expenses that are:

1) Paid or incurred during your tax year,
2) For carrying on your trade or business of being an employee, and
3) Ordinary and necessary.

An expense is ***ordinary*** if it is common and accepted in your type of trade, business, or profession. An expense is ***necessary*** if it is appropriate and helpful to your business. An expense does not have to be required to be considered necessary.

Examples of unreimbursed employee expenses are listed next. The list is followed by discussions of additional unreimbursed employee expenses.

- Business bad debt of an employee.
- Education that is work related. (See chapter 27.)
- Legal fees related to your job.
- Licenses and regulatory fees.
- Malpractice insurance premiums.
- Medical examinations required by an employer.
- Occupational taxes.
- Passport for a business trip.
- Subscriptions to professional journals and trade magazines related to your work.
- Travel, transportation, entertainment, gift, and car expenses related to your work. (See chapter 26.)

Business Liability Insurance

You can deduct insurance premiums you paid for protection against personal liability for wrongful acts on the job.

Damages for Breach of Employment Contract

If you break an employment contract, you can deduct damages you pay your former employer if the damages are attributable to the pay you received from that employer.

Depreciation on Computers

You can claim a depreciation deduction for a computer that you use in your work as an employee if its use is:

1) For the convenience of your employer, and
2) Required as a condition of your employment.

Tax Relief and Simplification for Cell Phone Deductions

The Small Business Jobs Act changes the rules so that the use of cell phones can be deducted without burdensome extra documentation.

Dues to Chambers of Commerce and Professional Societies

You may be able to deduct dues paid to professional organizations (such as bar associations and medical associations) and to chambers of commerce and similar organizations, if membership helps you carry out the duties of your job. Similar organizations include:

- Boards of trade,
- Business leagues,
- Civic or public service organizations,
- Real estate boards, and
- Trade associations.

Lobbying and political activities. You may not be able to deduct that part of your dues that is for certain lobbying and political activities. See *Dues used for lobbying* under *Lobbying Expenses,* later.

Educator Expenses Over Limit

If you were an educator in 2011 and you had qualified educator expenses that you cannot deduct as an adjustment to gross income, you can deduct the rest of those expenses that are ordinary and necessary as an itemized deduction subject to the 2% limit.

Home Office

If you use a part of your home regularly and exclusively for business purposes, you may be able to deduct a part of the operating expenses and depreciation of your home.

You can claim this deduction for the business use of a part of your home only if you use that part of your home ***regularly*** and ***exclusively:***

1) As your principal place of business for any trade or business,
2) As a place to meet or deal with your patients, clients, or customers in the normal course of your trade or business, or
3) In the case of a separate structure not attached to your home, in connection with your trade or business.

The regular and exclusive business use must be ***for the convenience of your employer*** and not just appropriate and helpful in your job.

Job Search Expenses

You can deduct certain expenses you have in looking for a new job in your present occupation, even if you do not get a new job.

You cannot deduct job search expenses if:

1) You are looking for a job in a new occupation,
2) There was a substantial break between the ending of your last job and your looking for a new one, or
3) You are looking for a job for the first time.

Employment and outplacement agency fees. You can deduct employment and outplacement agency fees you pay in looking for a new job in your present occupation.

Employer pays you back. If, in a later year, your employer pays you back for employment agency fees, you must include the amount you receive in your gross income up to the amount of your tax benefit in the earlier year. (See *Recoveries* in chapter 12.)

Employer pays the employment agency. If your employer pays the fees directly to the employment agency and you are not responsible for them, you do not include them in your gross income.

Resume. You can deduct amounts you spend for preparing and mailing copies of a resume to prospective employers if you are looking for a new job in your present occupation.

Travel and transportation expenses. If you travel to an area and, while there, you look for a new job in your present occupation, you may be able to deduct travel expenses to and from the area. You can deduct the travel expenses if the trip is primarily to look for a new job. The amount of time you spend on personal activity compared to the amount of time you spend in looking for work is important in determining whether the trip is primarily personal or is primarily to look for a new job.

Even if you cannot deduct the travel expenses to and from an area, you can deduct the expenses of looking for a new job in your present occupation while in the area.

You may choose to use the standard mileage rate to figure your car expenses.

Licenses and Regulatory Fees

You can deduct the amount you pay each year to state or local governments for licenses and regulatory fees for your trade, business, or profession.

Occupational Taxes

You can deduct an occupational tax charged at a flat rate by a locality for the privilege of working or conducting a business in the locality. If you are an employee, you can claim occupational taxes only as a miscellaneous deduction subject to the 2% limit; you cannot claim them as a deduction for taxes elsewhere on your return.

Repayment of Income Aid Payment

An "income aid payment" is one that is received under an employer's plan to aid employees who lose their jobs because of lack of work. If you repay a lump-sum income aid payment that you received and included in income in an earlier year, you can deduct the repayment.

Research Expenses of a College Professor

If you are a college professor, you can deduct research expenses, including travel expenses, for teaching, lecturing, or writing and publishing on subjects that relate directly to the field of your teaching duties. You must have undertaken the research as a means of carrying out the duties expected of a professor and without expectation of profit apart from salary. However, you cannot deduct the cost of travel as a form of education.

Tools Used in Your Work

Generally, you can deduct amounts you spend for tools used in your work if the tools wear out and are thrown away within 1 year from the date of purchase. You can depreciate the cost of tools that have a useful life substantially beyond the tax year.

Union Dues and Expenses

You can deduct dues and initiation fees you pay for union membership.

You can also deduct assessments for benefit payments to unemployed union members. However, you cannot deduct the part of the assessments or contributions that provides funds for the payment of sick, accident, or death benefits. Also, you cannot deduct contributions to a pension fund, even if the union requires you to make the contributions.

You may not be able to deduct amounts you pay to the union that are related to certain lobbying and political activities. See *Lobbying Expenses* under *Nondeductible Expenses,* later.

Work Clothes and Uniforms

You can deduct the cost and upkeep of work clothes if the following two requirements are met.

1) You must wear them as a condition of your employment.
2) The clothes are not suitable for everyday wear.

Examples of workers who may be able to deduct the cost and upkeep of work clothes are: delivery workers, firefighters, health care workers, law enforcement officers, letter carriers, professional athletes, and transportation workers (air, rail, bus, etc.).

Musicians and entertainers can deduct the cost of theatrical clothing and accessories if they are not suitable for everyday wear.

However, work clothing consisting of white cap, white shirt or white jacket, white bib overalls, and standard work shoes, which a painter is required by his union to wear on the job, is not distinctive in character or in the nature of a uniform. Similarly, the costs of buying and maintaining blue work clothes worn by a welder at the request of a foreman are not deductible.

Protective clothing. You can deduct the cost of protective clothing required in your work, such as safety shoes or boots, safety glasses, hard hats, and work gloves.

Examples of workers who may be required to wear safety items are: carpenters, cement workers, chemical workers, electricians, fishing boat crew members, machinists, oil field workers, pipe fitters, steamfitters, and truck drivers.

Military uniforms. You generally cannot deduct the cost of your uniforms if you are on full-time active duty in the armed forces. However, if you are an armed forces reservist, you can deduct the unreimbursed cost of your uniform if military regulations restrict you from wearing it except while on duty as a reservist. In figuring the deduction, you must reduce the cost by any nontaxable allowance you receive for these expenses.

If local military rules do not allow you to wear fatigue uniforms when you are off duty, you can deduct the amount by which the cost of buying and keeping up these uniforms is more than the uniform allowance you receive.

You can deduct the cost of your uniforms if you are a civilian faculty or staff member of a military school.

<u>TAX PREPARATION FEES (LINE 22)</u>

You can usually deduct tax preparation fees in the year you pay them. Thus, on your 2011 return, you can deduct fees paid in 2011 for preparing your 2010 return. These fees include the cost of tax preparation software programs and tax publications. They also include any fee you paid for electronic filing of your return. However, if you paid your tax by credit card, you cannot deduct the convenience fee you were charged.

OTHER EXPENSES (LINE 23)

You can deduct certain other expenses as miscellaneous itemized deductions subject to the 2%-of-adjusted-gross-income limit. These are expenses you pay:

1) To produce or collect income that must be included in your gross income,
2) To manage, conserve, or maintain property held for producing such income, or
3) To determine, contest, pay, or claim a refund of any tax.

You can deduct expenses you pay for the purposes in (1) and (2) above only if they are reasonably and closely related to these purposes. Some of these other expenses are explained in the following discussions.

Appraisal Fees

You can deduct appraisal fees if you pay them to figure a casualty loss or the fair market value of donated property.

Certain Casualty and Theft Losses

You can deduct a casualty or theft loss as a miscellaneous itemized deduction subject to the 2% limit if you used the damaged or stolen property in performing services as an employee. First report the loss in Section B of Form 4684, *Casualties and Thefts.* You may also have to include the loss on Form 4797, *Sales of Business Property,* if you are otherwise required to file that form. Your deduction is the amount of the loss included on lines 32 and 38b of Form 4684 and line 18a of Form 4797. For other casualty and theft losses, see chapter 25.

Clerical Help and Office Rent

You can deduct office expenses, such as rent and clerical help, that you have in connection with your investments and collecting the taxable income on them.

Credit or Debit Card Convenience Fees

You can deduct the convenience fee charged by the card processor for paying your income tax (including estimated tax payments) by credit or debit card. The fees are deductible in the year paid.

Depreciation on Home Computer

You can deduct depreciation on your home computer if you use it to produce income (for example, to manage your investments that produce taxable income). You generally must depreciate the computer using the straight line method over the Alternative Depreciation System (ADS) recovery period.

Excess Deductions of an Estate

If an estate's total deductions in its last tax year are more than its gross income for that year, the beneficiaries succeeding to the estate's property can deduct the excess. Do not include deductions for the estate's personal exemption and charitable contributions when figuring the estate's total deductions. The beneficiaries can claim the deduction only for the tax year in which, or with which, the estate terminates, whether the year of termination is a normal year or a short tax year.

Fees to Collect Interest and Dividends

You can deduct fees you pay to a broker, bank, trustee, or similar agent to collect your taxable bond interest or dividends on shares of stock. But you cannot deduct a fee you pay to a broker to buy investment property, such as stocks or bonds. You must add the fee to the cost of the property.

You cannot deduct the fee you pay to a broker to sell securities. You can use the fee only to figure gain or loss from the sale. See the instructions for columns (d) and (e) of Schedule D (Form 1040) for information on how to report the fee.

Hobby Expenses

You can generally deduct hobby expenses, but only up to the amount of hobby income. A hobby is not a business because it is not carried on to make a profit.

Indirect Deductions of Pass-Through Entities

Pass-through entities include partnerships, S corporations, and mutual funds that are not publicly offered. Deductions of pass-through entities are passed through to the partners or shareholders. The partners or shareholders can deduct their share of passed-through deductions for investment expenses as miscellaneous itemized deductions subject to the 2% limit.

Example. You are a member of an investment club that is formed solely to invest in securities. The club is treated as a partnership. The partnership's income is solely from taxable dividends, interest, and gains from sales of securities. In this case, you can deduct your share of the partnership's operating expenses as miscellaneous itemized deductions subject to the 2% limit. However, if the investment club partnership has investments that also produce nontaxable income, you cannot deduct your share of the partnership's expenses that produce the nontaxable income.

Publicly offered mutual funds. Publicly offered mutual funds do not pass deductions for investment expenses through to shareholders. A mutual fund is "publicly offered" if it is:

1) Continuously offered pursuant to a public offering,
2) Regularly traded on an established securities market, or
3) Held by or for at least 500 persons at all times during the tax year.

A publicly offered mutual fund will send you a Form 1099-DIV, *Dividends and Distributions,* or a substitute form, showing the net amount of dividend income (gross dividends minus investment expenses). This net figure is the amount you report on your return as income. You cannot deduct investment expenses.

Information returns. You should receive information returns from pass-through entities.

Partnerships and S corporations. These entities issue Schedule K-1, which lists the items and amounts you must report and identifies the tax return schedules and lines to use.

Nonpublicly offered mutual funds. These funds will send you a Form 1099-DIV, or a substitute form, showing your share of gross income and investment expenses. You can claim the expenses only as a miscellaneous itemized deduction subject to the 2% limit.

Investment Fees and Expenses

You can deduct investment fees, custodial fees, trust administration fees, and other expenses you paid for managing your investments that produce taxable income.

Legal Expenses

You can usually deduct legal expenses that you incur in attempting to produce or collect taxable income or that you pay in connection with the determination, collection, or refund of any tax.

You can also deduct legal expenses that are:

1) Related to either doing or keeping your job, such as those you paid to defend yourself against criminal charges arising out of your trade or business,
2) For tax advice related to a divorce if the bill specifies how much is for tax advice and it is determined in a reasonable way, or
3) To collect taxable alimony.

You can deduct expenses of resolving tax issues relating to profit or loss from business (Schedule C or C-EZ), rentals or royalties (Schedule E), or farm income and expenses (Schedule F) on the appropriate schedule. You deduct expenses of resolving nonbusiness tax issues on Schedule A (Form 1040).

Loss on Deposits

For information on whether, and if so, how, you may deduct a loss on your deposit in a qualified financial institution, see *Losses on Deposits* in chapter 25.

Repayments of Income

If you had to repay an amount that you included in income in an earlier year, you may be able to deduct the amount you repaid. If the amount you had to repay was ordinary income of $3,000 or less, the deduction is subject to the 2% limit. If it was more than $3,000, see *Repayments Under Claim of Right* under *Deductions Not Subject to the 2% Limit,* later.

Repayments of Social Security Benefits

For information on how to deduct your repayments of certain social security benefits, see *Repayments More Than Gross Benefits* in chapter 11.

Safe Deposit Box Rent

You can deduct safe deposit box rent if you use the box to store taxable income-producing stocks, bonds, or investment-related papers and documents. You cannot deduct the rent if you use the box only for jewelry, other personal items, or tax-exempt securities.

Service Charges on Dividend Reinvestment Plans

You can deduct service charges you pay as a subscriber in a dividend reinvestment plan. These service charges include payments for:

1) Holding shares acquired through a plan,
2) Collecting and reinvesting cash dividends, and
3) Keeping individual records and providing detailed statements of accounts.

Trustee's Administrative Fees for IRA

Trustee's administrative fees that are billed separately and paid by you in connection with your individual retirement arrangement (IRA) are deductible (if they are ordinary and necessary) as a miscellaneous itemized deduction subject to the 2% limit. For more information about IRAs, see chapter 17.

IV. <u>Deductions Not Subject to the 2% Limit</u>

You can deduct the items listed below as miscellaneous itemized deductions. They are not subject to the 2% limit. Report these items on line 28, Schedule A (Form 1040).

<u>LIST OF DEDUCTIONS</u>

Each of the following items are discussed in detail after the list.

- Amortizable premium on taxable bonds.
- Casualty and theft losses from income-producing property.
- Federal estate tax on income in respect of a decedent.
- Gambling losses up to the amount of gambling winnings.
- Impairment-related work expenses of persons with disabilities.
- Loss from other activities from Schedule K-1 (Form 1065-B), box 2.
- Losses from Ponzi-type investment schemes.
- Repayments of more than $3,000 under a claim of right.
- Unrecovered investment in an annuity.

Amortizable Premium on Taxable Bonds

In general, if the amount you pay for a bond is greater than its stated principal amount, the excess is bond premium. You can elect to amortize the premium on taxable bonds. The amortization of the premium is generally an offset to interest income on the bond rather than a separate deduction item.

Part of the premium on some bonds may be a miscellaneous deduction not subject to the 2% limit.

Certain Casualty and Theft Losses

You can deduct a casualty or theft loss as a miscellaneous itemized deduction not subject to the 2% limit if the damaged or stolen property was income-producing property (property held for investment, such as stocks, notes, bonds, gold, silver, vacant lots, and works of art). First report the loss in Section B of Form 4684. You may also have to include the loss on Form 4797 if you are otherwise required to file that form. Your deduction is the amount of the loss included on lines 32 and 38b of Form 4684 and line 18a of Form 4797.

Federal Estate Tax on Income in Respect of a Decedent

You can deduct the federal estate tax attributable to income in respect of a decedent that you as a beneficiary include in your gross income. Income in respect of the decedent is gross income that the decedent would have received had death not occurred and that was not properly includible in the decedent's final income tax return.

Gambling Losses Up to the Amount of Gambling Winnings

You must report the full amount of your gambling winnings for the year on line 21, Form 1040. You deduct your gambling losses for the year on line 28, Schedule A (Form 1040). You cannot deduct gambling losses that are more than your winnings.

Caution. *You cannot reduce your gambling winnings by your gambling losses and report the difference. You must report the full amount of your winnings as income and claim your losses up to the amount of winnings as an itemized deduction. Therefore, your records should show your winnings separately from your losses.*

Records. Diary of winnings and losses. You must keep an accurate diary or similar record of your losses and winnings.

Your diary should contain at least the following information.

1) The date and type of your specific wager or wagering activity.
2) The name and address or location of the gambling establishment.
3) The names of other persons present with you at the gambling establishment.
4) The amount(s) you won or lost.

Impairment-Related Work Expenses

If you have a physical or mental disability that limits your being employed, or substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, and working, you can deduct your impairment-related work expenses.

Impairment-related work expenses are ordinary and necessary business expenses for attendant care services at your place of work and other expenses in connection with your place of work that are necessary for you to be able to work.

Self-employed. If you are self-employed, enter your impairment-related work expenses on the appropriate form (Schedule C, C-EZ, E, or F) used to report your business income and expenses.

Loss From Other Activities From Schedule K-1 (Form 1065-B), Box 2

If the amount reported in Schedule K-1 (Form 1065-B), box 2, is a loss, report it on Schedule A (Form 1040), line 28. It is not subject to the passive activity limitations.

Repayments Under Claim of Right

If you had to repay more than $3,000 that you included in your income in an earlier year because at the time you thought you had an unrestricted right to it, you may be able to deduct the amount you repaid or take a credit against your tax. See *Repayments* in chapter 12 for more information.

Unrecovered Investment in Annuity

A retiree who contributed to the cost of an annuity can exclude from income a part of each payment received as a tax-free return of the retiree's investment. If the retiree dies before the entire investment is recovered tax free, any unrecovered investment can be deducted on the retiree's final income tax return.

V. Nondeductible Expenses

Examples of nondeductible expenses are listed next. The list is followed by discussions of additional nondeductible expenses.

LIST OF NONDEDUCTIBLE EXPENSES

- Broker's commissions that you paid in connection with your IRA or other investment property.
- Burial or funeral expenses, including the cost of a cemetery lot.
- Capital expenses.
- Fees and licenses, such as car licenses, marriage licenses, and dog tags.
- Hobby losses – but see *Hobby Expenses,* earlier.
- Home repairs, insurance, and rent.
- Illegal bribes and kickbacks.
- Losses from the sale of your home, furniture, personal car, etc.
- Personal disability insurance premiums.
- Personal, living, or family expenses.
- The value of wages never received or lost vacation time.

Adoption Expenses

You cannot deduct the expenses of adopting a child, but you may be able to take a credit for those expenses. See chapter 37.

Campaign Expenses

You cannot deduct campaign expenses of a candidate for any office, even if the candidate is running for re-election to the office. These include qualification and registration fees for primary elections.

Legal fees. You cannot deduct legal fees paid to defend charges that arise from participation in a political campaign.

Check-Writing Fees on Personal Account

If you have a personal checking account, you cannot deduct fees charged by the bank for the privilege of writing checks, even if the account pays interest.

Club Dues

Generally, you cannot deduct the cost of membership in any club organized for business, pleasure, recreation, or other social purpose. This includes business, social, athletic, luncheon, sporting, airline, hotel, golf, and country clubs.

You cannot deduct dues paid to an organization if one of its main purposes is to:

- Conduct entertainment activities for members or their guests, or
- Provide members or their guests with access to entertainment facilities.

Dues paid to airline, hotel, and luncheon clubs are not deductible.

Commuting Expenses

You cannot deduct commuting expenses (the cost of transportation between your home and your main or regular place of work). If you haul tools, instruments, or other items, in your car to and from work, you can deduct only the additional cost of hauling the items such as the rent on a trailer to carry the items.

Fines or Penalties

You cannot deduct fines or penalties you pay to a governmental unit for violating a law. This includes an amount paid in settlement of your actual or potential liability for a fine or penalty (civil or criminal). Fines or penalties include parking tickets, tax penalties, and penalties deducted from teachers' paychecks after an illegal strike.

Health Spa Expenses

You cannot deduct health spa expenses, even if there is a job requirement to stay in excellent physical condition, such as might be required of a law enforcement officer.

Home Security System

You cannot deduct the cost of a home security system as a miscellaneous deduction. However, you may be able to claim a deduction for a home security system as a business expense if you have a home office.

Investment-Related Seminars

You cannot deduct any expenses for attending a convention, seminar, or similar meeting for investment purposes.

Life Insurance Premiums

You cannot deduct premiums you pay on your life insurance. You may be able to deduct, as alimony, premiums you pay on life insurance policies assigned to your former spouse.

Lobbying Expenses

You generally cannot deduct amounts paid or incurred for lobbying expenses. These include expenses to:

1) Influence legislation,
2) Participate or intervene in any political campaign for, or against, any candidate for public office,
3) Attempt to influence the general public, or segments of the public, about elections, legislative matters, or referendums, or
4) Communicate directly with covered executive branch officials in any attempt to influence the official actions or positions of those officials.

Lobbying expenses also include any amounts paid or incurred for research, preparation, planning, or coordination of any of these activities.

Dues used for lobbying. If a tax-exempt organization notifies you that part of the dues or other amounts you pay to the organization are used to pay nondeductible lobbying expenses, you cannot deduct that part.

Lost or Mislaid Cash or Property

You cannot deduct a loss based on the mere disappearance of money or property. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Example. A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

Lunches with Coworkers

You cannot deduct the expenses of lunches with co-workers, except while traveling away from home on business. See chapter 26 for information on deductible expenses while traveling away from home.

Meals While Working Late

You cannot deduct the cost of meals while working late. However, you may be able to claim a deduction if the cost of meals is a deductible entertainment expense, or if you are traveling away from home. See chapter 26 for information on deductible entertainment expenses and expenses while traveling away from home.

Personal Legal Expenses

You cannot deduct personal legal expenses such as those for the following.

1) Custody of children.
2) Breach of promise to marry suit.
3) Civil or criminal charges resulting from a personal relationship.
4) Damages for personal injury, except for certain unlawful discrimination and whistleblower claims.
5) Preparation of a title (or defense or perfection of a title).
6) Preparation of a will.
7) Property claims or property settlement in a divorce.

You cannot deduct these expenses even if a result of the legal proceeding is the loss of income-producing property.

Political Contributions

You cannot deduct contributions made to a political candidate, a campaign committee, or a newsletter fund. Advertisements in convention bulletins and admissions to dinners or programs that benefit a political party or political candidate are not deductible.

Professional Accreditation Fees

You cannot deduct professional accreditation fees such as the following.

1) Accounting certificate fees paid for the initial right to practice accounting.
2) Bar exam fees and incidental expenses in securing admission to the bar.
3) Medical and dental license fees paid to get initial licensing.

Professional Reputation

You cannot deduct expenses of radio and TV appearances to increase your personal prestige or establish your professional reputation.

Relief Fund Contributions

You cannot deduct contributions paid to a private plan that pays benefits to any covered employee who cannot work because of any injury or illness not related to the job.

Residential Telephone Service

You cannot deduct any charge (including taxes) for basic local telephone service for the first telephone line to your residence, even if it is used in a trade or business.

Stockholders' Meetings

You cannot deduct transportation and other expenses you pay to attend stockholders' meetings of companies in which you own stock but have no other interest. You cannot deduct these expenses even if you are attending the meeting to get information that would be useful in making further investments.

Tax-Exempt Income Expenses

You cannot deduct expenses to produce tax-exempt income. You cannot deduct interest on a debt incurred or continued to buy or carry tax-exempt securities.

If you have expenses to produce both taxable and tax-exempt income, but you cannot identify the expenses that produce each type of income, you must divide the expenses based on the amount of each type of income to determine the amount that you can deduct.

Example. During the year, you received taxable interest of $4,800 and tax-exempt interest of $1,200. In earning this income, you had total expenses of $500 during the year. You cannot identify the amount of each expense item that is for each income item. Therefore, 80% ($4,800/$6,000) of the expense is for the taxable interest and 20% ($1,200/$6,000) is for the tax-exempt interest. You can deduct, subject to the 2% limit, expenses of $400 (80% of $500).

Travel Expenses for Another Individual

You generally cannot deduct travel expenses you pay or incur for a spouse, dependent, or other individual who accompanies you (or your employee) on business travel. See chapter 26 for more information on deductible travel expenses.

Voluntary Unemployment Benefit Fund Contributions

You cannot deduct voluntary unemployment benefit fund contributions you make to a union fund or a private fund. However, you can deduct contributions as taxes if state law requires you to make them to a state unemployment fund that covers you for the loss of wages from unemployment caused by business conditions.

Wristwatches

You cannot deduct the cost of a wristwatch, even if there is a job requirement that you know the correct time to properly perform your duties.

CHAPTER 28 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Membership dues may be deductible if paid to professional organizations such as chambers of commerce and similar organizations, if such membership helps you carry out your job duties. Similar organizations would not include:

   a) boards of trade
   b) civic or public service organizations
   c) trade associations
   d) airline frequent flyer airport clubs

2. You can usually deduct legal expenses that are paid to collect alimony.

   a) true
   b) false

3. Legal expenses can generally be deducted if they are incurred in an attempt to collect or produce taxable income. Such efforts would not include:

   a) those to keep or to continue doing your job
   b) those to collect taxable alimony
   c) those incurred for adopting a child
   d) those to collect a tax refund due from state or federal authorities

CHAPTER 28 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Generally, such an organization would have as its primary purpose to encourage business trade and therefore dues paid would likely be deductible.

   B: Incorrect. Dues paid to such an organization are likely deductible.

   C: Incorrect. Dues paid to a trade association are likely deductible.

   D: Correct. Dues paid to airline, hotel, and luncheon clubs are not deductible. You cannot deduct dues paid to an organization if one of its main purposes is to conduct entertainment activities for members, or their guests, or provide members or their guest with access to entertainment facilities.

2. **A: True is correct.** You can also usually deduct legal expenses that you incur in attempting to produce or collect taxable income or that you pay in connection with the determination, collection, or refund of any tax.

   B: False is incorrect. You can also deduct legal expenses that are related to either doing or keeping your job, such as those you paid to defend yourself against criminal charges arising out of your trade or business, or for tax advice related to a divorce if the bill specifies how much is for tax advice and it is determined in a reasonable way.

3. A: Incorrect. You can deduct legal costs associated with defending yourself against criminal charges resulting from job related activities.

   B: Incorrect. Legal fees paid in efforts to collect alimony due you are deductible as such efforts usually yield taxable income.

   C: Correct. Legal fees are generally only deductible if they are related to the determination, collection, or refund of income.

   D: Incorrect. Legal expenses incurred to pursue or collect tax refunds due are generally tax deductible.

Chapter 29: Limit on Itemized Deductions

I. Introduction

The reduction to itemized deductions and the personal exemption phaseout for high-income taxpayers were gradually eliminated between 2006 and 2010. For 2011 and 2012, there is no reduction in the personal exemption amount or itemized deductions.

CHAPTER 29 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. For 2011, there was a limit on certain itemized deductions based on the taxpayer's adjusted gross income.

   a) true
   b) false

<u>**CHAPTER 29 – SOLUTIONS AND SUGGESTED RESPONSES**</u>

1. A: True is incorrect. The limit on itemized deductions was removed in 2011.

   B: False is correct. In prior years, there had been a phaseout of certain itemized deductions for high-income taxpayers.

PART SIX. FIGURING YOUR TAXES AND CREDITS

The eight chapters in this part explain how to figure your tax and how to figure the tax of certain children who have more than $1,900 of investment income. They also discuss tax credits that, unlike deductions are subtracted directly from your tax and reduce your tax, dollar for dollar. Chapter 36 discusses the earned income credit and how you may be able to get part of the credit paid to you in advance throughout the year.

Chapter 30: How to Figure Your Tax

I. Figuring Your Tax

Your income tax is based on your taxable income. After you figure your income tax and any alternative minimum tax, subtract your tax credits and add any other taxes you may owe. The result is your total tax. Compare your total tax with your total payments to determine whether you are entitled to a refund or owe additional tax.

This section provides a general outline of how to figure your tax. You can find step-by-step directions in the instructions for Forms 1040EZ, 1040A, and 1040.

Tax. Most taxpayers use either the Tax Table or the Tax Computation Worksheet to figure their income tax. However, there are special methods if your income includes any of the following items.

- A net capital gain (see chapter 16).
- Qualified dividends taxed at the same rates as a net capital gain (see chapters 8 and 16).
- Lump-sum distributions (see chapter 10).
- Farming and fishing income (see Schedule J (Form 1040), *Income Averaging for Farmers and Fishermen*).
- Investment income over $1,900 for certain children (see chapter 31).
- Parents' election to report child's interest and dividends (see chapter 31).
- Foreign earned income exclusion or the housing exclusion.

Credits. After you figure your income tax and any alternative minimum tax (discussed later), determine your tax credits. This chapter does not explain whether you are eligible for these credits. You can find that information in chapters 32 through 37 and your form instructions.

II. Alternative Minimum Tax

This section briefly discusses an additional tax you may have to pay.

The tax law gives special treatment to some kinds of income and allows special deductions and credits for some kinds of expenses. Taxpayers who benefit from the law in these ways may have to pay at least a minimum amount of tax through an additional tax. This additional tax is called the alternative minimum tax (AMT).

You may have to pay the alternative minimum tax if your taxable income for regular tax purposes, combined with certain adjustments and tax preference items, is more than:

- $74,450 if your filing status is married filing joint (or qualifying widow(er) with dependent child),
- $48,450 if your filing status is single or head of household, or
- $37,225 if your filing status is married filing separate.

Adjustments and tax preference items. The more common adjustments and tax preference items include:

- Addition of ***personal exemptions***,
- Addition of ***standard deduction*** *(if claimed)*,
- Addition of ***itemized deductions*** claimed for state and local taxes, certain interest, most miscellaneous deductions, and part of medical expenses,
- Subtraction of any ***refund of state and local taxes*** included in gross income,
- Changes to accelerated ***depreciation*** of certain property,
- Difference between ***gain or loss*** on the sale of property reported for regular tax purposes and AMT purposes,
- Addition of certain income from ***incentive stock options,***
- Change in certain ***passive activity loss*** deductions,
- Addition of certain ***depletion*** that is more than the adjusted basis of the property,
- Addition of part of the deduction for certain ***intangible drilling costs***, and
- Addition of ***tax-exempt interest*** on certain private activity bonds.

CHAPTER 30 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. You may have to calculate and pay the alternative minimum tax (AMT) if your taxable income for regular tax purposes, combined with certain adjustments and tax preference items exceeds specified level. Which of the following is <u>not</u> a tax preference item or an adjustment:

    a) changes to accelerated depreciation of certain property
    b) deductions for intangible drilling costs
    c) tax-exempt interest on certain private activity bonds
    d) interest income from savings accounts

CHAPTER 30 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. This would be an example of an adjustment or tax preference item.

   B: Incorrect. This would be an example of an adjustment or tax preference item.

   C: Incorrect. This would be an example of an adjustment or tax preference item.

   D: Correct. Interest income on a standard savings account would be reported on Schedule B and not a tax preference item.

Chapter 31: Tax on Investment Income of Certain Children

I. <u>Introduction</u>

This chapter discusses two special rules that apply to the tax on investment income of certain children.

1) If the child's interest and dividend income total less than $9,500, the child's parent may be able to choose to include that income (including capital gain distributions) on the parent's return rather than file a return for the child.
2) If the child's interest, dividends, and other investment income total more than $1,900, part of that income may be taxed at the parent's tax rate instead of the child's tax rate.

For these rules, the term "child" includes a legally adopted child and a stepchild. These rules apply whether or not the child is a dependent.

These rules do ***not*** apply if:

1) The child is not required to file a tax return, or
2) Neither of the child's parents were living at the end of the tax year, or
3) The child files a joint return for the year.

II. <u>Which Parent's Return to Use</u>

If a child's parents are married to each other and file a joint return, use the joint return to figure the tax on the investment income of a child. For parents who do not file a joint return, the following discussions explain which parent's tax return must be used to figure the tax. Only the parent whose tax return is used can make the election described under *Parent's Election To Report Child's Interest and Dividends.*

Parents are married. If the child's parents file separate returns, use the return of the parent with the greater taxable income.

Parents not living together. If the child's parents are married to each other but not living together, and the parent with whom the child lives (the custodial parent) is considered unmarried, use the return of the custodial parent. If the custodial parent is not considered unmarried, use the return of the parent with the greater taxable income.

For an explanation of when a married person living apart from his or her spouse is considered unmarried, see *Head of Household* in chapter 2.

Parents are divorced. If the child's parents are divorced or legally separated, and the parent who had custody of the child for the greater part of the year (the custodial parent) has not remarried, use the return of the custodial parent.

Custodial parent remarried. If the custodial parent has remarried, the stepparent (rather than the noncustodial parent) is treated as the child's other parent. Therefore, if the custodial parent and the stepparent file a joint return, use that joint return. Do not use the return of the noncustodial parent.

If the custodial parent and the stepparent are married, but file separate returns, use the return of the one with the greater taxable income. If the custodial parent and the stepparent are married but not living together, the earlier discussion under *Parents not living together* applies.

Parents never married. If a child's parents did not marry each other, but lived together all year, use the return of the parent with the greater taxable income. If the parents did not live together all year, the rules explained earlier under *Parents are divorced* apply.

Widowed parent remarried. If a widow or widower remarries, the new spouse is treated as the child's other parent. The rules explained earlier under *Custodial parent remarried* apply.

III. Parent's Election to Report Child's Interest and Dividends

You may be able to elect to include your child's interest and dividend income (including capital gain distributions) on your tax return. If you do, your child will not have to file a return.

You can make this election only if ***all*** the following conditions are met.

- Your child was under age 19 (or under age 24 if a full-time student) at the end of the year.
- Your child had income only from interest and dividends (including capital gain distributions and Alaska Permanent Fund dividends).
- The child's gross income was less than $9,500.
- The child is required to file a return unless you make this election.
- The child does not file a joint return for the year.
- No estimated tax payment was made for the year, and no overpayment from the previous year was applied to this year under your child's name and social security number.
- No federal income tax was taken out of your child's income under the backup withholding rules.
- You are the parent whose return must be used when applying the special tax rules for children. (See *Which Parent's Return to Use*, earlier.)

How to make the election. Make the election by attaching **Form 8814** to your Form 1040. (If you make this election, you cannot file Form 1040A or Form 1040EZ.) Attach a separate Form 8814 for each child for whom you make the election. You can make the election for one or more children and not for others.

EFFECT OF MAKING THE ELECTION

The federal income tax on your child's income may be more if you make the Form 8814 election.

Rate may be higher. If your child received qualified dividends or capital gain distributions, you may pay up to $95 more tax if you make this election instead of filing a separate tax return for the child. This is because the tax rate on the child's income between $950 and $1,900 is 10% if you make this election. However, if you file a separate return for the child, the tax rate may be as low as 0% because of the preferential tax rates for qualified dividends and capital gain distributions.

Deductions you cannot take. By making the Form 8814 election, you cannot take any of the following deductions that the child would be entitled to on his or her return.

1) The additional standard deduction for a blind child.
2) The deduction for a penalty on an early withdrawal of your child's savings.
3) Itemized deductions (such as your child's investment expenses or charitable contributions).

Reduced deductions or credits. If you use Form 8814, your increased adjusted gross income may reduce certain deductions or credits on your return including the following.

1) Deduction for contributions to a traditional individual retirement arrangement (IRA).
2) Deduction for student loan interest.
3) Itemized deductions for medical expenses, casualty and theft losses, and certain miscellaneous expenses.
4) Total itemized deductions.
5) Personal exemptions.
6) Credit for child and dependent care expenses.
7) Child tax credit.
8) Education tax credits.
9) Earned income credit.
10) Making work pay credit.
11) First-time homebuyer credit.

Penalty for underpayment of estimated tax. If you make this election for 2011 and did not have enough tax withheld or pay enough estimated tax to cover the tax you owe, you may be subject to a penalty. If you plan to make this election for 2012, you may need to increase your federal income tax withholding or your estimated tax payments to avoid the penalty. See chapter 4 for more information.

FIGURING CHILD'S INCOME

Use ***Part I*** of Form 8814 to figure your child's interest and dividend income to report on your return. Only the amount over $1,900 is added to your income. This amount is shown on line 6 of Form 8814. Unless the child’s income includes qualified dividends or capital gain distributions, the same amount is shown on line 12 of Form 8814. Include the amount on line 12 of Form 8814 on line 21 of Form 1040. Enter "Form 8814" in the space next to line 21. If you file more than one Form 8814, include the total amounts from line 12 of all your Forms 8814 on line 21.

FIGURING ADDITIONAL TAX

Use ***Part II*** of Form 8814 to figure the tax on the $1,900 of your child's interest and dividends that you do not include in your income. This tax is added to the tax figured on your income.

This additional tax is the ***smaller*** of:

1) 10% x (your child's gross income - $950), or
2) $95.

Include the amount from line 15 of all your Forms 8814 in the total on line 44, Form 1040. Check box **a** on Form 1040, line 44.

ILLUSTRATED EXAMPLE

David and Linda Parks are married and will file separate tax returns for 2011. Their only child, Philip, is 8. Philip received a Form 1099-INT showing $1,650 taxable interest income and a Form 1099-DIV showing $1,150 ordinary dividends. All the dividends were qualified dividends. His parents decide to include that income on one of their returns so they will not have to file a return for Philip.

First, David and Linda each figure their taxable income (Form 1040, line 43) without regard to Philip's income. David's taxable income is $56,700 and Linda's is $74,300. Because her taxable income is greater, Linda can elect to include Philip's income on her return. See *Which Parent's Return To Use*, earlier.

On Form 8814 (see illustrated form), Linda enters her name and social security number, then Philip's name and social security number. She enters Philip's taxable interest income, $1,650, on line 1a. Philip had no tax-exempt interest income, so she leaves line 1b blank. She enters Philip's ordinary dividends, $1,150, on line 2a. All of Philip's ordinary dividends were qualified dividends, so Linda also enters $1,150 on line 2b. Philip did not have any capital gain distributions, so she leaves line 3 blank.

Linda adds lines 1a and 2a and enters the result, $2,800, on line 4. Because Philip had qualified dividends, Linda must complete lines 7 through 11 of Form 8814. She includes the amount from line 9 of Form 8814 ($370) on lines 9a and 9b of her Form 1040. On the dotted lines next to lines 9a and 9b, she enters "Form 8814–$370."

Linda includes $530 in the total on line 21 of her Form 1040 (not illustrated) and in the space next to that line writes "Form 8814–$530." Adding that amount, plus the $370 of qualified dividends, to her income increases each of the amounts on lines 22, 37, 38, 41, and 43 of her Form 1040 by $900. Linda is not claiming any deductions that are affected by the increase to her income. Therefore, her revised taxable income on line 43 is $75,200 ($74,300 + $370 + $530).

On Form 8814, Linda subtracts the $950 shown on line 13 from the $2,800 on line 4 and enters the result, $1,850, on line 14. Because that amount is not less than $950, she enters $95 on line 15. This is the tax on the first $1,900 of Philip's income, which Linda did not have to add to her income. She must add this additional tax to the tax figured on her revised taxable income.

The tax on her $75,200 revised taxable income, figured using the Qualified Dividends and Capital Gain Tax Worksheet in the Form 1040 instructions, is $15,139. She adds $95, and enters the $15,234 total on Form 1040, line 44, and checks box a.

Linda attaches Form 8814 to her Form 1040.

Form **8814**

Department of the Treasury
Internal Revenue Service (99)

Parents' Election To Report Child's Interest and Dividends

▶ See instructions.
▶ Attach to parents' Form 1040 or Form 1040NR.

OMB No. 1545-0074
2011
Attachment Sequence No. **40**

Name(s) shown on your return	Your social security number
Linda Parks	111-00-1111

Caution. The federal income tax on your child's income, including qualified dividends and capital gain distributions, may be less if you file a separate tax return for the child instead of making this election. This is because you cannot take certain tax benefits that your child could take on his or her own return. For details, see **Tax benefits you cannot take** on page 3.

A Child's name (first, initial, and last)	B Child's social security number
Philip Parks	000-00-0000

C If more than one Form 8814 is attached, check here . . . . . ▶ ☐

Part I Child's Interest and Dividends To Report on Your Return

1a	Enter your child's **taxable** interest. If this amount is different from the amounts shown on the child's Forms 1099-INT and 1099-OID, see the instructions			1a	1,650
b	Enter your child's **tax-exempt** interest. **Do not** include this amount on line 1a	1b			
2a	Enter your child's ordinary dividends, including any Alaska Permanent Fund dividends. If your child received any ordinary dividends as a nominee, see the instructions			2a	1,150
b	Enter your child's qualified dividends included on line 2a. See the instructions	2b	1,150		
3	Enter your child's capital gain distributions. If your child received any capital gain distributions as a nominee, see the instructions			3	
4	Add lines 1a, 2a, and 3. If the total is $1,900 or less, skip lines 5 through 12 and go to line 13. If the total is $9,500 or more, **do not** file this form. Your child **must** file his or her own return to report the income			4	2,800
5	Base amount			5	1,900 00
6	Subtract line 5 from line 4			6	900
	If both lines 2b and 3 are zero or blank, skip lines 7 through 10, enter -0- on line 11, and go to line 12. Otherwise, go to line 7.				
7	Divide line 2b by line 4. Enter the result as a decimal (rounded to at least three places)	7	. 411		
8	Divide line 3 by line 4. Enter the result as a decimal (rounded to at least three places)	8	.		
9	Multiply line 6 by line 7. Enter the result here. See the instructions for where to report this amount on your return	9	370		
10	Multiply line 6 by line 8. Enter the result here. See the instructions for where to report this amount on your return	10			
11	Add lines 9 and 10			11	370
12	Subtract line 11 from line 6. Include this amount in the total on Form 1040, line 21, or Form 1040NR, line 21. In the space next to line 21, enter "Form 8814" and show the amount. If you checked the box on line C above, see the instructions. Go to line 13 below			12	530

Part II Tax on the First $1,900 of Child's Interest and Dividends

13	Amount not taxed	13	950 00
14	Subtract line 13 from line 4. If the result is zero or less, enter -0-	14	1,850
15	**Tax.** Is the amount on line 14 less than $950? ☑ **No.** Enter $95 here and see the **Note** below. ☐ **Yes.** Multiply line 14 by 10% (.10). Enter the result here and see the **Note** below.	15	95

Note. If you checked the box on line C above, see the instructions. Otherwise, include the amount from line 15 in the tax you enter on Form 1040, line 44, or Form 1040NR, line 42. Be sure to check box **a** on Form 1040, line 44, or Form 1040NR, line 42.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 10750J Form **8814** (2011)

IV. Tax for Certain Children Who Have Investment Income of More Than $1,900

If a child's interest, dividends, and other investment income total more than $1,900, part of that income may be taxed at the parent's tax rate instead of the child's tax rate. If the parent does not or cannot choose to include the child's income on the parent's return, use Form 8615 to figure the child's tax. Attach the completed form to the child's Form 1040 or Form 1040A.

When Form 8615 must be filed. Form 8615 must be filed for a child if all of the following statements are true.

1) The child's investment income was more than $1,900.
2) The child is required to file a return for 2011.
3) The child either:
   a) Was under age 18 at the end of the year,
   b) Was age 18 at the end of the year and did not have earned income that was more than half of his or her support, or
   c) Was a full-time student over age 18 and under age 24 at the end of the year and did not have earned income that was more than half of his or her support.
4) At least one of the child's parents was alive at the end of 2011.
5) The child does not file a joint return for 2011.

Earned income. Earned income includes wages, tips, and other payments received for personal services performed. It does not include investment income as defined later in this chapter.

Support. Your child's support includes all amounts spent to provide the child with food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities. To figure your child's support, count support provided by you, your child, and others. However, a scholarship received by your child is not considered support if your child is a full-time student. See chapter 3 for details about support.

Certain January 1 birthdays. Use the following chart to determine whether certain children with January 1 birthdays meet condition 3 under *When Form 8615 must be filed*.

IF a child was born on …	**THEN, at the end of 2011, the child is considered to be …**
January 1, 1994	18*
January 1, 1993	19**
January 1, 1988	24***
* This child is not under age 18. The child meets condition 3 only if the child did not have earned income that was more than half of the child's support. ** This child meets condition 3 only if the child was a full-time student who did not have earned income that was more than half of the child's support. ***Do not use Form 8615 for this chilld.	

PROVIDING PARENTAL INFORMATION (FORM 8615, LINES A-C)

On lines A and B of Form 8615, enter the parent's name and social security number. (If the parents filed a joint return, enter the name and social security number listed first on the joint return.) On line C, check the box for the parent's filing status.

See *Which Parent's Return To Use* at the beginning of this chapter for information on which parent's return information must be used on Form 8615.

Parent with different tax year. If the parent and the child do not have the same tax year, complete Form 8615 using the information on the parent's return for the tax year that ends in the child's tax year.

Parent's return information not known timely. If the information needed from the parent's return is not known by the time the child's return is due (usually April 15), you can file the return using estimates.

You can use any reasonable estimate. This includes using information from last year's return. If you use an estimated amount on Form 8615, write "Estimated" on the line next to the amount.

When you get the correct information, file an amended return on Form 1040X, *Amended U.S. Individual Income Tax Return.*

Instead of using estimated information, you may want to request an extension of time to file. Extensions are discussed in chapter 1.

STEP 1. FIGURING THE CHILD'S NET INVESTMENT INCOME (FORM 8615, PART I)

The first step in figuring a child's tax using Form 8615 is to figure the child's net investment income. To do that, use Part I of Form 8615.

Line 1 (investment income). If the child had ***no earned income,*** enter on this line the adjusted gross income shown on the child's return. Adjusted gross income is shown on line 38 of Form 1040 or line 22 of Form 1040A. Form 1040EZ cannot be used if Form 8615 must be filed.

If the child had ***earned income,*** figure the amount to enter on line 1 of Form 8615 by using the worksheet in the instructions for the form.

However, if the child has excluded any foreign earned income or deducted either a loss from self-employment or a net operating loss from another year, use the *Alternate Worksheet for Line 1 of Form 8615* in Publication 929 to figure the amount to enter on line 1 of Form 8615.

Investment income defined. Investment income is generally all income other than salaries, wages, and other amounts received as pay for work actually done. It includes taxable interest, dividends, capital gains (including capital gain distributions), the taxable part of social security and pension payments, and certain distributions from trusts. Investment income includes amounts produced by assets the child obtained with earned income (such as interest on a savings account into which the child deposited wages).

Nontaxable income. For this purpose, investment income includes only amounts that the child must include in total income. Nontaxable investment income, such as tax-exempt interest and the nontaxable part of social security and pension payments, is not included.

Income from property received as a gift. A child's investment income includes all income produced by property belonging to the child. This is true even if the property was transferred to the child regardless of when the property was transferred or purchased or who transferred it.

A child's investment income includes income produced by property given as a gift to the child. This includes gifts to the child from grandparents or any other person and gifts made under the Uniform Gift to Minors Act.

Example. Amanda Black, age 13, received the following income:

- Dividends - $600
- Wages - $2,100
- Taxable interest - $1,200
- Tax-exempt interest - $100
- Net capital gains - $100

The dividends were qualified dividends on stock given to her by her grandparents.

Amanda's investment income is $1,900. This is the total of the dividends ($600), taxable interest ($1,200), and net capital gains ($100). Her wages are earned (not investment) income because they are received for work actually done. Her tax-exempt interest is not included because it is nontaxable.

Trust income. If a child is the beneficiary of a trust, distributions of taxable interest, dividends, capital gains, and other investment income from the trust are investment income to the child.

However, for purposes of completing Form 8615, a taxable distribution from a qualified disability trust is considered earned income, not investment income.

Line 2 (deductions). If the child does not itemize deductions on Schedule A (Form 1040), enter $1,900 on line 2.

If the child does itemize deductions, enter on line 2 the larger of:

1) $950 plus the child's itemized deductions on Schedule A (Form 1040), line 29, that are directly connected with the production of investment income entered on line 1, or
2) $1,900.

Directly connected. Itemized deductions are directly connected with the production of investment income if they are for expenses paid to produce or collect taxable income or to manage, conserve, or maintain property held for producing income. These expenses include custodian fees and service charges, service fees to collect taxable interest and dividends, and certain investment counsel fees.

These expenses are added to certain other miscellaneous deductions on Schedule A (Form 1040). Only the amount greater than 2% of the child's adjusted gross income can be deducted. See chapter 28 for more information.

Example 1. Roger, age 12, has investment income of $8,000, no other income, no adjustments to income, and itemized deductions of $300 (net of the 2%-of-adjusted-gross-income limit) that are directly connected with his investment income. His adjusted gross income is $8,000, which is entered on line 38 of Form 1040 and on line 1 of Form 8615. Line 2 is $1,900 because that is more than the sum of $950 and his directly-connected itemized deductions of $300.

Example 2. Eleanor, 8, has investment income of $16,000 and an early withdrawal penalty of $100. She has no other income. She has itemized deductions of $1,050 (net of the 2%-of-adjusted-gross-income limit) that are directly connected with the production of her investment income. Her adjusted gross income, entered on line 1, is $15,900 ($16,000 - $100). The amount on Line 2 is $2,000. This is the larger of:

1) $950 plus the $1,050 of directly connected itemized deductions, or
2) $1,900.

Line 3. Subtract line 2 from line 1 and enter the result on this line. If zero or less, do not complete the rest of the form. However, you must still attach Form 8615 to the child's tax return. Figure the tax on the child's taxable income in the normal manner.

Line 4 (child's taxable income). Enter on line 4 the child's taxable income from Form 1040, line 43 or Form 1040A, line 27.

However, if the child files Form 2555 or 2555-EZ to claim the foreign earned income exclusion or housing exclusion, see the Form 8615 instructions.

Line 5 (net investment income). A child's net investment income cannot be more than his or her taxable income. Enter on line 5 the smaller of line 3 or line 4 of Form 8615. This is the child's ***net investment income***. If zero or less, do not complete the rest of the form. However, you must still attach Form 8615 to the child's tax return. Figure the tax on the child's taxable income in the normal manner.

STEP 2. FIGURING TENTATIVE TAX AT THE PARENT'S TAX RATE (FORM 8615, PART II)

The tentative tax is the difference between the tax on the parent's taxable income figured with the child's net investment income (plus the net investment income of any other child whose Form 8615 includes the tax return information of that parent) and the tax figured without it.

When figuring the tentative tax at the parent's tax rate, do not refigure any of the exclusions, deductions, or credits on the parent's return because of the child's net investment income. For example, do not refigure the medical expense deduction.

Figure the tentative tax on lines 6 through 13 of Form 8615.

Line 6 (parent's taxable income). Enter on line 6 the parent's taxable income from Form 1040, line 43, or Form 1040A, line 27.

If the Foreign Earned Income Tax Worksheet (in the Form 1040 instructions) was used to figure the parent's tax, enter the amount from line 3 of that worksheet instead of the parent's taxable income.

Line 7 (net investment income of other children). If the tax return information of the parent is also used on any other child's Form 8615, enter on line 7 the total of the amounts from line 5 of all the other children's Forms 8615. Do not include the amount from line 5 of the Form 8615 being completed.

Example. Paul and Jane Persimmon have three children, Sharon, Jerry, and Mike, who must attach Form 8615 to their tax returns. The children's net investment income amounts on line 5 of their Forms 8615 are:

- Sharon -- $800
- Jerry -- $600
- Mike -- $1,000

Line 7 of Sharon's Form 8615 will show $1,600 ($600 + $1,000), the total of the amounts on line 5 of Jerry's and Mike's Forms 8615.

Line 7 of Jerry's Form 8615 will show $1,800 ($800 + $1,000).

Line 7 of Mike's Form 8615 will show $1,400 ($800 + $600).

Other children's information not available. If the net investment income of the other children is not available when the return is due, either file the return using estimates or get an extension of time to file. See *Parent's return information not known timely,* earlier.

Line 11 (tentative tax). Subtract line 10 from line 9 and enter the result on this line. This is the tentative tax.

If line 7 is blank, skip lines 12a and 12b and enter the amount from line 11 on line 13.

Lines 12a and 12b (dividing the tentative tax). If an amount is entered on line 7, divide the tentative tax shown on line 11 among the children according to each child's share of the total net investment income. This is done on lines 12a, 12b, and 13. Add the amount on line 7 to the amount on line 5 and enter the total on line 12a. Divide the amount on line 5 by the amount on line 12a and enter the result as a decimal on line 12b.

Example. In the earlier example under *Line 7 (net investment income of other children),* Sharon's Form 8615 shows $1,600 on line 7. The amount entered on line 12a is $2,400, the total of lines 5 and 7 ($800 + $1,600). The decimal on line 12b is .333, figured as follows and rounded to three places.

$$\frac{\$800}{\$2{,}400} = .333$$

STEP 3. FIGURING THE CHILD'S TAX (FORM 8615, PART III)

The final step in figuring a child's tax using Form 8615 is to determine the ***larger*** of:

1) The total of:
   a) The child's share of the tentative tax based on the parent's tax rate, plus
   b) The tax on the child's taxable income in excess of net investment income, figured at the child's tax rate, or
2) The tax on the child's taxable income, figured at the child's tax rate.

This is the child's tax. It is figured on lines 14 through 18 of Form 8615.

Alternative minimum tax. A child may be subject to alternative minimum tax (AMT) if he or she has certain items given preferential treatment under the tax law. See *Alternative Minimum Tax* in chapter 30.

For more information on who is liable for AMT and how to figure it, get Form 6251. For information on special limits that apply to a child who files Form 6251, *Alternative Minimum Tax--Individuals,* see *Alternative Minimum Tax* in Publication 929.

ILLUSTRATED EXAMPLE

The following example includes a completed Form 8615. Form 1040A is not shown.

John and Laura Brown have one child, Sara. She is 13 and has $2,800 taxable interest income and $1,500 earned income. She does not itemize deductions. John and Laura file a joint return with John’s name and social security number listed first. They claim three exemptions, including an exemption for Sara, on their return.

Because Sara is under age 18 and has more than $1,900 investment income, part of her income may be subject to tax at her parents’ rate. A completed Form 8615 must be attached to her return.

Sara’s father, John, fills out Sara’s return for her. He completes her Form 1040A through line 27, then begins completing her Form 8615.

John enters his name and social security number on Sara’s Form 8615 because his name and number are listed first on the joint return he and Laura are filing. He checks the box for married filing jointly.

He enters Sara’s investment income, $2,800, on line 1. Sara does not itemize deductions, so John enters $1,900 on line 2. He enters $900 ($2,800 − $1,900) on line 3.

Sara’s taxable income on her Form 1040A, line 27, is $2,500. This is her total income ($4,300) minus her standard deduction ($1,800). Her standard deduction is limited to the amount of her earned income plus $300. John enters $2,500 on line 4.

John compares lines 3 and 4 and enters the smaller amount, $900, on line 5.

John enters $48,000 on line 6. This is the taxable income from line 43 of John and Laura’s joint Form 1040 return. Sara is an only child, so line 7 is blank. He adds line 5 ($900), line 6 ($48,000), and line 7 (blank), and enters $48,900 on line 8.

Using the column for married filing jointly in the Tax Table, John finds the tax on $48,900. He enters the tax, $6,501, on line 9. He enters $6,366 on line 10. This is the tax from line 44 of John and Laura’s Form 1040. He enters $135 on line 11 ($6,501 − $6,366).

Because line 7 is blank, John skips lines 12a and 12b and enters $135 on line 13.

John subtracts line 5 ($900) from line 4 ($2,500) and enters the result, $1,600, on line 14. Using the column for single filing status in the Tax Table, John finds the tax on $1,600 and enters this tax, $161, on line 15. He adds lines 13 ($135) and 15 ($161) and enters $296 on line 16.

Using the column for single filing status in the Tax Table, John finds the tax on $2,500 (line 4) and enters this tax, $251, on line 17.

John compares lines 16 and 17 and enters the larger amount, $296, on line 18 of Sara's Form 8615. He also enters that amount on line 28 of Sara's Form 1040A.

John also completes Schedule B (Form 1040A or 1040) for Sara.

Form **8615**

Department of the Treasury
Internal Revenue Service (99)

Tax for Certain Children Who Have Investment Income of More Than $1,900

▶ Attach only to the child's Form 1040, Form 1040A, or Form 1040NR.
▶ See separate instructions.

OMB No. 1545-0074
2011
Attachment Sequence No. **33**

Child's name shown on return	Child's social security number
Sara L. Brown	117-00-1111

Before you begin: If the child, the parent, or any of the parent's other children for whom Form 8615 must be filed must use the Schedule D Tax Worksheet or has income from farming or fishing, see **Pub. 929,** Tax Rules for Children and Dependents. It explains how to figure the child's tax using the **Schedule D Tax Worksheet** or **Schedule J** (Form 1040).

A Parent's name (first, initial, and last). **Caution:** *See instructions before completing.*	**B** Parent's social security number
John J. Brown	007-00-0001

C Parent's filing status (check one):
☐ Single ☑ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Part I Child's Net Investment Income

1	Enter the child's investment income (see instructions)	1	2,800
2	If the child **did not** itemize deductions on **Schedule A** (Form 1040 or Form 1040NR), enter $1,900. Otherwise, see instructions	2	1,900
3	Subtract line 2 from line 1. If zero or less, **stop;** do not complete the rest of this form but **do** attach it to the child's return	3	900
4	Enter the child's **taxable income** from Form 1040, line 43; Form 1040A, line 27; or Form 1040NR, line 41. If the child files Form 2555 or 2555-EZ, see the instructions	4	2,500
5	Enter the **smaller** of line 3 or line 4. If zero, **stop;** do not complete the rest of this form but **do** attach it to the child's return	5	900

Part II Tentative Tax Based on the Tax Rate of the Parent

6	Enter the parent's **taxable income** from Form 1040, line 43; Form 1040A, line 27; Form 1040EZ, line 6; Form 1040NR, line 41; or Form 1040NR-EZ, line 14. If zero or less, enter -0-. If the parent files Form 2555 or 2555-EZ, see the instructions	6	48,000
7	Enter the total, if any, from Forms 8615, line 5, of **all other** children of the parent named above. **Do not** include the amount from line 5 above	7	
8	Add lines 5, 6, and 7 (see instructions)	8	48,900
9	Enter the tax on the amount on line 8 based on the **parent's** filing status above (see instructions). If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here ▶ ☐	9	6,501
10	Enter the parent's tax from Form 1040, line 44; Form 1040A, line 28, minus any alternative minimum tax; Form 1040EZ, line 11; Form 1040NR, line 42; or Form 1040NR-EZ, line 15. **Do not** include any tax from **Form 4972** or **8814** or any tax from recapture of an education credit. If the parent files Form 2555 or 2555-EZ, see the instructions. If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) was used to figure the tax, check here ▶ ☐	10	6,366
11	Subtract line 10 from line 9 and enter the result. If line 7 is blank, also enter this amount on line 13 and go to **Part III**	11	135
12a	Add lines 5 and 7 — 12a		
b	Divide line 5 by line 12a. Enter the result as a decimal (rounded to at least three places)	12b	× .
13	Multiply line 11 by line 12b	13	135

Part III Child's Tax—If lines 4 and 5 above are the same, enter -0- on line 15 and go to line 16.

14	Subtract line 5 from line 4 — 14 — 1,600		
15	Enter the tax on the amount on line 14 based on the **child's** filing status (see instructions). If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here ▶ ☐	15	161
16	Add lines 13 and 15	16	296
17	Enter the tax on the amount on line 4 based on the **child's** filing status (see instructions). If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here ▶ ☐	17	251
18	Enter the **larger** of line 16 or line 17 here and on the **child's** Form 1040, line 44; Form 1040A, line 28; or Form 1040NR, line 42. If the child files Form 2555 or 2555-EZ, see the instructions	18	296

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 64113U Form **8615** (2011)

CHAPTER 31 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. It is always advantageous to elect to report a child's interest and dividend income on a parent's tax return when eligible.

   a) true
   b) false

CHAPTER 31 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. The federal income tax on the child's income may be more if the election is made using Form 8814.

   B: False is correct. If the election is made, the federal income tax on the child's income may be more. This may result from higher tax rates, deductions that cannot be taken, and reduced deductions or credits. Also, penalty for underpayment of estimated tax may be due if not enough tax was withheld or pay enough estimated tax to cover the tax owed.

Chapter 32: Child and Dependent Care Credit

I. Introduction

Temporarily extend the expanded dependent care credit. The dependent care credit allows a taxpayer a credit for an applicable percentage of child care expenses for children under 13 and disabled dependents. The EGTRRA increased the amount of eligible expenses from $2,400 for one child and $4,800 for two or more children to $3,000 and $6,000, respectively. The EGTRRA also increased the applicable percentage from 30 percent to 35 percent. The 2010 Act extends the changes to the dependent care credit made by the EGTRRA for an additional two years, through 2012.

This chapter discusses the ***credit for child and dependent care expenses*** and covers the following topics.

- Tests you must meet to claim the credit.
- How to figure the credit.
- How to claim the credit.
- Employment taxes you may have to pay as a household employer.

You may be able to claim the credit if you pay someone to care for your dependent who is under age 13 or for your spouse or dependent who is not able to care for himself or herself. The credit can be up to 35% of your expenses. To qualify, you must pay these expenses so you can work or look for work.

Dependent care benefits. If you received any dependent care benefits from your employer during the year, you may be able to exclude from your income all or part of them. You must complete Part III of Form 2441 before you can figure the amount of your credit.

II. Tests to Claim the Credit

To be able to claim the credit for child and dependent care expenses, you must file Form 1040 or Form 1040A, not Form 1040EZ, and meet ***all*** the following tests.

1) The care must be for one or more qualifying persons who are identified on the form you use to claim the credit. (See *Qualifying Person Test.*)
2) You (and your spouse if you are married) must have earned income during the year. (However, see *Rule for student-spouse or spouse not able to care for self* under *Earned Income Test*, later.)
3) You must pay child and dependent care expenses so you (and your spouse if you are married) can work or look for work. (See *Work-Related Expense Test*, later.)
4) You must make payments for child and dependent care to someone you (or your spouse) cannot claim as a dependent. If you make payments to your child, he or she cannot be your dependent and must be age 19 or older by the end of the year. You cannot make payments to:
   a) Your spouse, or
   b) The parent of your qualifying child who is your qualifying person and under age 13.

   (See *Payments to Relatives* under *Work-Related Expense Test*, later.)

5) Your filing status must be single, head of household, qualifying widow(er) with dependent child, or married filing jointly. You must file a joint return if you are married, unless an exception applies to you. (See *Joint Return Test*, later.)
6) You must identify the care provider on your tax return. (See *Provider Identification Test,* later.)
7) If you exclude or deduct dependent care benefits provided b*y a dependent care benefits pl*an, the total amount you exclude or deduct must be less than the dollar limit for qualifying expenses (generally, $3,000 if one qualifying person was cared for or $6,000 if two or more qualifying persons were cared for). (If two or more qualifying persons were cared for, the amount you exclude or deduct will always be less than the dollar limit, since the amount you can exclude or deduct is limited to $5,000. See *Reduced Dollar Limit* under *How to Figure the Credit*, later.)

These tests are presented in *Figure 32-A* and are also explained in detail in this chapter.

QUALIFYING PERSON TEST

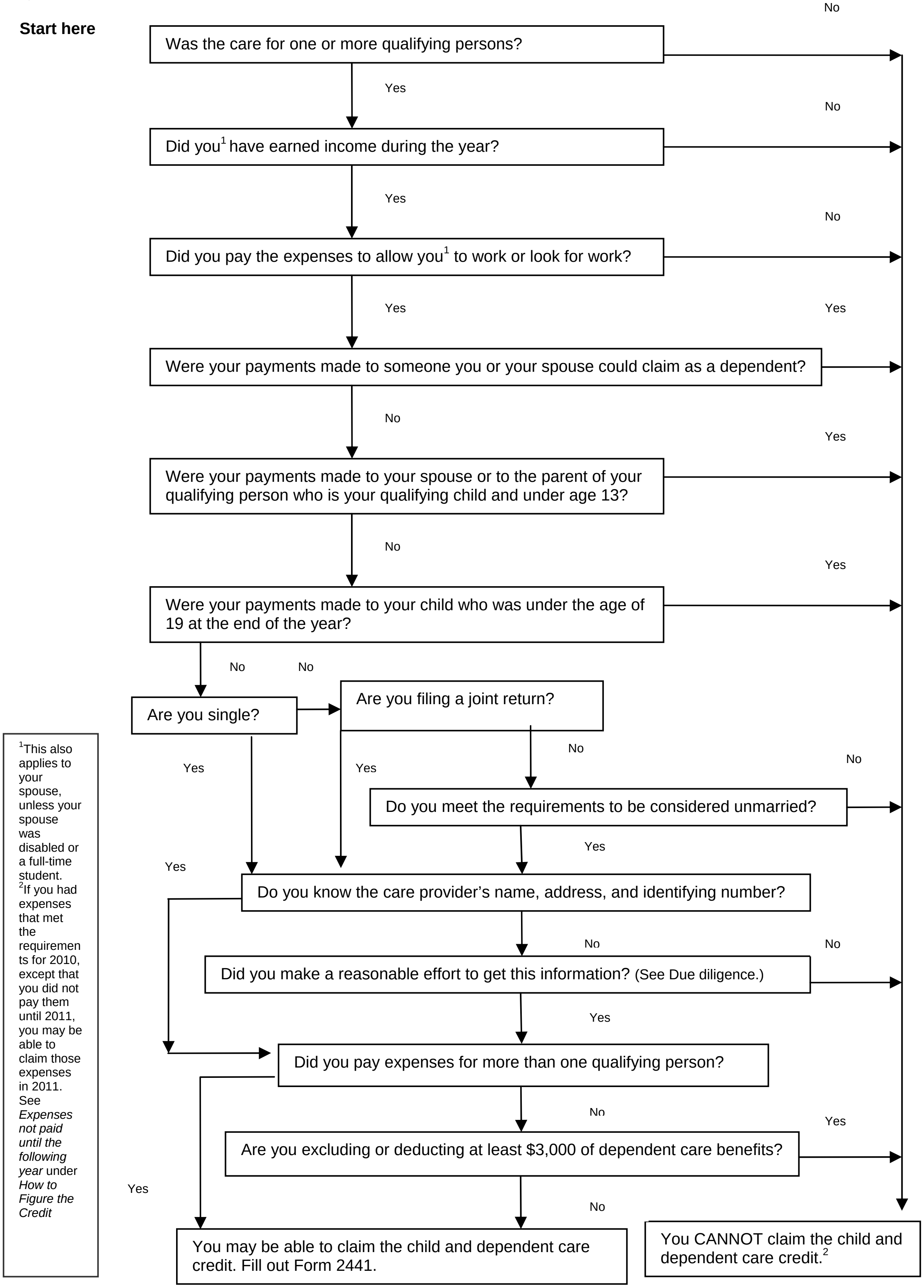
Your child and dependent care expenses must be for the care of one or more qualifying persons.

A qualifying person is:

1) Your qualifying child who is your dependent and who was under age 13 when the care was provided,
2) Your spouse who was physically or mentally not able to care for himself or herself and lived with you more than half the year, or
3) A person who was physically or mentally not able to care for himself or herself, lived with you for more than half the year, and either:
   a) Was your dependent, or
   b) Would have been your dependent except that (i) he or she received gross income of $3,700 or more, (ii) he or she filed a joint return, or (iii) you, or your spouse if filing jointly, could be claimed as a dependent on someone else's 2011 return

If you are divorced or separated, see *Child of Divorced or Separated Parents,* later, to determine which parent may treat the child as a qualifying person.

Figure 32-A. Can You Claim the Credit?



[1]This also applies to your spouse, unless your spouse was disabled or a full-time student.
[2]If you had expenses that met the requirements for 2010, except that you did not pay them until 2011, you may be able to claim those expenses in 2011. See *Expenses not paid until the following year* under *How to Figure the Credit*

Person qualifying for part of year. You determine a person's qualifying status each day. For example, if the person for whom you pay child and dependent care expenses no longer qualifies on September 16, count only those expenses through September 15. Also see *Dollar Limit* under *How To Figure the Credit,* later.

Taxpayer identification number. You must include on your return the name and taxpayer identification number (generally the social security number) of the qualifying person(s). If the correct information is not shown, the credit may be reduced or disallowed.

Individual taxpayer identification number (ITIN) for aliens. If your qualifying person is a nonresident or resident alien who does not have and cannot get a social security number (SSN), use that person's ITIN. To apply for an ITIN, file Form W-7 with the IRS. The ITIN is entered wherever an SSN is requested on a tax return.

An ITIN is for tax use only. It does not entitle the holder to social security benefits or change the holder's employment or immigration status under U.S. law.

Adoption taxpayer identification number (ATIN). If your qualifying person is a child who was placed in your home for adoption and for whom you do not have an SSN, you must get an ATIN for the child. File Form W-7A, *Application for Taxpayer Identification Number for Pending U.S. Adoptions.*

Child of Divorced or Separated Parents. Even if you cannot claim your child as a dependent, he or she is treated as your qualifying person if:

- The child was under age 13 or was physically or mentally not able to care for himself or herself,
- The child received over half of his or her support during the calendar year from one or both parents who are divorced or legally separated under a decree of divorce or separate maintenance, are separated under a written separation agreement, or lived apart at all times during the last six months of the calendar year,
- The child was in the custody of one or both parents for more than half the year, and
- You were the child’s custodial parent (the parent with whom the child lived for the greater part of 2011).

The noncustodial parent cannot treat the child as a qualifying person even if that parent is entitled to claim the child as a dependent under the special rule for a child of divorced or separated parents.

EARNED INCOME TEST

To claim the credit, you (and your spouse if you are married) must have earned income during the year.

Earned income. Earned income includes wages, salaries, tips, other taxable employee compensation, and net earnings from self-employment. A net loss from self-employment reduces earned income. Earned income also includes strike benefits and any disability pay you report as wages.

Generally, only taxable compensation is included. However, you can elect to include nontaxable combat pay in earned income. If you are filing a joint return and both you and your spouse received nontaxable combat pay, you can each make your own election. You should figure your credit both ways and make the election if it gives you a greater tax benefit.

Members of certain religious faiths opposed to social security. Certain income earned by persons who are members of certain religious faiths that are opposed to participation in Social Security Act Programs and have an IRS-approved form that exempts certain income from social security and Medicare taxes may not be considered earned income for this purpose.

Not earned income. Earned income does not include:

- Child support payments received by you,
- Pensions and annuities,
- Social security and railroad retirement benefits,
- Workers' compensation,
- Interest and dividends,
- Unemployment compensation,
- Scholarship or fellowship grants, except for those reported on a Form W-2 and paid to you for teaching or other services,
- Nontaxable workfare payments,
- Income of nonresident aliens that is not effectively connected with a U.S. trade or business, or
- Any amount received for work while an inmate in a penal institution.

Rule for student-spouse or spouse not able to care for self. Your spouse is treated as having earned income for any month that he or she is:

1) A full-time student, or
2) Physically or mentally not able to care for himself or herself. (Your spouse also must live with you for more than half the year.)

Figure the earned income of the nonworking spouse described under (1) or (2) above as explained under *Earned Income Limit,* later.

This rule applies to only one spouse for any one month. If, in the same month, both you and your spouse do not work and are either full-time students or physically or mentally not able to care for yourselves, only one of you can be treated as having earned income in that month.

Full-time student. You are a full-time student if you are enrolled at and attend a school for the number of hours or classes that the school considers full time. You must have been a student for some part of each of 5 calendar months during the year. (The months need not be consecutive.)

School. The term "school" includes high schools, colleges, universities, and technical, trade, and mechanical schools. It does not include on-the-job training courses, correspondence schools, or school offering courses only through the Internet.

WORK-RELATED EXPENSE TEST

Child and dependent care expenses must be work related to qualify for the credit. Expenses are considered work related only if both of the following are true.

- They allow you (and your spouse if you are married) to work or look for work.
- They are for a qualifying person's care.

Working or Looking for Work

To be work related, your expenses must allow you to work or look for work. If you are married, generally both you and your spouse must work or look for work. Your spouse is treated as working during any month he or she is a full-time student or is physically or mentally not able to care for himself or herself.

Your work can be for others or in your own business or partnership. It can be either full time or part time.

Work also includes actively looking for work. However, if you do not find a job and have no earned income for the year, you cannot take this credit. See *Earned Income Test,* earlier.

An expense is not considered work related merely because you had it while you were working. The purpose of the expense must be to enable you to work. Whether your expenses allow you to work or look for work depends on the facts.

Volunteer work. For this purpose, you are not considered to be working if you do unpaid volunteer work or volunteer work for a nominal salary.

Work for part of year. If you work or actively look for work during only part of the period covered by the expenses, then you must figure your expenses for each day. For example, if you work all year and pay care expenses of $250 a month ($3,000 for the year), all the expenses are work related. However, if you work or look for work for only 2 months and 15 days during the year and pay expenses of $250 a month, your work-related expenses are limited to $625 (2 ½ months X $250).

Temporary absence from work. You do not have to figure your expenses for each day during a short, temporary absence from work, such as for vacation or a minor illness, if you have to pay for care anyway. Instead, you can figure your credit including the expenses you paid for the period of absence.

An absence of 2 weeks or less is a short, temporary absence. An absence of more than 2 weeks may be considered a short, temporary absence, depending on the circumstances.

Example. You pay a nanny to care for your 2-year-old son and 4-year-old daughter so you can work. You become ill and miss 4 months of work but receive sick pay. You continue to pay the nanny to care for the children while you are ill. Your absence is not a short, temporary absence, and your expenses are not considered work-related.

Part-time work. If you work part-time, you generally must figure your expenses for each day. However, if you have to pay for care weekly, monthly, or in another way that includes both days worked and days not worked, you can figure your credit including the expenses you paid for days you did not work. Any day when you work at least 1 hour is a day of work.

Example 1. You work 3 days a week. While you work, your 6-year-old child attends a dependent care center, which complies with all state and local regulations. You can pay the center $150 for any 3 days a week or $250 for 5 days a week. Your child attends the center 5 days a week. Your work-related expenses are limited to $150 a week.

Example 2. The facts are the same as in Example 1 except the center does not offer a 3-day option. The entire $250 weekly fee may be a work-related expense.

Care of a Qualifying Person

To be work related, your expenses must be to provide care for a qualifying person. You do not have to choose the least expensive way of providing the care.

Expenses are for the care of a qualifying person only if their main purpose is the person's well-being and protection.

Expenses for ***household services*** qualify if part of the services is for the care of qualifying persons. See *Household services,* later.

Expenses not for care. Expenses for care do not include amounts you pay for food, clothing, education, and entertainment. However, you can include small amounts paid for these items if they are incident to and cannot be separated from the cost of caring for the qualifying person.

Education. Expenses for a child in nursery school, pre-school, or similar programs for children below the level of kindergarten are expenses for care. Expenses to attend kindergarten or a higher grade are not expenses for care. Do not use these expenses to figure your credit.

However, expenses for before- or after-school care of a child in kindergarten or a higher grade may be expenses for care.

Summer school and tutoring programs are not for care.

Example 1. You take your 3-year-old child to a nursery school that provides lunch and educational activities as a part of its preschool child-care service. The lunch and educational activities are incident to the childcare, and their cost cannot be separated from the cost of care. You can count the total cost when you figure the credit.

Example 2. You place your 10-year-old child in a boarding school so you can work full time. Only the part of the boarding school expense that is for the care of your child is a work-related expense. You can count that part of the expense in figuring your credit if it can be separated from the cost of education. You cannot count any part of the amount you pay the school for your child's education.

Care outside your home. You can count the cost of care provided outside your home if the care is for your dependent under age 13 or any other qualifying person who regularly spends at least 8 hours each day in your home.

Dependent care center. You can count care provided outside your home by a dependent care center only if the center complies with all state and local regulations that apply to these centers.

A dependent care center is a place that provides care for more than six persons (other than persons who live there) and receives a fee, payment, or grant for providing services for any of those persons, even if the center is not run for profit.

Camp. The cost of sending your child to an overnight camp is ***not*** considered a work-related expense. The cost of sending your child to a day camp may be a work-related expense, even if the camp specializes in a particular activity, such as computers or soccer.

Transportation. If a care provider takes a qualifying person to or from a place where care is provided, that transportation is for the care of the qualifying person. This includes transportation by bus, subway, taxi, or private car. However, transportation not provided by a care provider is not for the care of a qualifying person. Also, if you pay the transportation cost for the care provider to come to your home, that expense is not for care of a qualifying person.

Fees and deposits. Fees you paid to an agency to get the services of a care provider, deposits you paid to an agency or pre-school, application fees, and other indirect expenses are work-related expenses if you have to pay them to get care, even though they are not directly for care. However, a forfeited deposit is not for the care of a qualifying person if care is not provided.

Example 1. You paid a fee to an agency to get the services of the nanny who cares for your 2-year-old daughter while you work. The fee you paid is a work-related expense.

Example 2. You placed a deposit with a pre-school to reserve a place for your 3-year-old child. You later sent your child to a different pre-school and forfeited the deposit. The forfeited deposit is not for care and so is not a work-related expense.

Household services. Expenses you pay for household services meet the work-related expense test if they are at least partly for the well-being and protection of a qualifying person.

Household services are ordinary and usual services done in and around your home that are necessary to run your home. They include the services of a housekeeper, maid, or cook. However, they do not include the services of a chauffeur, bartender, or gardener. See *Household Services* in Publication 503 for more information.

In this chapter, the term housekeeper refers to any household employee whose services include the care of a qualifying person.

Taxes paid on wages. The taxes you pay on wages for qualifying child and dependent care services are work-related expenses. See *Employment Taxes for Household Employers,* later.

Payments to Relatives or Dependents

You can count work-related payments you make to relatives who are not your dependents, even if they live in your home. However, do not count any amounts you pay to:

1) A dependent for whom you (or your spouse if you are married) can claim an exemption,
2) Your child who was under age 19 at the end of the year, even if he or she is not your dependent,
3) A person who was your spouse any time during the year, or
4) The parent of your qualifying child who is your qualifying person and is under age 13.

JOINT RETURN TEST

Generally, married couples must file a joint return to take the credit. However, if you are legally separated or living apart from your spouse, you may be able to file a separate return and still take the credit. However, you cannot use the filing status, Married Filing Separately, if you plan to claim the credit.

Legally separated. You are not considered married if you are legally separated from your spouse under a decree of divorce or separate maintenance. You are eligible to take the credit on your return using Head of Household filing status.

Married and living apart. You are not considered married and are eligible to take the credit if ***all*** the following apply.

1) You file a separate return.
2) Your home is the home of a qualifying person for more than half the year.
3) You pay more than half the cost of keeping up your home for the year.
4) Your spouse does not live in your home for the last 6 months of the year.

Death of spouse. If your spouse died during the year and you do not remarry before the end of the year, you generally must file a joint return to take the credit. If you do remarry before the end of the year, the credit can be claimed on your deceased spouse's own return.

PROVIDER IDENTIFICATION TEST

You must identify all persons or organizations that provide care for your child or dependent. Use Part I of Form 2441 to show the information.

Information needed. To identify the care provider, you must give the provider's:

1) Name,
2) Address, and
3) Taxpayer identification number.

If the care provider is an individual, the taxpayer identification number is his or her social security number or individual taxpayer identification number. If the care provider is an organization, then it is the employer identification number (EIN).

You do not have to show the taxpayer identification number if the care provider is one of certain tax-exempt organizations (such as a church or school). In this case, write "Tax-Exempt" in the space where the tax form calls for the number.

If you cannot provide all of the information or if the information you provide is incorrect you must be able to show that you used due diligence (discussed later) in trying to furnish the necessary information.

Getting the information. You can use **Form W-10** to request the required information from the care provider. If you do not use Form W-10, you can get the information from:

1) A copy of the provider's social security card,
2) A copy of the provider's completed Form W-4 if he or she is your household employee,
3) A copy of the statement furnished by your employer if the provider is your employer's dependent care plan, or
4) A letter or invoice from the provider if it shows the information.

Due diligence. If the care provider information you give is incorrect or incomplete, your credit may not be allowed. However, if you can show that you used due diligence in trying to supply the information, you can still claim the credit.

You can show due diligence by getting and keeping the provider's completed Form W-10 or one of the other sources of information listed earlier. Care providers can be penalized if they do not provide this information to you or if they provide incorrect information.

Provider refusal. If the provider refuses to give you their identifying information, you should report whatever information you have (such as the name and address) on the form you use to claim the credit. Enter “See Attached Statement” in the columns calling for the information you do not have. Then, attach a statement explaining that you requested the information from the care provider, but the provider did not give you the information. Be sure to write your name and social security number on this statement. The statement will show that you used due diligence in trying to furnish the necessary information.

III. How to Figure the Credit

Your credit is a percentage of your work-related expenses. Your expenses are subject to the earned income limit and the dollar limit. The percentage is based on your adjusted gross income.

FIGURING TOTAL WORK-RELATED EXPENSES

To figure the credit for 2011 work-related expenses, count only those you paid by December 31, 2011.

Expenses prepaid in an earlier year. If you pay for services before they are provided, you can count the prepaid expenses only in the year the care is received. Claim the expenses for the later year as if they were actually paid in that later year.

Expenses not paid until the following year. Do ***not*** count 2010 expenses that you paid in 2011 as work-related expenses for 2011. You may be able to claim an additional credit for them on your 2011 return, but you must figure it separately.

Expenses reimbursed. If a state social services agency pays you a nontaxable amount to reimburse you for some of your child and dependent care expenses, you cannot count the expenses that are reimbursed as work-related expenses.

Example. You paid work-related expenses of $3,000. You are reimbursed $2,000 by a state social services agency. You can use only $1,000 to figure your credit.

Medical expenses. Some expenses for the care of qualifying persons who are not able to care for themselves may qualify as work-related expenses and also as medical expenses. You can use them either way, but you cannot use the same expenses to claim both a credit and a medical expense deduction.

If you use these expenses to figure the credit and they are more than the earned income limit or the dollar limit, discussed later, you can add the excess to your medical expenses. However, if you use your total expenses to figure your medical expense deduction, you cannot use any part of them to figure your credit.

Dependent Care Benefits

Dependent care benefits include:

1) Amounts your employer pays directly to either you or your care provider for the care of your qualifying person while you work,
2) The fair market value of care in a day-care facility provided or sponsored by your employer, and
3) Pre-tax contributions you made under a dependent care flexible spending arrangement.

Your salary may have been reduced to pay for these benefits. If you received benefits, they should be shown on your W-2 form. See *Statement for employee,* later.

Exclusion or deduction. If your employer provides dependent care benefits under a qualified plan, you may be able to exclude these benefits from your income. Your employer can tell you whether your benefit plan qualifies. To claim the exclusion, you must complete Part III of Form 2441. You cannot use Form 1040EZ.

If you are self-employed and receive benefits from a qualified dependent care benefit plan, you are treated as both employer and employee. Therefore, you would not get an exclusion from wages. Instead, you would get a deduction on Form 1040, Schedule C, line 14; Schedule E, line 18 or 28; or Schedule F, line 17. To claim the deduction, you must use Form 2441.

The amount you can exclude or deduct is limited to the smallest of:

1) The total amount of dependent care benefits you received during the year,
2) The total amount of qualified expenses you incurred during the year,
3) Your earned income,
4) Your spouse's earned income, or
5) $5,000 ($2,500 if married filing separately).

The definition of earned income for the exclusion or deduction is the same as the definition used when figuring the credit except that earned income for the exclusion or deduction does not include any dependent care benefits you receive. See the instructions for Form 2441.

Statement for employee. Your employer must give you a **Form W-2** (or similar statement), showing in box 10 the total amount of dependent care benefits provided to you during the year under a qualified plan. Your employer will also include any dependent care benefits over $5,000 in your wages shown in box 10 of your Form W-2.

Effect of exclusion. If you exclude dependent care benefits from your income, the amount of the excluded benefits:

1) Is not included in your work-related expenses, and
2) Reduces the dollar limit, discussed later.

EARNED INCOME LIMIT

The amount of work-related expenses you use to figure your credit cannot be more than:

1) Your earned income for the year if you are ***single*** at the end of the year, or
2) The smaller of your or your spouse's earned income for the year if you are ***married*** at the end of the year.

Earned income is defined under *Earned Income Test,* earlier.

Tip. *For purposes of item (2), use your spouse's earned income for the entire year, even if you were married for only part of the year.*

Separated spouse. If you are legally separated or married and living apart from your spouse (as described under *Joint Return Test,* earlier), you are not considered married for purposes of the earned income limit. Use only your income in figuring the earned income limit.

Surviving spouse. If your spouse died during the year and you file a joint return as a surviving spouse, you are not considered married for purposes of the earned income limit. Use only your income in figuring the earned income limit.

Community property laws. You should disregard community property laws when you figure earned income for this credit.

Student-spouse or spouse not able to care for self. Your spouse who is either a full-time student or not able to care for himself or herself is treated as having earned income. His or her earned income for each month is considered to be at least $250 if there is one qualifying person in your home, or at least $500 if there are two or more.

Spouse works. If your spouse works during that month, use the higher of $250 (or $500) or his or her actual earned income for that month.

Spouse qualifies for part of month. If your spouse is a full-time student or not able to care for himself or herself for only part of a month, the full $250 (or $500) still applies for that month.

Both spouses qualify. If, in the same month, both you and your spouse are either full-time students or not able to care for yourselves, only one spouse can be considered to have this earned income of $250 (or $500) for that month.

DOLLAR LIMIT

There is a dollar limit on the amount of your work-related expenses you can use to figure the credit. This limit is $3,000 for one qualifying person, or $6,000 for two or more qualifying persons.

Yearly limit. The dollar limit is a yearly limit. The amount of the dollar limit remains the same no matter how long, during the year, you have a qualifying person in your household. Use the $3,000 limit if you paid work-related expenses for the care of one qualifying person at any time during the year. Use $6,000 if you paid work-related expenses for the care of more than one qualifying person at any time during the year.

Reduced Dollar Limit

If you received dependent care benefits from your employer that you exclude from your income, you must subtract that amount from the dollar limit that applies to you. Your reduced dollar limit is figured in Part III of Form 2441. See *Employer-Provided Dependent Care Benefits,* earlier, for information on excluding or deducting these benefits.

> ***Example.*** George is a widower with one child and earns $24,000 a year. He pays work-related expenses of $2,900 for the care of his 4-year-old child and qualifies to claim the credit for child and dependent care expenses. His employer pays an additional $1,000 under a dependent care benefit plan. This $1,000 is excluded from George's income.
>
> Although the dollar limit for his work-related expenses is $3,000 (one qualifying person), George figures his credit on only $2,000 of the $2,900 work-related expenses he paid. This is because his dollar limit is reduced as shown next.

George's Reduced Dollar Limit

1) Maximum allowable expenses for one qualifying person	$3,000
2) **Minus**: Dependent care benefits George excludes from income	1,000
3) Reduced dollar limit on expenses George can use for the credit	$2,000

AMOUNT OF CREDIT

To determine the amount of your credit, multiply your work-related expenses (after applying the earned income and dollar limits) by a percentage. This percentage depends on your adjusted gross income shown on line 38 of Form 1040 or line 22 of Form 1040A. The following table shows the percentage to use based on adjusted gross income.

If your adjusted gross income is: Over	But not over	Then the percentage is
$0	$15,000	35%
15,000	17,000	34%
17,000	19,000	33%
19,000	21,000	32%
21,000	23,000	31%
23,000	25,000	30%
25,000	27,000	29%
27,000	29,000	28%
29,000	31,000	27%
31,000	33,000	26%
33,000	35,000	25%
35,000	37,000	24%
37,000	39,000	23%
39,000	41,000	22%
41,000	43,000	21%
43,000	No limit	20%

IV. How to Claim the Credit

To claim the credit, you can file Form 1040 or Form 1040A. You cannot claim the credit on Form 1040EZ.

Form 1040 or 1040A. You must complete **Form 2441** and attach it to your Form 1040 or 1040A. Enter the credit on line 48 of Form 1040 or line 29 of Form 1040A. An example of a filled-in Form 2441 is at the end of this chapter.

Limit on credit. The amount of credit you can claim is limited to your regular tax (after reduction by any allowable foreign tax credit) plus your alternative minimum tax, if any.

Tax credit not refundable. You cannot get a refund for any part of the credit that is more than this limit.

V. Employment Taxes for Household Employers

If you pay someone to come to your home and care for your dependent or spouse, you may be a household employer. If you are a household employer, you will need an employer identification number (EIN) and you may have to pay employment taxes. If the individuals who work in your home are self-employed, you are not liable for any of the taxes discussed in this section. Self-employed persons who are in business for themselves are not household employees. Usually, you are ***not*** a household employer if the person who cares for your dependent or spouse does so at his or her home or place of business.

If you use a placement agency that exercises control over what work is done and how it will be done by a babysitter or companion who works in your home, that person is not your employee. This control could include providing rules of conduct and appearance and requiring regular reports. In this case, you do not have to pay employment taxes. But, if an agency merely gives you a list of sitters and you hire one from that list, the sitter may be your employee.

If you have a household employee you may be subject to:

1) Social security and Medicare taxes,
2) Federal unemployment tax, and
3) Federal income tax withholding.

Social security and Medicare taxes are generally withheld from the employee's pay and matched by the employer. Federal unemployment (FUTA) tax is paid by the employer only and provides for payments of unemployment compensation to workers who have lost their jobs. Federal income tax is withheld from the employee's total pay if the employee asks you to do so and you agree.

State employment tax. You may also have to pay state unemployment tax. Contact your state unemployment tax office for information. You should also find out whether you need to pay or collect other state employment taxes or carry workers' compensation insurance.

EXAMPLE

The following example shows how to figure the credit for child and dependent care expenses for two children when employer-provided dependent care benefits are involved. The filled-in draft Form 2441 is shown at the end of this chapter.

Illustrated example. Joan Thomas is divorced and has two children, ages 3 and 9. She works at ACME Computers. Her adjusted gross income (AGI) is $29,000, and the entire amount is earned income.

Joan's younger child (Susan) stays at her employer's on-site childcare center while she works. The benefits from this childcare center qualify to be excluded from her income. Her employer reports the value of this service as $3,000 for the year. This $3,000 is shown on her Form W-2 in box 10, but is not included in taxable wages in box 1.

A neighbor cares for Joan's older child (Seth) after school, on holidays, and during the summer. Joan pays her neighbor $2,400 for this care.

Joan figures her credit on Form 2441 as follows.

1) Work-related expenses Joan paid	$2,400
2) Dollar limit (2 or more qualified individuals)	$6,000
3) Minus: Dependent care benefits excluded from Joan's income	-3,000
4) Reduced dollar limit	$3,000
5) Lesser of expenses paid ($2,400 or dollar limit ($3,000)	$2,400
6) Percentage for AGI of $29,000 (28%)	.28
7) Multiply the amount on line 5 by the percentage on line 6 ($2,400 x .28)	$672
8) Enter the tax liability limit from Form 2441, line 10	$963
9) Credit (Enter the smaller of line 7 or line 8)	$672

Form **2441**

Department of the Treasury
Internal Revenue Service (99)

Child and Dependent Care Expenses

▶ Attach to Form 1040, Form 1040A, or Form 1040NR.

▶ See separate instructions.

1040 1040A 1040NR 2441

OMB No. 1545-0074

2011

Attachment Sequence No. **21**

Name(s) shown on return: Joan Thomas

Your social security number: 559-00-3436

Part I **Persons or Organizations Who Provided the Care**—You **must** complete this part.
(If you have more than two care providers, see the instructions.)

1 (a) Care provider's name	(b) Address (number, street, apt. no., city, state, and ZIP code)	(c) Identifying number (SSN or EIN)	(d) Amount paid (see instructions)
Pat Green	12 Ash Avenue Hometown, TX 75240	240-00-3811	2,400
ACME Computers	(See W-2)		

Did you receive **dependent care benefits?**
No ▶ Complete only Part II below.
Yes ▶ Complete Part III on the back next.

Caution. If the care was provided in your home, you may owe employment taxes. If you do, you cannot file Form 1040A. For details, see the instructions for Form 1040, line 59a, or Form 1040NR, line 58a.

Part II **Credit for Child and Dependent Care Expenses**

2 Information about your **qualifying person(s)**. If you have more than two qualifying persons, see the instructions.

(a) Qualifying person's name — First	Last	(b) Qualifying person's social security number	(c) **Qualified expenses** you incurred and paid in 2011 for the person listed in column (a)
Seth	Thomas	559-00-1234	2,400
Susan	Thomas	559-00-5678	

3	Add the amounts in column (c) of line 2. **Do not** enter more than $3,000 for one qualifying person or $6,000 for two or more persons. If you completed Part III, enter the amount from line 31	3	2,400
4	Enter your **earned income.** See instructions	4	29,000
5	If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions); **all others**, enter the amount from line 4	5	29,000
6	Enter the **smallest** of line 3, 4, or 5	6	2,400
7	Enter the amount from Form 1040, line 38; Form 1040A, line 22; or Form 1040NR, line 37. — 7: 29,000		
8	Enter on line 8 the decimal amount shown below that applies to the amount on line 7	8	X. 28

If line 7 is:

Over	But not over	Decimal amount is	Over	But not over	Decimal amount is
$0	15,000	.35	$29,000	31,000	.27
15,000	17,000	.34	31,000	33,000	.26
17,000	19,000	.33	33,000	35,000	.25
19,000	21,000	.32	35,000	37,000	.24
21,000	23,000	.31	37,000	39,000	.23
23,000	25,000	.30	39,000	41,000	.22
25,000	27,000	.29	41,000	43,000	.21
27,000	29,000	.28	43,000	No limit	.20

9	Multiply line 6 by the decimal amount on line 8. If you paid 2010 expenses in 2011, see the instructions	9	672
10	Tax liability limit. Enter the amount from the Credit Limit Worksheet in the instructions. — 10: 963		
11	**Credit for child and dependent care expenses.** Enter the **smaller** of line 9 or line 10 here and on Form 1040, line 48; Form 1040A, line 29; or Form 1040NR, line 46	11	672

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11862M Form **2441** (2011)

Part III Dependent Care Benefits

12	Enter the total amount of **dependent care benefits** you received in 2011. Amounts you received as an employee should be shown in box 10 of your Form(s) W-2. **Do not** include amounts reported as wages in box 1 of Form(s) W-2. If you were self-employed or a partner, include amounts you received under a dependent care assistance program from your sole proprietorship or partnership		12	3,000
13	Enter the amount, if any, you carried over from 2010 and used in 2011 during the grace period. See instructions		13	
14	Enter the amount, if any, you forfeited or carried forward to 2012. See instructions		14	( )
15	Combine lines 12 through 14. See instructions		15	3,000
16	Enter the total amount of **qualified expenses** incurred in 2011 for the care of the **qualifying person(s)**	16 — 5,400		
17	Enter the **smaller** of line 15 or 16	17 — 3,000		
18	Enter your **earned income.** See instructions	18 — 29,000		
19	Enter the amount shown below that applies to you. • If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions for line 5). • If married filing separately, see instructions. • All others, enter the amount from line 18.	19 — 29,000		
20	Enter the **smallest** of line 17, 18, or 19	20 — 3,000		
21	Enter $5,000 ($2,500 if married filing separately **and** you were required to enter your spouse's earned income on line 19)	21 — 5,000		
22	Is any amount on line 12 from your sole proprietorship or partnership? (Form 1040A filers go to line 25.) ☐ **No.** Enter -0-. ☐ **Yes.** Enter the amount here		22	
23	Subtract line 22 from line 15	23		
24	**Deductible benefits.** Enter the **smallest** of line 20, 21, or 22. Also, include this amount on the appropriate line(s) of your return. See instructions		24	
25	**Excluded benefits. Form 1040 and 1040NR filers:** If you checked "No" on line 22, enter the smaller of line 20 or 21. Otherwise, subtract line 24 from the smaller of line 20 or line 21. If zero or less, enter -0-. **Form 1040A filers:** Enter the **smaller** of line 20 or line 21		25	3,000
26	**Taxable benefits. Form 1040 and 1040NR filers:** Subtract line 25 from line 23. If zero or less, enter -0-. Also, include this amount on Form 1040, line 7; or Form 1040NR, line 8. On the dotted line next to Form 1040, line 7; or Form 1040NR, line 8, enter "DCB." **Form 1040A filers:** Subtract line 25 from line 15. Also, include this amount on Form 1040A, line 7. In the space to the left of line 7, enter "DCB"		26	-0-

To claim the child and dependent care credit, complete lines 27 through 31 below.

27	Enter $3,000 ($6,000 if two or more qualifying persons)	27	6,000
28	**Form 1040 and 1040NR filers:** Add lines 24 and 25. **Form 1040A filers:** Enter the amount from line 25	28	3,000
29	Subtract line 28 from line 27. If zero or less, **stop.** You cannot take the credit. **Exception.** If you paid 2010 expenses in 2011, see the instructions for line 9	29	3,000
30	Complete line 2 on the front of this form. **Do not** include in column (c) any benefits shown on line 28 above. Then, add the amounts in column (c) and enter the total here.	30	2,400
31	Enter the **smaller** of line 29 or 30. Also, enter this amount on line 3 on the front of this form and complete lines 4 through 11	31	2,400

Form **2441** (2011)

CHAPTER 32 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The credit for child and dependent care expenses can be up to ______ percent of your expenses.

   a) 10
   b) 25
   c) 35
   d) 50

2. The dollar limit on the amount of your work-related expenses that you can use to figure the child and dependent care credit for two qualifying persons is:

   a) $1,000
   b) $3,000
   c) $5,000
   d) $6,000

CHAPTER 32 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. You can claim a credit for greater than 10%.

   B: Incorrect. The percentage of child and dependent care expenses that can be claimed is not 25%.

   C: Correct. The credit is limited to 35% of the expenses for your dependent who is under 13, your spouse, or another dependent not able to care for him or herself. The expenses must have been paid so you can work or look for work.

   D: Incorrect. The credit is limited to less than 50% of your expenses.

2. A: Incorrect. The dollar limit is higher.

   B: Incorrect. This amount applies to one qualifying person, not two persons.

   C: Incorrect. This amount does not relate to the question asked. $5,000 is the maximum amount excludable from income if your employer provides dependent care benefits under a qualified plan.

   D: Correct. The limit for two or more qualifying persons is $6,000. The percentage of the expenses that can be claimed as a credit varies from 20% to 35%, depending on the amount of your reported adjusted gross income.

Chapter 33: Credit for the Elderly or the Disabled

I. Introduction

If you qualify, the law provides a number of credits that can reduce the tax you owe for a year. One of these credits is the credit for the elderly or the disabled.

This chapter explains:

- Who qualifies for the credit for the elderly or the disabled, and
- How to figure this credit.

You may be able to take this credit if you are:

- Age 65 or older, or
- Retired on permanent and total disability and have taxable disability income.

II. Can You Take the Credit?

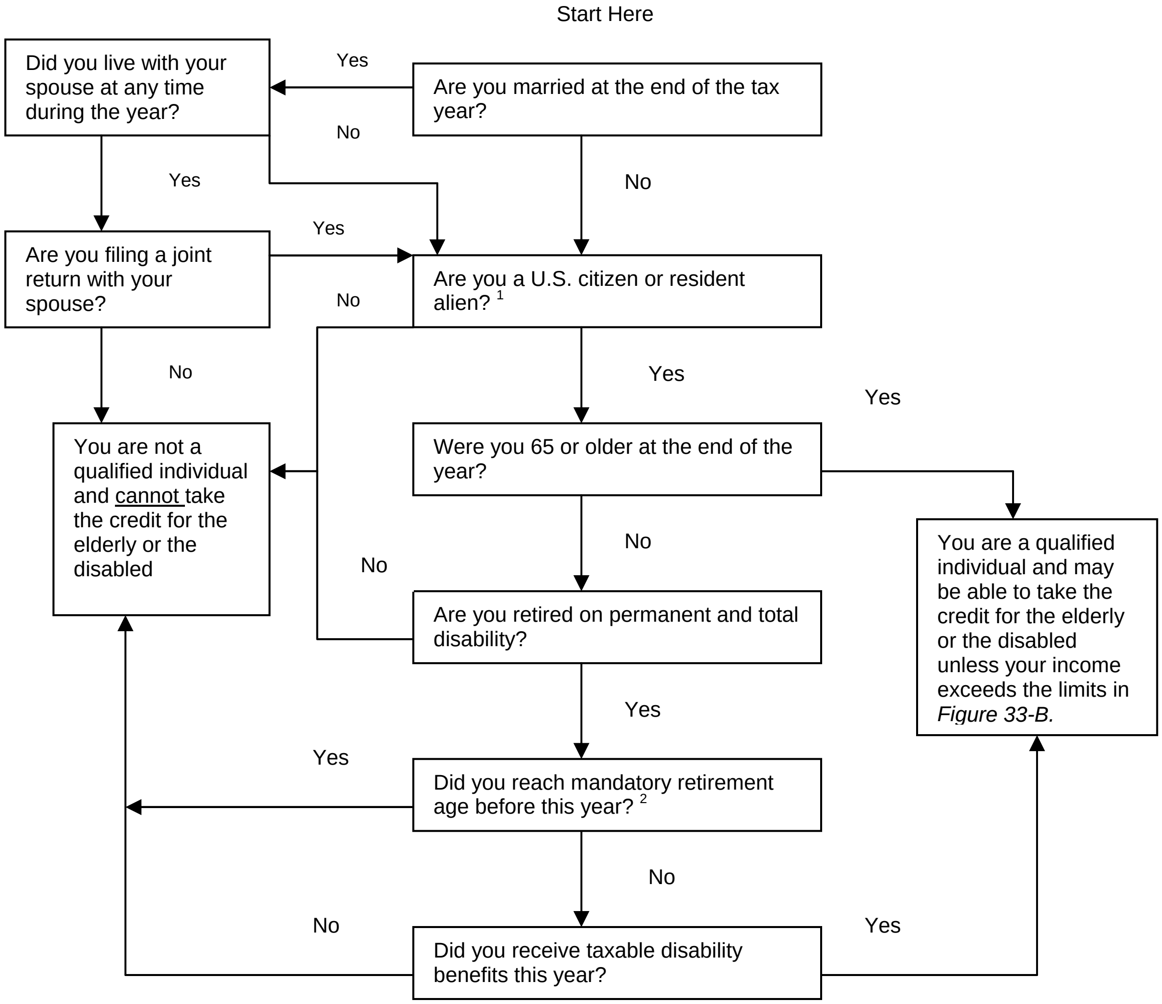
You can take the credit for the elderly or the disabled if you meet ***both*** of the following requirements.

1) You are a ***qualified individual.***
2) Your income is not more than certain limits.

You can use *Figure 33-A* and *Figure 33-B* as guides to see if you qualify.

Use *Figure 33-A* first to see if you are a qualified individual. If you are, go to *Figure 33-B* to make sure your income is not too high to take the credit.

Figure 33-A. Are You a Qualified Individual?



[1] If you were a nonresident alien at any time during the tax year and were married to a U.S. citizen or resident at the end of the tax year, see *U.S. Citizen or Resident* under *Qualified Individual*. If you and your spouse choose to treat you as a U.S. resident, answer "yes" to this question.
[2] Mandatory retirement age is the age set by your employer at which you would have been required to retire, had you not become disabled.

Figure 33-B. Income Limits

IF your filing status is…	**THEN even if you qualify (see *Figure 33-A*), you CANNOT take the credit if…** Your adjusted gross income (AGI)* is equal to or more than…	**OR the total of your nontaxable social security and other nontaxable pension(s) is equal to or more than…**
single, head of household, or qualifying widow(er) with dependent child	$17,500	$5,000
married filing a joint return and both spouses qualify in *Figure 33-A*	$25,000	$7,500
married filing a joint return and only one spouse qualifies in *Figure 33-A*	$20,000	$5,000
married filing a separate return and you did not live with your spouse at any time during the year	$12,500	$3,750

*AGI is the amount on Form 1040A, line 22, or Form 1040, line 38.

QUALIFIED INDIVIDUAL

You are a qualified individual for this credit if you are a U.S. citizen or resident and either of the following applies.

1) You were age 65 or older at the end of 2011
2) You were under age 65 at the end of 2011 and all three of the following statements are true.
   a) You retired on permanent and total disability (explained later).
   b) You received taxable disability income for 2011.
   c) On January 1, 2011, you had not reached mandatory retirement age (defined later under *Disability income*).

Age 65. You are considered to be age 65 on the day before your 65th birthday. Therefore, you are 65 at the end of the year if your 65th birthday is on January 1 of the following year.

U.S. Citizen or Resident Alien

You must be a U.S. citizen or resident alien (or be treated as a resident alien) to take the credit. Generally, you cannot take the credit if you were a nonresident alien at any time during the tax year.

Exceptions. You may be able to take the credit if you are a nonresident alien who is married to a U.S. citizen or resident alien at the end of the tax year and you and your spouse choose to treat you as a U.S. resident alien. If you make that choice, both you and your spouse are taxed on your worldwide incomes.

If you were a nonresident alien at the beginning of the year and a resident alien at the end of the year, and you were married to a U.S. citizen or resident alien at the end of the year, you may be able to choose to be treated as a U.S. resident alien for the entire year. In that case, you may be allowed to take the credit.

Married Persons

Generally, if you are married at the end of the tax year, you and your spouse must file a joint return to take the credit. However, if you and your spouse did not live in the same household at any time during the tax year, you can file either joint or separate returns and still take the credit.

Head of household. You can file as head of household and qualify to take the credit, even if your spouse lived with you during the first 6 months of the year, if you meet all the tests.

Under Age 65

If you are under age 65 at the end of the year, you can qualify for the credit only if you are retired on permanent and total disability and have taxable disability income.

You are retired on permanent and total disability if:

- You were permanently and totally disabled when you retired, and
- You retired on disability before the close of the tax year.

Even if you do not retire formally, you are considered retired on disability when you have stopped working because of your disability.

Permanent and total disability. You are permanently and totally disabled if you cannot engage in any substantial gainful activity because of your physical or mental condition. A physician must certify that the condition has lasted or can be expected to last continuously for 12 months or more, or that the condition can be expected to result in death. See *Physician's statement,* later.

Substantial gainful activity. Substantial gainful activity is the performance of significant duties over a reasonable period of time while working for pay or profit, or in work generally done for pay or profit. Full-time work (or part-time work done at your employer's convenience) in a competitive work situation for at least the minimum wage conclusively shows that you are able to engage in substantial gainful activity.

Substantial gainful activity is not work you do to take care of yourself or your home. It is not unpaid work on hobbies, institutional therapy or training, school attendance, clubs, social programs, and similar activities. However, doing this kind of work may show that you are able to engage in substantial gainful activity.

The fact that you have not worked for some time is not, of itself, conclusive evidence that you cannot engage in substantial gainful activity.

Sheltered employment. Certain work offered at qualified locations to physically or mentally impaired persons is considered sheltered employment. These qualified locations are in sheltered workshops, hospitals and similar institutions, homebound programs, and Department of Veterans Affairs (VA) sponsored homes.

Compared to commercial employment, pay is lower for sheltered employment. Therefore, one usually does not look for sheltered employment if he or she can get other employment. The fact that one has accepted sheltered employment is not proof of that person's ability to engage in substantial gainful activity.

Physician's statement. If you are under age 65, you must have your physician complete a statement certifying that you were permanently and totally disabled on the date you retired. You can use the statement in the instructions for Schedule R.

You do not have to file this statement with your Form 1040 or Form 1040A, but you ***must*** keep it for your records.

Veterans. If the Department of Veterans Affairs (VA) certifies that you are permanently and totally disabled, you can substitute VA Form 21-0172, *Certification of Permanent and Total Disability,* for the physician's statement you are required to keep. VA Form 21-0172 must be signed by a person authorized by the VA to do so. You can get this form from your local VA regional office.

Physician's statement obtained in earlier year. If you got a physician's statement in an earlier year ***and***, due to your continued disabled condition, you were unable to engage in any substantial gainful activity during 2011, you may not need to get another physician's statement for 2011. For a detailed explanation of the conditions you must meet, see the instructions for Part II of Schedule R. If you meet the required conditions, check the box on line 2 of Part II of Schedule R.

If you checked box 4, 5, or 6 in Part I of Schedule R, enter in the space above the box on line 2 in Part II, the first name(s) of the spouse(s) for whom the box is checked.

Disability income. If you are under age 65, you can qualify for the credit only if you have taxable disability income. Disability income must meet both of the following requirements.

1) It must be paid under your employer's accident or health plan or pension plan.
2) It must be included in your income as wages (or payments instead of wages) for the time you are absent from work because of permanent and total disability.

Payments that are not disability income. Any payment you receive from a plan that does not provide for disability retirement is not disability income. Any lump-sum payment for accrued annual leave that you receive when you retire on disability is a salary payment and is not disability income.

For purposes of the credit for the elderly or the disabled, disability income does not include amounts you receive after you reach mandatory retirement age. ***Mandatory retirement age*** is the age set by your employer at which you would have had to retire, had you not become disabled.

INCOME LIMITS

To determine if you can claim the credit, you must consider two income limits. The first limit is the amount of your adjusted gross income (AGI). The second limit is the amount of nontaxable social security and other nontaxable pensions you received. The limits are shown in *Figure 33-B,* earlier.

If both your AGI and nontaxable pensions are less than the income limits, you may be able to claim the credit. See *Figuring the Credit,* next.

Caution. *If either your AGI* ***or*** your nontaxable pensions are equal to or more than the income limits, you cannot take the credit.

III. Figuring the Credit

You can figure the credit yourself (see the explanation that follows) or the IRS will figure it for you. See *Credit Figured for You,* later.

Figuring the credit yourself. If you figure the credit yourself, fill out the front of Schedule R. Next, fill out Part III of Schedule R.

There are five steps in Part III to determine the amount of your credit:

1) Determine your ***initial amount*** (lines 10-12).
2) Determine the total of any ***nontaxable social security*** and certain other nontaxable pensions and disability benefits you received (lines 13a, 13b, and 13c).
3) Determine your ***excess adjusted gross income*** (lines 14-17).
4) Determine the total of Steps 2 and 3 (line 18).
5) Determine your credit (lines 19-22).

These steps are discussed in more detail next.

STEP 1. DETERMINE INITIAL AMOUNT

To figure the credit, you must first determine your initial amount using lines 10 through 12. See *Table 33-1*. Your initial amount is on line 12.

Initial amounts for persons under age 65. If you are a qualified individual under age 65, your initial amount cannot be more than your taxable disability income.

Table 33-1. Initial Amounts

IF your filing status is…	THEN enter on line 10 of Schedule R (Form 1040) or Schedule 3 (Form 1040A)…
Single, head of household, or qualifying widow(er) with dependent child and, by the end of 2011, you were	
• 65 or older	$5,000
• under 65 and retired on permanent and total disability[1]	$5,000
Married filing a joint return and by the end of 2011	
• both of you were 65 or older	$7,500
• both of you were under 65 and one of you retired on permanent and total disability[1]	$5,000
• both of you were under 65 and both of you retired on permanent and total disability[2]	$7,500
• one of you was 65 or older, and the other was under 65 and retired on permanent and total disability[3]	$7,500
• one of you was 65 or older, and the other was under 65 and not retired on permanent and total disability	$5,000
Married filing a separate return and you did not live with your spouse at any time during the year and, by the end of 2011, you were	
• 65 or older	$3,750
• Under 65 and retired on permanent and total disability[1]	$3,750

[1] Amount cannot be more than the taxable disability income.
[2] Amount cannot be more than your combined taxable disability income.
[3] Amount is $5,000 plus the taxable disability income of the spouse under age 65, but not more than $7,500.

STEP 2. TOTAL CERTAIN NONTAXABLE PENSIONS AND BENEFITS

Step 2 is to figure the total amount of nontaxable social security and certain other nontaxable payments you received during the year. You must reduce your initial amount by these payments.

Enter these nontaxable payments on lines 13a or 13b, and total them on line 13c. If you are married filing a joint return, you must enter the combined amount of nontaxable payments both you and your spouse receive.

Nontaxable payments. Include the following nontaxable payments in the amounts you enter on lines 13a and 13b.

- Nontaxable social security payments. This is the nontaxable part of the amount of benefits shown in box 5 of Form SSA-1099, which includes disability benefits, before deducting any amounts withheld to pay premiums on supplementary Medicare insurance, and before any reduction because of receipt of a benefit under workers' compensation.

Do not include a lump-sum death benefit payment you may receive as a surviving spouse, or a surviving child's insurance benefit payment you may receive as a guardian.

- Nontaxable railroad retirement pension payments treated as social security. This is the nontaxable part of the amount of benefits shown in box 5 of Form RRB-1099.

- Nontaxable pension or annuity payments or disability benefits that are paid under a law administered by the Department of Veterans Affairs (VA).

  Do not include 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 or in the National Oceanic and Atmospheric Administration or the Public Health Service, or as a disability annuity under section 808 of the Foreign Service Act of 1980.

- Pension or annuity payments or disability benefits that are excluded from income under any provision of federal law other than the Internal Revenue Code.

  Do not include amounts that are a return of your cost of a pension or annuity. These amounts do not reduce your initial amount.

STEP 3. DETERMINE EXCESS ADJUSTED GROSS INCOME

You also must reduce your initial amount by your excess adjusted gross income. Figure your excess adjusted gross income on lines 14 through 17.

You figure your excess adjusted gross income as follows:

1) Subtract from your adjusted gross income (line 38 of Form 1040 or line 22 of Form 1040A) the amount shown for your filing status in the following list:
   a) **$7,500** if you are single, a head of household, or a qualifying widow(er) with a dependent child,
   b) **$10,000** if you are married filing a joint return, or
   c) **$5,000** if you are married filing a separate return and you and your spouse did not live in the same household at any time during the tax year.
2) Divide the result of (1) by 2.

STEP 4. DETERMINE THE TOTAL OF STEPS 2 AND 3

To determine if you can take the credit, you must add (on line 18) the amounts you figured in Step 2 and Step 3.

IF the total of Steps 2 and 3 is…	THEN…
equal to or more than the amount in Step 1	you **cannot** take the credit.
less than the amount in Step 1	you **can** take the credit.

STEP 5. DETERMINE YOUR CREDIT

If you can take the credit, subtract the amount determined in Step 4 (line 18) from the amount determined in Step 1 (line 12) and multiply the result by 15%.

In certain cases, the amount of your credit may be limited. See *Limit on credit*, later.

Example. You are 66 years old and your spouse is 64. Your spouse is not disabled. You file a joint return on Form 1040. Your adjusted gross income is $14,630. Together you received $3,200 from social security, which was nontaxable. You figure the credit as follows:

Applying the 5 Step Process		**Amount**
1) Initial amount		$5,000
2) Total of social security and other nontaxable pensions	$3,200	
3) Excess adjusted gross income ($14,630 - $10,000) ÷ 2)	2,315	
4) Add line 2 and line 3		5,515
5) Subtract line 4 from line 1 (Do not enter less than -0-)		-0-

You cannot take the credit since your nontaxable social security (line 2a) plus your excess adjusted gross income (line 2b) is more than your initial amount on line 1.

Limit on credit. The amount of credit you can claim is generally limited to the amount of your tax.

CREDIT FIGURED FOR YOU

If you choose to have the Internal Revenue Service (IRS) figure the credit for you, read the following discussion for the form you will file (Form 1040 or 1040A). If you want the IRS to figure your tax, see chapter 30.

Form 1040. If you want the IRS to figure your credit, see *Form 1040 Line Entries* under *Tax Figured by IRS* in chapter 30.

Form 1040A. If you want the IRS to figure your credit, see *Form 1040A Line Entries* under *Tax Figured by IRS* in chapter 30.

EXAMPLE

The following example illustrates the credit for the elderly or the disabled. The initial amounts are taken from *Table 33-1,* shown earlier.

Example 1. James Davis is 58 years old, single, and files Form 1040A. In 2006 he retired on permanent and total disability, and he is still permanently and totally disabled. He got the required physician's statement in 2006, and kept it with his records. His physician signed on line B of the statement. This year James checks the box in Part II of Schedule R. He does not need to get another statement for 2011.

He received the following income for the year:

Nontaxable social security	$1,500
Interest (taxable)	100
Taxable disability pension	11,400

James' adjusted gross income is $11,500 ($11,400 + $100). He figures the credit on Schedule R as follows:

1) Initial amount		$ 5,000
2) Taxable disability pension		11,400
3) Smaller of (1) or (2)		5,000
4) Nontaxable social security benefits	$1,500	
5) Excess adjusted gross income ($11,500 - $7,500) ÷ 2	2,000	
6) Add lines 2 and 3		$3,500
7) Subtract line 6 from line 3 (Do not enter less than -0-)		1,500
8) Multiply line 7 by 15% (.15)		225
9) Enter the amount from the Credit Limit Worksheet in the Schedule R instructions		216
10) Credit (Enter the smaller of line 8 or line 9)		$ 216

His credit is $216. He enters $216 on line 30 of Form 1040A. The Schedule R for James Davis is not shown.

CHAPTER 33 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. You may be able to take a credit for the elderly or the disabled if you meet which of the following conditions:

   a) you are a qualified individual
   b) your income is not more than certain limits
   c) both a and b above
   d) you are over age 59½ and are retired

CHAPTER 33 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. This is only one of the necessary conditions to claim the credit.

   B: Incorrect. This is only one of the necessary conditions to claim the credit.

   C: Correct. You must meet both an income limit test and an age/residency test.

   D: Incorrect. You are a qualified individual for this credit if you are a U.S. citizen or a resident, meet certain income limits, <u>and either</u>: (1) you were age 65 or older at the end of the year, or (2) you were under age 65 and you were retired on permanent and total disability, you received taxable disability income, and you had not reached the mandatory retirement age.

Chapter 34: Child Tax Credit

I. Introduction

The ***child tax credit*** is a credit that you may be able to take on your tax return. It may reduce your tax by as much as $1,000 for each of your qualifying children.

The ***additional child tax credit*** is a credit you may be able to take if you are not able to claim the full amount of the child tax credit.

This chapter explains:

- Who is a qualifying child.
- How much is the credit.
- How to claim the credit.
- Why you should check your tax withholding.

II. Qualifying Child

A qualifying child for purposes of the child tax credit must be all of the following.

1) Your son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them.
2) Under age 17 at the end of 2011.
3) Did not provide over half his own support in 2011.
4) Lived with you for more than half of 2011.
5) Claimed as a dependent on your return.
6) A U.S. citizen, a U.S. national, or a resident of the United States. If the child was adopted, see *Adopted child*, later.

For each qualifying child, you must check the box on Form 1040 or Form 1040A, line 6c, column (4).

Example. Your son turned 17 on December 30, 2011. He is a citizen of the United States and you claimed him as a dependent on your return. He is ***not*** a qualifying child for the child tax credit because he was not ***under*** age 17 at the end of 2011.

Adopted child. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption.

If you are a U.S. citizen or U.S. national and your adopted child lived with you as a member of your household all year, that child meets condition (6) above to be a qualifying child for the child tax credit.

III. <u>Amount of Credit</u>

The maximum credit you can claim is $1,000 for each qualifying child.

<u>LIMITS ON THE CREDIT</u>

You must reduce your child tax credit if either (1) or (2) applies.

1) The amount on line 46 (Form 1040) or line 28 (Form 1040A) is less than the credit. If this amount is zero, you cannot take this credit because there is no tax to reduce. But you may be able to take the ***additional child tax credit***. See *Additional Child Tax Credit,* later.
2) Your modified adjusted gross income (AGI) is above the amount shown below for your filing status.
   - Married filing jointly - $110,000.
   - Single, head of household, or qualifying widow(er) - $75,000.
   - Married filing separately - $55,000.

Modified AGI. For purposes of the child tax credit, your modified AGI is your AGI plus the following amounts that may apply to you.

- Any amount excluded from income because of the exclusion of income from Puerto Rico.
- Any amount on line 45 or line 50 of Form 2555, *Foreign Earned Income.*
- Any amount on line 18 of Form 2555-EZ, *Foreign Earned Income Exclusion.*
- Any amount on line 15 of Form 4563, *Exclusion of Income for Bona Fide Residents of American Samoa.*

If you do not have any of the above, modified AGI is the AGI amount on line 38 (Form 1040) or line 22 (Form 1040A).

IV. <u>Claiming the Credit</u>

To claim the child tax credit, you must file Form 1040 or Form 1040A. You must provide the name and identification number (usually a social security number) on your tax return for each qualifying child.

If you are filing Form 1040, answer the *Questions* in your form instructions for line 51 (Form 1040) to find out which child tax credit worksheet you can use to figure the credit.

If you answer "Yes" to question 1, 2, or 3 in your Form 1040 instructions or question 1 in your Form 1040A instructions, you must complete the child tax credit worksheet in Publication 972, *Child Tax Credit.* Otherwise, you can use the *Child Tax Credit Worksheet* in your Form 1040 or Form 1040A instructions. (See the filled-in example, later.)

V. <u>Additional Child Tax Credit</u>

This credit is for certain individuals who get less than the full amount of the child tax credit. The additional child tax credit may give you a refund even if you do not owe any tax.

How to claim the additional child tax credit. To claim the additional child tax credit, follow the steps below.

1) Make sure you figured the amount, if any, of your child tax credit. See *Claiming the Credit,* earlier.
2) If you answered "Yes" on line 9 or line 10 of the Child Tax Credit Worksheet in the Form 1040 instructions or line 9 or 10 in the Form 1040A instructions, or line 13 of the Child Tax Credit Worksheet in Publication 972, use Form 8812 to see if you can take the additional child tax credit.
3) If you have an additional child tax credit on line 13 of Form 8812, carry it to line 65 (Form 1040) or line 42 (Form 1040A).

EXAMPLE

Amy Brown files as head of household and has two dependent children under age 17. The children are qualifying children for purposes of the child tax credit. Amy's only income is her salary of $30,450. Amy chooses to itemize her deductions and files Form 1040. Her AGI, shown on line 38 of her Form 1040, is $30,450. This is her taxable earned income.

Amy does not file Form 2555, 2555-EZ, or 4563. She does not exclude income from Puerto Rico. Her modified AGI is $30,450.

Amy's tax, shown on line 46 of her Form 1040, is $1,108. She claims a $225 credit for child and dependent care expenses on line 48. She claims a $2,089 earned income credit on line 64a. She has no other credits.

After answering the *Questions* in the Form 1040 instructions for line 51, she completes the child tax credit worksheet to figure her child tax credit of $883. Amy's completed questions and child tax credit worksheet are shown later.

Amy reads the *TIP* in the worksheet and finds that she may be able to take the additional child tax credit. See *Additional Child Tax Credit* and Amy's completed Form 8812, later.

Filled-in Questions for Amy Brown
(Page references are to the Form 1040 instructions.)

Questions **Who Must Use Pub. 972**

1. Are you claiming any of the following credits?
   - Mortgage interest credit, Form 8396.
   - District of Columbia first-time homebuyer credit, Form 8859.
   - Residential energy efficient property credit, Form 5695, Part II.

☐ **Yes.** STOP You must use Pub. 972 to figure your child tax credit. You will also need the form(s) listed above for any credit(s) you are claiming.

☑ **No.** Continue

2. Are you excluding income from Puerto Rico or are you filing any of the following forms?
   - Form 2555 or 2555-EZ (relating to foreign earned income).
   - Form 4563 (exclusion of income for residents of American Samoa).

☐ **Yes.** STOP You must use Pub. 972 to figure your credit.

☑ **No.** Use the worksheet on pages 41 and 42 to figure your credit.

Child Tax Credit Worksheet—Line 51

Keep for Your Records

CAUTION

- To be a qualifying child for the child tax credit, the child must be your dependent, **under age 17** at the end of 2010, and meet all the conditions in Steps 1 through 3 on page 15.
- **Do not** use this worksheet if you answered "Yes" to question 1 or 2 on page 40. Instead, use Pub. 972.

Part 1

1. Number of qualifying children: 2 × $1,000. Enter the result. — **1** 2,000

2. Enter the amount from Form 1040, line 38. — **2** 30,450

3. Enter the amount shown below for your filing status.

- Married filing jointly — $110,000
- Single, head of household, or qualifying widow(er) — $75,000
- Married filing separately — $55,000

— **3** 75,000

4. Is the amount on line 2 more than the amount on line 3?

☑ **No.** Leave line 4 blank. Enter -0- on line 5.

☐ **Yes.** Subtract line 3 from line 2.

If the result is not a multiple of $1,000, increase it to the next multiple of $1,000. For example, increase $425 to $1,000, increase $1,025 to $2,000, etc.

— **4**

5. Multiply the amount on line 4 by 5% (.05). Enter the result. — **5** -0-

6. Is the amount on line 1 more than the amount on line 5?

☐ **No.** STOP

You cannot take the child tax credit on Form 1040, line 51. You also cannot take the additional child tax credit on Form 1040, line 65. Complete the rest of your Form 1040.

☑ **Yes.** Subtract line 5 from line 1. Enter the result. *Go to Part 2 on the next page.* — **6** 2,000

Before you begin Part 2: √ Figure the amount of any credits you are claiming on Form 5695, Part I; Form 8834, Part I; Form 8910; Form 8936; or Schedule R.

Part 2

7. Enter the amount from Form 1040, line 46. | 7 | **1,108**

8. Add the following amounts from:

Form 1040, line 47	
Form 1040, line 48 +	225
Form 1040, line 49 +	
Form 1040, line 50 +	
Form 5695, line 11 +	
Form 8834, line 22 +	
Form 8910, line 21 +	
Form 8936, line 14 +	
Schedule R, line 22 +	

Enter the total. | 8 | **225**

9. Are the amounts on lines 7 and 8 the same?

☐ **Yes.** STOP
You cannot take this credit because there is no tax to reduce. However, you may be able to take the **additional child tax credit.** See the **TIP** below.

☑ **No.** Subtract line 8 from line 7. | 9 | **883**

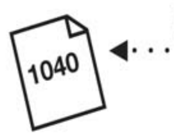
10. Is the amount on line 6 more than the amount on line 9?

☑ **Yes.** Enter the amount from line 9. Also, you may be able to take the **additional child tax credit.** See the **TIP** below.

☐ **No.** Enter the amount from line 6.

This is your child tax credit. | 10 | **883**

Enter this amount on Form 1040, line 51.



TIP You may be able to take the **additional child tax credit** on Form 1040, line 65, if you answered "Yes" on line 9 **or** line 10 above.

- First, complete your Form 1040 through lines 64a and 64b.
- Then, use Form 8812 to figure any additional child tax credit.

Form **8812**

Department of the Treasury
Internal Revenue Service (99)

Additional Child Tax Credit

1040 / 1040A / 1040NR ← 8812

Complete and attach to Form 1040, Form 1040A, or Form 1040NR.

OMB No. 1545-0074

2011

Attachment Sequence No. **47**

Name(s) shown on return	Your social security number
Amy Brown	012-00-5678

Part I All Filers

1	**1040 filers:** Enter the amount from line 6 of your Child Tax Credit Worksheet (see the Instructions for Form 1040, line 51). **1040A filers:** Enter the amount from line 6 of your Child Tax Credit Worksheet (see the Instructions for Form 1040A, line 33). **1040NR filers:** Enter the amount from line 6 of your Child Tax Credit Worksheet (see the Instructions for Form 1040NR, line 48). If you used Pub. 972, enter the amount from line 8 of the Child Tax Credit Worksheet in the publication.	1	2,000
2	Enter the amount from Form 1040, line 51, Form 1040A, line 33, or Form 1040NR, line 48	2	883
3	Subtract line 2 from line 1. If zero, **stop**; you cannot take this credit	3	1,117
4a	Earned income (see instructions on back) — **4a** 30,450		
b	Nontaxable combat pay (see instructions on back) — **4b**		
5	Is the amount on line 4a more than $3,000? ☐ **No.** Leave line 5 blank and enter -0- on line 6. ☑ **Yes.** Subtract $3,000 from the amount on line 4a. Enter the result — **5** 27,450		
6	Multiply the amount on line 5 by 15% (.15) and enter the result	6	4,118
	Next. Do you have three or more qualifying children? ☑ **No.** If line 6 is zero, stop; you cannot take this credit. Otherwise, skip Part II and enter the **smaller** of line 3 or line 6 on line 13. ☐ **Yes.** If line 6 is equal to or more than line 3, skip Part II and enter the amount from line 3 on line 13. Otherwise, go to line 7.		

Part II Certain Filers Who Have Three or More Qualifying Children

7	Withheld social security and Medicare taxes from Form(s) W-2, boxes 4 and 6. If married filing jointly, include your spouse's amounts with yours. If you worked for a railroad, see instructions on back — **7**		
8	**1040 filers:** Enter the total of the amounts from Form 1040, lines 27 and 57, plus any taxes that you identified using code "UT" and entered on line 60. **1040A filers:** Enter -0-. **1040NR filers:** Enter the total of the amounts from Form 1040NR, lines 27 and 55, plus any taxes that you identified using code "UT" and entered on line 59. — **8**		
9	Add lines 7 and 8 — **9**		
10	**1040 filers:** Enter the total of the amounts from Form 1040, lines 64a and 69. **1040A filers:** Enter the total of the amount from Form 1040A, line 38a, plus any excess social security and tier 1 RRTA taxes withheld that you entered to the left of line 41 (see instructions on back). **1040NR filers:** Enter the amount from Form 1040NR, line 65. — **10**		
11	Subtract line 10 from line 9. If zero or less, enter -0-	11	
12	Enter the **larger** of line 6 or line 11	12	
	Next, enter the **smaller** of line 3 or line 12 on line 13.		

Part III Additional Child Tax Credit

13	**This is your additional child tax credit**	13	1,117

Enter this amount on Form 1040, line 65, Form 1040A, line 39, or Form 1040NR, line 63. → 1040 / 1040A / 1040NR

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 10644E Form **8812** (2011)

CHAPTER 34 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The Child Tax Credit may reduce your tax by as much as _______ for each qualifying child.

    a) $500
    b) $1,000
    c) $2,000
    d) $3,000

2. The additional child tax credit is for individuals who exceed the modified adjusted gross income limit for the regular child tax credit.

    a) true
    b) false

CHAPTER 34 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The child tax credit is greater than this suggested amount per child.

   B: Correct. The child tax credit may reduce your tax by as much as $1,000 for each qualifying child.

   C: Incorrect. The maximum child tax credit is less than this amount, but multiple qualifying children will increase the total amount of the credit to the taxpayer.

   D: Incorrect. The maximum child tax credit is less than this amount per child.

2. A: True is incorrect. This credit is for individuals who get less than the full amount of the child tax credit.

   B: False is correct. This credit is for individuals who get less than the full amount of the child tax credit, not for those that exceeded the modified adjusted gross income limit for the regular child tax credit.

Chapter 35: Education Credits

I. Important for 2011

American opportunity credit. This education tax credit is available for 2011 and 2012. The maximum credit per student is $2,500 (100% of the first $2,000 and 25% of the next $2,000 of qualified education expenses). The credit is available for the first 4 years of postsecondary education, and 40% of the credit is refundable for most taxpayers. The threshold at which this credit is reduced is higher than that for the lifetime learning credit. For 2011, the amount of your credit is gradually reduced (phased out) if your modified adjusted gross income (MAGI) is between $80,000 and $90,000 ($160,000 and $180,000 if you file a joint return). You cannot claim a credit if your MAGI is $90,000 or more ($180,000 or more if you file a joint return).

Lifetime learning credit income limits. For 2011, the amount of your lifetime learning credit is gradually reduced (phased out) if your MAGI is between $51,000 and $61,000 ($102,000 and $122,000 if you file a joint return). You cannot claim a credit if your MAGI is $61,000 or more ($122,000 or more if you file a joint return).

II. Introduction

For 2011, there are two tax credits available to persons who pay expenses for higher (postsecondary) education. They are:

- The American opportunity credit, and
- The lifetime learning credit.

The chapter will present an overview of these education credits. To get the detailed information you will need to claim any of the credits, and for examples illustrating that information, see chapters 2 and 3 of Publication 970.

Can you claim more than one education credit this year? For each student, you can elect for any year only one of the credits. For example, if you elect to take the American opportunity credit for a child on your 2011 tax return, you cannot, for that same child, also claim the lifetime learning credit for 2011.

If you are eligible to claim the American opportunity credit and you are also eligible to claim the lifetime learning credit for the same student in the same year, you can choose to claim either credit, but not both.

If you pay qualified education expenses for more than one student in the same year, you can choose to take the American opportunity and the lifetime learning credits on a per-student, per-year basis. This means that, for example, you can claim the American opportunity credit for one student and the lifetime learning credit for another student in the same year.

Differences between the American opportunity and lifetime learning credits. There are several differences between these two credits. These differences are summarized in Table 35-1, next.

Table 35-1. Comparison of Education Credits

Caution. *You can claim both the American opportunity credit and the lifetime learning credit on the same return – but not for the same student.*

	American Opportunity Credit	**Lifetime Learning Credit**
Maximum credit	Up to $2,500 per **eligible student**	Up to $2,000 credit per **return**
Limit on modified adjusted gross income (MAGI)	$180,000 if married filing jointly; $90,000 if single, head of household, or qualifying widow(er)	$122,000 if married filing jointly; $61,000 if single, head of household, or qualifying widow(er)
Refundable or nonrefundable	40% of credit may be refundable	Credit limited to the amount of tax you must pay on your taxable income
Number of years of postsecondary education	Available **ONLY** for first 4 years of postsecondary education	Available for all years of postsecondary education and for courses to acquire or improve job skills
Number of tax years credit available	Available **ONLY** for 4 tax years per eligible student	Available for an unlimited number of years
Type of degree required	Student must be pursuing an undergraduate degree or other recognized education credential	Student does not need to be pursuing a degree or other recognized education credential
Number of courses	Student must be enrolled at least half time for at least one academic period beginning during the tax year	Available for one or more courses
Felony drug conviction	No felony drug convictions on student's records	Felony drug convictions are permitted
Qualified expenses	Tuition and required enrollment fees. Course-related books, supplies, and equipment **do not** need to be purchased from the institution in order to qualify	Tuition and required enrollment fees, including amounts required to be paid to the institution for course-related books, supplies, and equipment.
Payments for academic periods	Payments made in 2011 for academic periods beginning in 2011 and in the first 3 months of 2012	Payments made in 2011 for academic periods beginning in 2011 and in the first 3 months of 2012

III. Who Can Claim an Education Credit

You may be able to claim an education credit if you, your spouse, or a dependent you claim on your tax return was a student enrolled at or attending an eligible educational institution. The credits are based on the amount of qualified education expenses paid for the student in 2011 for academic periods beginning in 2011 and in the first 3 months of 2012.

For example, if you paid $1,500 in December 2011 for qualified tuition for the spring 2012 semester beginning in January 2012, you may be able to use that $1,500 in figuring your 2011 education credit(s).

You cannot use any amount paid in 2010 or 2012 to figure your 2011 education credit(s).

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions.

Who can claim a dependent's expenses. If a student is claimed as a dependent on another person's tax return, only the person who claims the student as a dependent can claim a credit for the student's qualified education expenses. If a student is not claimed as a dependent on another person's tax return, only the student can claim a credit.

Generally, qualified education expenses paid on behalf of the student by someone other than the student (such as a relative) are treated as paid by the student. However, qualified education expenses paid (or treated as paid) by a student who is claimed as a dependent on your tax return are treated as paid by you. Therefore, you are treated as having paid expenses that were paid from your dependent student's earnings, gifts, inheritances, savings, etc.

Who cannot claim a credit. You cannot take an education credit if any of the following apply.

1) You are claimed as a dependent on another person's tax return, such as your parent's return.

2) Your filing status is married filing separately.

3) You (or your spouse) were a nonresident alien for any part of 2011 and did not elect to be treated as a resident alien for tax purposes.

4) Your MAGI is one of the following.
   a) American opportunity credit: $180,000 or more if married filing jointly, or $90,000 or more if single, head of household, or qualifying widow(er).
   b) Lifetime learning credit: $122,000 or more if married filing jointly, or $61,000 or more if single, head of household, or qualifying widow(er).

Figure 35-A, at the end of this chapter, may be helpful in determining if you can claim an education credit on your tax return.

There are a number of factors, such as your filing status, your MAGI, and whether you are subject to the alternative minimum tax that will affect the amount of any education credit you are eligible to claim. When you figure your taxes, you may want to compare the different education credits in order to choose the method(s) that gives you the lowest tax liability. If you qualify, you may find that a combination of credit(s) and other education benefit(s) gives you the lowest tax.

IV. <u>Qualified Education Expenses</u>

Generally, qualified education expenses are amounts paid in 2011 for tuition and fees required for the student's enrollment or attendance at an eligible educational institution. It does not matter whether the expenses were paid in cash, by check, by credit card, or with borrowed funds.

Only certain expenses for course-related books, supplies, and equipment qualify.

- American opportunity credit: Qualified education expenses include amounts spent on books, supplies, and equipment needed for a course of study, whether or not the materials are purchased from the educational institution as a condition of enrollment or attendance.
- Lifetime learning credit: Qualified education expenses include only amounts for books, supplies, and equipment required to be paid to the institution as a condition of enrollment or attendance.

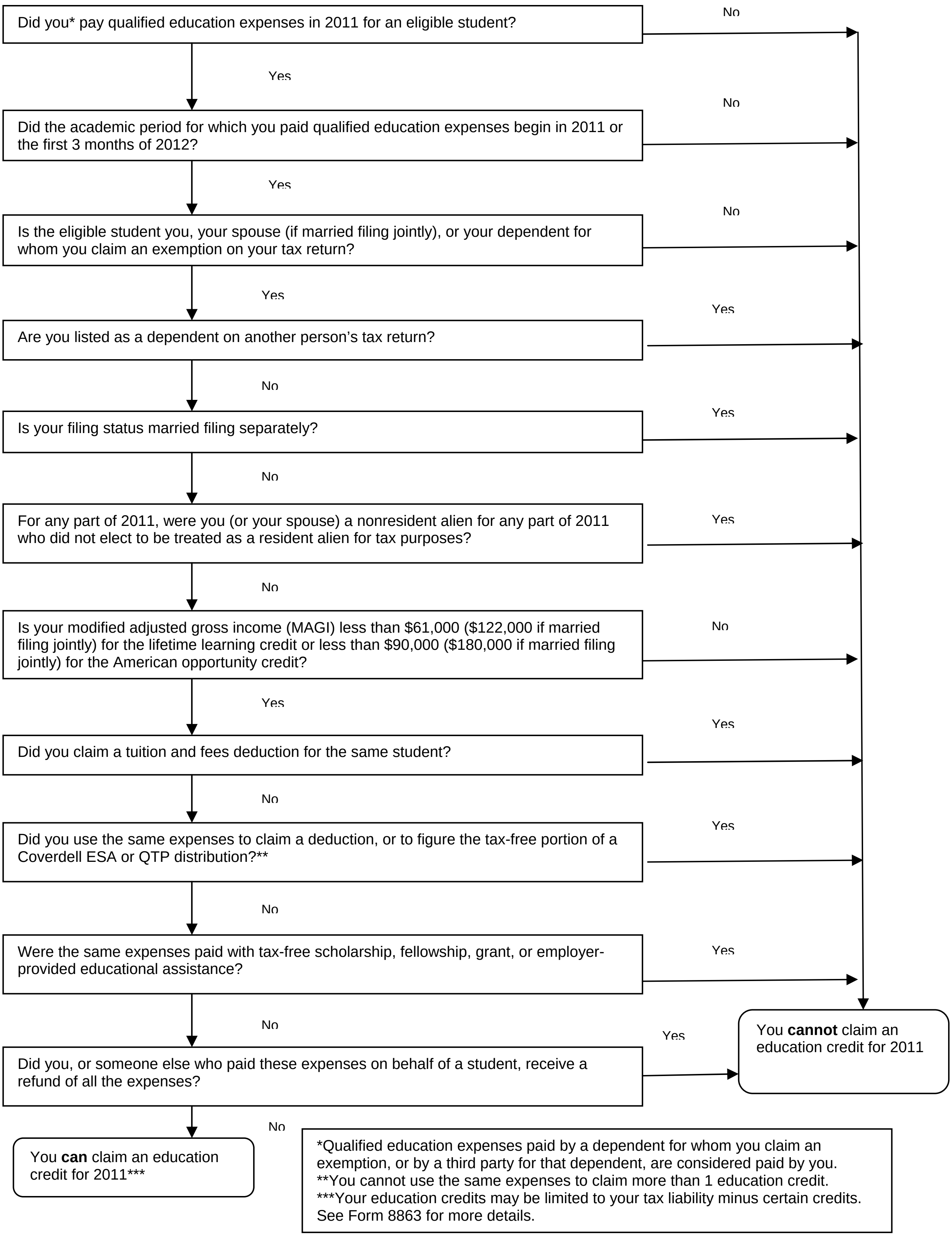
Qualified education expenses do not include amounts paid for:

- Room and board, insurance, medical expenses (including student health fees), transportation, or other similar personal, living, or family expenses.
- Any course or other education involving sports, games, or hobbies, or any noncredit course, unless such course or other education is part of the student's degree program or (for the lifetime learning credit only) helps the student acquire or improve job skills.
- Nonacademic fees, such as student activity fees, athletic fees, insurance expenses, or other expenses unrelated to the academic course of instruction.

Paid with borrowed funds. You can claim an education credit for qualified education expenses paid with the proceeds of a loan. Use the expenses to figure the credit for the year in which the expenses are paid, not the year in which the loan is repaid. Treat loan payments sent directly to the educational institution as paid on the date the institution credits the student's account.

Student withdraws from class(es). You can claim an education credit for qualified education expenses not refunded when a student withdraws.

Figure 35-A. Can You Claim An Education Credit for 2011?



NO DOUBLE BENEFIT ALLOWED

You cannot do any of the following.

- Deduct higher education expenses on your income tax return (as, for example, a business expense) and also claim an education credit based on those same expenses.
- Claim an education credit in the same year you are claiming a tuition and fees deduction for the same student.
- Claim more than 1 education credit based on the same qualified education expenses.
- Claim an education credit based on the same expenses used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or qualified tuition program (QTP).
- Claim an education credit based on qualified education expenses paid with educational assistance, such as a tax-free scholarship, grant, or employer-provided educational assistance. See *Adjustments to Qualified Education Expenses*, next.

ADJUSTMENTS TO QUALIFIED EDUCATION EXPENSES

If you pay qualified education expenses with certain tax-free funds, you cannot claim an education credit for those amounts. You must reduce the qualified education expenses by the amount of any tax-free educational assistance and refund(s) you received.

Tax-free educational assistance. This includes:

- Tax-free parts of scholarships and fellowships,
- Pell grants,
- Employer-provided educational assistance,
- Veterans' educational assistance, and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Refunds. Qualified education expenses do not include expenses for which you, or someone else who paid qualified education expenses on behalf of a student, receive a refund.

Amounts that do not reduce qualified education expenses. Do not reduce qualified education expenses by amounts paid with funds the student receives as:

- Payment for services, such as wages,
- A loan,
- A gift,
- An inheritance, or
- A withdrawal from the student's personal savings.

Do not reduce the qualified education expenses by any scholarship or fellowship reported as income on the student's tax return in the following situations.

- The use of the money is restricted to costs of attendance (such as room and board) other than qualified education expenses.
- The use of the money is not restricted and is used to pay education expenses that are not qualified (such as room and board).

V. When Must the Credit Be Repaid (Recaptured)

If, after you file your 2011 tax return, you or someone else receives tax-free educational assistance for, or a refund of, an expense you used to figure an education credit on that return, you may have to repay all or part of the credit. You must refigure your education credit(s) for 2011 as if the assistance or refund was received in 2011. Subtract the amount of the refigured credit from the amount of the credit you claimed. The result is the amount you must repay. Add the repayment (recapture) to your tax liability for the year in which you receive the assistance or refund. See the instructions for your tax return for that year to find out how to report the recapture amount. Your original 2011 tax return does not change.

CHAPTER 35 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The lifetime learning credit may be claimed for qualified educational expenses paid to postsecondary institutions, but is restricted to:

   a) the first 2 years of study
   b) the first 3 years
   c) a total of 4 years
   d) none of the above; there is no limit on the years of study

2. You cannot claim an education credit if your filing status is married filing separately.

   a) true
   b) false

CHAPTER 35 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Neither of the education credits are restricted to claiming a tax credit to two years.

   B: Incorrect. Neither of the education credits are restricted to claiming a tax credit to three years.

   C: Incorrect. The American opportunity credit is limited to four years postsecondary education.

   D: Correct. There is no limit on the number of years for which the lifetime learning credit can be claimed for qualifying students. The lifetime learning credit can be up to $2,000 per year for <u>all</u> students.

2. **A: True is correct.** This is one example of who cannot claim these credits.

   B: False is incorrect. You also cannot claim an education credit if you exceed certain income limitations or you claim a tuition and fees deduction for the same student in 2011.

Chapter 36: Earned Income Credit

I. Introduction

The earned income credit (EIC) is a tax credit for certain people who work and have a limited earned income. A tax credit usually means more money in your pocket. It reduces the amount of tax you owe. The EIC may also give you a refund.

Earned income amount is more. The EIC has increased for people with three or more children and for many married couples filing jointly. Also, the maximum amount of income you can earn and still get the credit has increased. You may be able to take the credit if:

- You have three or more qualifying children and you earned less than $43,998 ($49,078 if married filing jointly),
- You have two qualifying children and you earned less than $40,964 ($46,044 if married filing jointly),
- You have one qualifying child and you earned less than $36,052 ($41,132 if married filing jointly), or
- You do not have a qualifying child and you earned less than $13,660 ($18,740 if married filing jointly).

Your adjusted gross income also must be less than the amount in the above list that applies to you.

Investment income amount is more. The maximum amount of investment income you can have and still get the credit has increased to $3,150.

How do you get the earned income credit? To claim the EIC, you must:

1) Qualify by meeting certain rules, and
2) File a tax return, even if you:
   a) Do not owe any tax,
   b) Did not earn enough money to file a return, or
   c) Did not have income taxes withheld from your pay.

When you complete your return, you can figure your EIC by using a worksheet in the instructions for Form 1040, Form 1040A, or Form 1040EZ. Or, if you prefer, you can let the IRS figure the credit for you.

II. Do You Qualify for the Credit?

To qualify to claim the EIC, you must first meet all of the rules explained in Part A, *Rules for Everyone*. Then, you must meet the rules in Part B, *Rules If You Have a Qualifying Child*, or Part C, *Rules If You Do Not Have a Qualifying Child*. There is one final rule you must meet in Part D, *Figuring and Claiming the EIC*. You qualify for the credit if you meet all the rules in each part that applies to you.

- If you have a qualifying child, the rules in *Parts A, B,* and *D* apply to you.
- If you do not have a qualifying child, the rules in *Parts A, C,* and *D* apply to you.

IF IMPROPER CLAIM MADE IN PRIOR YEAR

If your EIC for any year after 1996 was denied or reduced for any reason other than a mathematical or clerical error, you must attach a completed Form 8862 to your next tax return if you wish to claim the EIC. You must also qualify to claim the EIC by meeting the rules.

If your EIC was denied or reduced as a result of a mathematical or clerical error, do not attach Form 8862 to your next tax return. For example, if your arithmetic is incorrect, the IRS can correct it. If you do not provide a correct social security number, the IRS can deny the EIC. These kinds of errors are called mathematical or clerical errors.

If your EIC for any year after 1996 was denied and it was determined that your error was due to reckless or intentional disregard of the EIC rules, then you cannot claim the EIC for the next 2 years. If your error was due to fraud, then you cannot claim the EIC for the next 10 years.

Table 36-1. Earned Income Credit in a Nutshell

First, you must meet all the rules in this column.		**Second, you must meet all the rules in *one* of these columns, whichever applies.**		**Third, you must meet the rule in this column.**
Part A. Rules for Everyone		**Part B. Rules If You Have a Qualifying Child**	**Part C. Rules If You Do Not Have a Qualifying Child**	**Part D. Figuring and Claiming the EIC**
1. Your adjusted gross income (AGI) must be less than: • $43,998 ($49,078 for married filing jointly) if you have three or more qualifying children. • $40,964 ($46,044 for married filing jointly) if you have two qualifying children. • $36,052 ($41,132 for married filing jointly) if you have one qualifying child, or • $13,660 ($18,740 for married filing jointly) if you do not have a qualifying child.	**2.** You must have a valid social security number. **3.** Your filing status cannot be “married filing separately.” **4.** You must be a U.S. citizen or resident alien all year. **5.** You cannot file Form 2555 or Form 2555-EZ (relating to foreign earned income). **6.** Your investment income must be $3,150 or less. **7.** You must have earned income.	**8.** Your child must meet the relationship, age, and residency tests. **9.** Your qualifying child cannot be used by more than one person to claim the EIC. **10.** You cannot be a qualifying child of another person.	**11.** You must be at least age 25 but under age 65. **12.** You cannot be the dependent of another person. **13.** You cannot be a qualifying child of another person. **14.** You must have lived in the United States more than half of the year.	**15.** Your earned income must be less than: • $43,998 ($49,078 for married filing jointly) if you have three or more qualifying children. • $40,964 ($46,044 for married filing jointly) if you have two qualifying children. • $36,052 ($41,132 for married filing jointly) if you have one qualifying child, or • $13,660 ($18,740 for married filing jointly) if you do not have a qualifying child.

Example 1. You, your 5-year-old son, and your son's father lived together all year. You and your son's father are not married. Your son is a qualifying child of both you and his father because he meets the relationship, age, residency, and joint return tests for both you and his father. Your earned income and AGI are $12,000, and your son's father's earned income and AGI are $14,000. Neither of you had any other income. Your son's father agrees to let you treat the child as a qualifying child. This means, if your son's father does not claim your son as a qualifying child for the EIC or any of the other tax benefits listed earlier, you can claim him as a qualifying child for the EIC and any other tax benefits listed for which you qualify.

Example 2. You and your 7-year-old niece, your sister's child, lived with your mother all year. You are 25 years old, and your AGI is $9,300. Your only income was from a part-time job. Your mother's AGI is $15,000. Her only income was from her job. Your niece's parents file jointly, have an AGI of less than $9,000, and do not live with you or their child. Your niece is a qualifying child of both you and your mother because she meets the relationship, age, residency, and joint return tests for both you and your mother. However, only your mother can treat her as a qualifying child. This is because your mother's AGI, $15,000, is more than your AGI, $9,300.

CHAPTER 36 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The earned income credit not only may reduce the tax you owe, but also give you a refund.

   a) true
   b) false

2. To qualify for the earned income credit (EIC), which condition is not required:

   a) you must have a valid social security number
   b) you must have earned income
   c) you must be a U.S. citizen or resident alien all year
   d) you must have a dependent child

CHAPTER 36 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** The earned income credit is different than most credits because not only does it reduce the amount of tax you may owe, but it also may give you a refund.

   B: False is incorrect. To get your earned income credit, you must qualify by meeting certain rules, and file a tax return even if you did not owe any tax, did not earn enough money to file a return, or did not have income taxes withheld from your pay.

2. A: Incorrect. This rule must be met by all individuals claiming the EIC.

   B: Incorrect. A person must have earned income, among other requirements, to claim an EIC.

   C: Incorrect. U.S. citizenship or full-year resident alien status is necessary for claiming an EIC.

   D: Correct. The earned income credit can be received whether or not you have a qualifying or dependent child.

Chapter 37: Other Credits

I. Important

Adoption credit. The maximum adoption credit has been increased to $13,360 in 2011.

Revised Home Energy Credit. For 2011, the credit for energy efficient home energy improvements such as storm windows, insulation, furnaces, and water heaters is reduced from 30% to 10%, with an overall limit of $500 that is reduced by prior-year credits, plus specific property limits such as $200 for exterior windows and $150 for a furnace.

Plug-in electric vehicle credits. A 10% credit, up to $2,500, is allowed for the cost of qualified two- or three-wheel rechargeable electric vehicles and four-wheel low-speed rechargeable electric vehicles placed in service in 2011.

Another credit applies for plug-in electric drive motor vehicles with at least four wheels. The minimum credit of $2,500 is increased depending on the battery capacity and weight of the vehicle to a maximum credit of $7,500.

Solar energy credit. A 30% credit is available for solar energy property, equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for) a structure, or to provide solar process heat (but not for heating a swimming pool.) The previous limit for homeowners has been repealed. The 30% credit is available only for periods ending before 2017. After 2016, the credit will be 10%.

Additional child tax credit. The child tax credit is refundable for 2011 and 2012 to the extent of 15% of earned income in excess of $3,000.

Refundable credit for prior year AMT. The refundable portion of the credit for prior-year AMT will apply through 2012. The phaseout threshold will be adjusted annually.

II. Introduction

This chapter discusses the following nonrefundable credits.

- Alternative motor vehicle credit.
- Alternative fuel vehicle refueling property credit.
- Credit to holders of tax credit bonds.
- Foreign tax credit.
- Mortgage interest credit.
- Nonrefundable credit for prior year minimum tax.
- Plug-in electric drive motor vehicle credit.
- Plug-in electric vehicle credit.
- Residential energy credits.
- Retirement savings contributions credit.

This chapter also discusses the following refundable credits.

- Adoption credit.
- Credit for tax on undistributed capital gain.
- Health coverage tax credit.

- Refundable credit for prior year minimum tax.
- Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld.

Nonrefundable credits. The first part of this chapter, *Nonrefundable Credits,* covers ten credits that you subtract directly from your tax. These credits may reduce your tax to zero. If these credits are more than your tax, the excess is not refunded to you.

Refundable credits. The second part of this chapter, *Refundable Credits,* covers five credits that are treated as payments and are refundable to you. These credits are added to the federal income tax withheld and any estimated tax payments you made. If this total is more than your total tax, the excess will be refunded to you.

III. Nonrefundable Credits

ALTERNATIVE MOTOR VEHICLE CREDIT

You may be able to take a credit if you place an alternative motor vehicle in service in 2011.

Alternative motor vehicle. An alternative motor vehicle is a new vehicle that qualifies as one of the following four types of vehicles.

- Qualified hybrid vehicle.
- Advanced lean burn technology vehicle.
- Qualified alternative fuel vehicle.
- Qualified fuel cell vehicle.

The credit is also allowed for the cost of converting a vehicle to a qualified plug-in electric drive vehicle.

Amount of credit. Generally, you can rely on the manufacturer's (or, in the case of a foreign manufacturer, its domestic distributor's) certification that a specific make, model, and model year vehicle qualifies for the credit and the maximum amount of the credit for which it qualifies.

Ordinarily the amount of the credit is 100% of the manufacturer's (or domestic distributor's) certification of the maximum credit allowable. However, the credit for converting a vehicle to a qualified plug-in electric drive vehicle is the smaller of: (a) $4,000, or (b) 10% of the cost of the conversion.

If you purchased a qualified hybrid vehicle weighing 8,500 pounds or less or an advanced lean burn technology vehicle from a manufacturer who previously sold at least 60,000 of these vehicles, the amount of your credit may be reduced. Your manufacturer should give you the information you need to figure your phaseout percentage. Also see the Form 8910 instructions.

Recapture of credit. If the vehicle no longer qualifies for credit, you must recapture part or all of the credit.

How to take the credit. To take the credit, you must complete Form 8910 and attach it to your Form 1040. Include the credit in your total for Form 1040, line 53. Check box c and enter "8910" on the line next to box c.

ALTERNATIVE FUEL VEHICLE REFUELING PROPERTY CREDIT

You may be able to take a credit if you place qualified alternative fuel vehicle refueling property in service in 2011.

Qualified alternative fuel vehicle refueling property. Qualified alternative fuel vehicle refueling property is any property (other than a building or its structural components) used to store or dispense alternative fuel into the fuel tank of a motor vehicle propelled by the fuel, but only if the storage or dispensing is at the point where the fuel is delivered into the tank.

The following are alternative fuels.

- Any fuel at least 85% of the volume of which consists of one or more of the following: ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, or hydrogen.
- Any mixture which consists of two or more of the following: biodiesel, diesel fuel, or kerosene, and at least 20% of the volume of which consists of biodiesel determined without regard to any kerosene.
- Electricity.

Amount of the credit. For personal use property, the credit is generally the smaller of 50% of the property's cost or $2,000. For business use property, the credit is generally the smaller of 50% of the property's cost or $50,000. The amounts are different for hydrogen refueling property.

How to take the credit. To take the credit, you must complete Form 8911 and attach it to your Form 1040. Include the credit in your total for Form 1040, line 53. Check box c and enter "8911" on the line next to box c.

More information. For more information on the credit, see the instructions for Form 8911.

CREDIT TO HOLDERS OF TAX CREDIT BONDS

You may be able to take a credit if you are a holder of a tax credit bond. Tax credit bonds include:

- Clean renewable energy bonds,
- Qualified energy conservation bonds,
- Midwestern tax credit bonds,
- Qualified forestry conservation bonds,
- Qualified school construction bonds,
- Qualified zone academy bonds, and
- Build America bonds.

The issuers do not pay interest on these types of bonds (except build America bonds). Instead of receiving interest, the bondholders qualify to claim a tax credit.

Interest income. The amount of any tax credit allowed (figured before applying tax liability limits) must be included as interest income on your tax return.

How to take the credit. Complete Form 8912 and attach it to your Form 1040. Include the credit in your total for Form 1040, line 53. Check box c, and enter "8912" on the line next to box c.

More information. For more information, see the instructions for Form 8912.

FOREIGN TAX CREDIT

You generally can choose to claim income taxes you paid or accrued during the year to a foreign country or U.S. possession as a credit against your U.S. income tax. Or, you can deduct them as an itemized deduction (see chapter 22).

You cannot take a credit (or deduction) for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion, the foreign housing exclusion, income from Puerto Rico exempt from U.S. tax, or the possession exclusion.

Limit on the credit. Unless you can elect not to file Form 1116, your foreign tax credit cannot be more than your U.S. tax liability (line 44, Form 1040) multiplied by a fraction. The numerator of the fraction is your taxable income from sources outside the United States. The denominator is your total taxable income from U.S. and foreign sources.

How to claim the credit. Complete Form 1116 and attach it to your Form 1040. Enter the credit on line 47, Form 1040.

Exception. You do not have to complete Form 1116 to take the credit if all of the following apply.

- All of your foreign source gross income was from passive income, which generally includes interest and dividends.
- All of your foreign source gross income and the foreign tax paid on it were reported to you on a qualified payee statement, which includes Form 1099-INT and Form 1099-DIV.
- The total of your creditable foreign taxes was not more than $300 (not more than $600 if married filing jointly).
- You elect this procedure for the tax year.

For more details on these requirements, see the instruction Form 1116.

MORTGAGE INTEREST CREDIT

The mortgage interest credit is intended to help lower-income individuals own a home. If you qualify, you can take a credit each year for part of the home mortgage interest you pay.

Who qualifies. You may be eligible for the credit if you were issued a mortgage credit certificate (MCC) from your state or local government. Generally, an MCC is issued only in connection with a new mortgage for the purchase of your main home.

Amount of credit. Figure your credit on Form 8396. If your mortgage is equal to (or smaller than) the certified indebtedness amount (loan) shown on your MCC, enter on Form 8396, line 1, all the interest you paid on your mortgage during the year.

If your mortgage loan amount is larger than the certified indebtedness amount shown on your MCC, you can figure the credit on only part of the interest you paid. To find the amount to enter on line 1, multiply the total interest you paid during the year on your mortgage by the following fraction.

$$\frac{\text{Certified indebtedness amount on your MCC}}{\text{Original amount of your mortgage}}$$

Limit based on credit rate. If two or more persons (other than a married couple filing a joint return) hold an interest in the home to which the MCC relates, the credit must be divided based on the interest held by each person.

Caution. *If the certificate credit rate is more than 20%, the credit cannot be more than $2,000.*

Carryforward. If your allowable credit is more than your tax liability reduced by certain credits, you can carry forward the unused portion of the credit to your next 3 tax years or until used, whichever comes first.

If you are subject to the $2,000 limit because your certificate credit rate is more than 20%, no amount over the $2,000 (or your prorated share of the $2,000 if you must allocate the credit) may be carried forward.

How to claim the credit. Figure your 2011 credit and any carryforward to 2012 on Form 8396, and attach it to your Form 1040.

Include the credit in your total for line 53, Form 1040. Check box c, and enter “8396” on the line next to box c.

Reduced home mortgage interest deduction. If you claim the credit and itemize your deductions on Schedule A (Form 1040), you must reduce your home mortgage interest deduction. Reduce your deduction by the amount on line 3 of Form 8396, even if part of that amount is to be carried forward to 2012.

Recapture of federal mortgage subsidy. If you received an MCC with your mortgage loan, you may be subject to a recapture rule. The recapture may be required if you sell or dispose of your home at a gain during the first 9 years after the date you closed your mortgage loan.

NONREFUNDABLE CREDIT FOR PRIOR YEAR MINIMUM TAX

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. If you benefit from these laws, you may have to pay at least a minimum amount of tax in addition to any other tax on these items. This is called the alternative minimum tax.

The special treatment of some items of income and expenses only allows you to postpone paying tax until a later year. If in prior years you paid alternative minimum tax because of these tax postponement items, you may be able to claim a credit for prior year minimum tax against your current year's regular tax.

You may be able to take a credit against your regular tax if for 2010 you:

1) Had an alternative minimum tax liability and adjustments or preferences other than exclusion items,
2) Had a minimum tax credit that you are carrying forward to 2011, or
3) Had an unallowed qualified electric vehicle credit.

How to claim the credit. Figure your 2011 credit and any carryforward to 2012 on Form 8801, and attach it to your Form 1040. Include the credit in your total for line 53, Form 1040, and check box b. You can carry forward any unused credit for prior year minimum tax to later years until it is completely used.

For additional information about the credit, see the instructions for Form 8801.

PLUG-IN ELECTRIC DRIVE MOTOR VEHICLE CREDIT

You may be able to take this credit if you placed in service for business or personal use a qualified plug-in electric drive motor vehicle in 2011.

Amount of credit. The amount of the credit varies depending on the battery capacity and vehicle weight limitations and ranges from $2,500 to $7,500.

Qualified vehicle. A qualified plug-in electric drive motor vehicle is a new vehicle that:

- Draws propulsion using a traction battery with at least 4 kilowatts of capacity, and
- Uses an offboard source of energy to recharge the battery.

How to take the credit. To take the credit, you must complete Form 8936 and attach it to your Form 1040. Include the credit in your total for Form 1040, line 53. Check box c and enter “8936” on the line next to box c.

PLUG-IN ELECTRIC VEHICLE CREDIT

You may be able to take this credit if you acquired a qualified plug-in electric vehicle in 2011. A qualified vehicle can have 2, 3, or 4 wheels. A vehicle with 4 wheels must be a low speed vehicle.

Amount of credit. The credit is 10% of the cost of the vehicle, limited to $2,500 per vehicle.

Qualified vehicle. A qualified plug-in electric vehicle is a motor vehicle the original use of which starts with you and that:

1) Is acquired for your use or lease and not for resale,

2) Is made by a manufacturer,

3) Is manufactured primarily for use on public streets, roads, and highways,

4) Has a gross vehicle weight rating of less than 3,000 pounds if it has 4 wheels and less than 14,000 pounds if it has 2 or 3 wheels,

5) Is a low speed vehicle if it has 4 wheels, and

6) Is propelled to a significant extent by an electric motor that draws electricity from a battery that:
   a) Has a capacity of at least 4 kilowatt hours (2.5 kilowatt hours in the case of a vehicle with 2 or 3 wheels), and
   b) Is capable of being recharged from an external source of electricity.

How to take the credit. To take the credit, you must complete Form 8834 and attach it to your Form 1040. Include the credit in your total for Form 1040, line 53. Check box c and enter "8834" on the line next to box c.

RESIDENTIAL ENERGY CREDITS

You may be able to take one or both of the following credits if you made energy saving improvements to your home located in the United States in 2011.

- Nonbusiness energy property credit.
- Residential energy efficient property credit.

If you are a member of a condominium management association for a condominium you own or a tenant-stockholder in a cooperative housing corporation, you are treated as having paid your proportionate share of any costs of the association or corporation for purposes of these credits.

Nonbusiness energy property credit. You may be able to take a credit of 30% of the costs paid or incurred in 2011 for any qualified energy efficiency improvements and any residential energy property.

The credit is limited to a total of $500 for 2011. The $500 limit must be reduced by any nonbusiness energy property credit claimed after 2005.

Qualified energy efficiency improvements are the following improvements that are new, can be expected to remain in use at least 5 years, and meet certain requirements for energy efficiency.

- Any insulation material or system that is specifically and primarily designed to reduce heat loss or gain of a home.
- Exterior windows (including skylights).
- Exterior doors.
- Any metal or asphalt roof that has appropriate pigmented coatings or cooling granules specifically and primarily designed to reduce heat gain of the home.

Residential energy property is any of the following.

- Certain heat pump water heaters; electric heat pumps; central air conditioners; natural gas, propane, or oil water heaters; and stoves that use biomass fuel.
- Qualified natural gas, propane, or oil furnaces; and qualified natural gas, propane, or oil hot water boilers.
- Certain advanced main air circulating fans used in natural gas, propane, or oil furnaces.

Residential energy efficient property credit. You may be able to take a credit of 30% of your costs of qualified solar electric property, solar water heating property, fuel cell property, small wind energy property, and geothermal heat pump property. The credit amount for costs paid for qualified fuel cell property is limited to $500 for each one-half kilowatt of capacity of the property.

RETIREMENT SAVINGS CONTRIBUTIONS CREDIT

You may be able to take this credit if you, or your spouse if filing jointly, made:

- Contributions (other than rollover contributions) to a traditional or Roth IRA,
- Elective deferrals to a 401(k) or 403(b) plan (including designated Roth contributions) or to a governmental 457, SEP, or SIMPLE plan,
- Voluntary employee contributions to a qualified retirement plan (including the federal Thrift Savings Plan), or
- Contributions to a 501(c)(18)(D) plan.

However, you cannot take the credit if either of the following applies.

1) The amount on Form 1040, line 38, or Form 1040A, line 22, is more than $28,250 ($42,375 if head of household; $56,500 if married filing jointly).
2) The person(s) who made the qualified contribution or elective deferral (a) was born after January 1, 1994, (b) is claimed as a dependent on someone else's 2011 tax return or (c) was a student (defined next).

Student. You were a student if during any part of 5 calendar months of 2011 you:

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

School. A school includes a technical, trade, or mechanical school. It does not include an on-the-job training course, correspondence school, or school offering courses only through the Internet.

How to take the credit. Figure the credit on Form 8880. Enter the credit on your Form 1040, line 50, or your Form 1040A, line 32, and attach Form 8880 to your return.

IV. Refundable Credits

ADOPTION CREDIT

You may be able to take a tax credit of up to $13,360 for qualifying expenses paid to adopt an eligible child. The credit may be allowed for the adoption of a child with special needs even if you do not have any qualified expenses.

If your modified adjusted gross income (AGI) is more than $185,210, your credit is reduced. If your modified AGI is $225,210 or more, you cannot claim the credit.

Qualified adoption expenses. Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorney fees, traveling expenses (including amounts spent for meals and lodging) while away from home, and other expenses directly related to, and whose principal purpose is for, the legal adoption of an eligible child. These expenses include:

- Adoption fees,
- Court costs,
- Attorney fees,

- Travel expenses (including amounts spent for meals and lodging) while away from home, and
- Re-adoption expenses to adopt a foreign child.

Nonqualified expenses. Qualified adoption expenses do not include expenses:

- That violate state or federal law,
- For carrying out any surrogate parenting arrangement,
- For the adoption of your spouse's child,
- For which you received funds under any federal, state, or local program,
- Allowed as a credit or deduction under any other federal income tax rule, or
- Paid or reimbursed by your employer or any other person or organization.

Eligible child. The term "eligible child" means any individual:

1) Under 18 years old, or
2) Physically or mentally incapable of caring for himself or herself.

Child with special needs. An eligible child is a child with special needs if:

1) The child was a citizen or resident of the United States (including the District of Columbia and U.S. possessions).
2) A state determines that the child cannot or should not be returned to his or her parents' home.
3) The state has determined that the child will not be adopted unless assistance is provided to the adoptive parents. Factors used by states to make this determination include:

    - The child's ethnic background,
    - The child's age,
    - Whether the child is a member of a minority or sibling group, or
    - Whether the child has a medical condition or physical, mental, or emotional handicap.

Foreign child. If the child is not a U.S. citizen or resident, you cannot take the credit unless the adoption becomes final. You treat all adoption expenses paid or incurred in years before the adoption becomes final as paid or incurred in the year it becomes final.

When to claim the credit. Generally, for any year before the adoption becomes final, you take the credit in the year after your qualified expenses are paid or incurred. If the adoption becomes final, you take the credit in the year your expenses were paid or incurred.

How to claim the credit. To claim the credit, you must complete Form 8839 and attach it to your Form 1040. Enter the credit on line 71, Form 1040, and check box b on that line.

CREDIT FOR TAX ON UNDISTRIBUTED CAPITAL GAIN

You must include in your income any amounts that regulated investment companies (commonly called mutual funds) or real estate investment trusts (REITs) allocated to you as capital gain distributions, even if you did not actually receive them. If the mutual fund or REIT paid a tax on the capital gain, you are allowed a credit for the tax since it is considered paid by you. The mutual fund or REIT will send you Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains,* showing the undistributed capital gains and the tax paid, if any. Claim the credit for the tax paid by entering the amount on line 71, Form 1040, and checking box a. Attach

Copy B of Form 2439 to your return. See *Capital Gain Distributions* in chapter 8 for more information on undistributed capital gains.

HEALTH COVERAGE TAX CREDIT

You may be able to take this credit for any month in which all of the following statements were true on the first day of the month.

- You were an eligible trade adjustment assistance (TAA) recipient, alternative TAA recipient, or Pension Benefit Guaranty Corporation (PBGC) pension recipient (defined later).
- You were covered by a qualified health insurance plan for which you paid the premiums, or your portion of the premiums, directly to your health plan.
- You were not entitled to Medicare Part A or enrolled in Medicare Part B.
- You were not enrolled in Medicaid or Children's Health Insurance Program (CHIP).
- You were not enrolled in the Federal Employees Health Benefits Program (FEHBP) or eligible to receive benefits under the U.S. military health system (TRICARE).
- You were not imprisoned under federal, state, or local authority.
- Your employer did not pay 50% or more of the cost of coverage.
- You did not receive a 65% COBRA premium reduction from your former employer or COBRA administrator.

But, you cannot take the credit if you can be claimed as a dependent on someone else's 2011 tax return. If you meet all of these conditions, you may be able to take a credit of up to 65% of the amount you paid for qualified health insurance coverage. You cannot take the credit for insurance premiums on coverage that was partially paid for with a National Emergency Grant.

The amount you paid for qualified health insurance coverage must be reduced by any Archer MSA and health savings account distributions used to pay for the coverage.

You can take this credit on your tax return or have it paid on your behalf in advance to your insurance company. If the credit is paid on your behalf in advance, that amount will reduce the amount of the credit you can take on your tax return.

For definitions and special rules including those relating to qualified health insurance plans and employer-sponsored health insurance plans, see Publication 502 and the instructions for Form 8885.

TAA Recipient

You were an eligible TAA recipient on the first day of the month if, for any day in that month or the prior month, you:

- Received a trade readjustment allowance, or
- Would have been entitled to receive such an allowance except that you had not exhausted all rights to any unemployment insurance (except additional compensation that is funded by a state and is not reimbursed from any federal funds) to which you were entitled (or would be entitled if you applied).

Alternative TAA Recipient

You were an eligible alternative TAA recipient on the first day of the month if, for that month or the prior month, you received benefits under an alternative trade adjustment assistance program for older workers established by the Department of Labor.

PBGC Pension Recipient

You were an eligible PBGC pension recipient on the first day of the month, if both of the following apply:

1) You were age 55 or older on the first day of the month.
2) You received a benefit for that month that was paid by the PBGC under title IV of the Employee Retirement Income Security Act of 1974 (ERISA).

If you received a lump-sum payment from the PBGC after August 5, 2002, you meet item (2) above for any month that you would have received a PBGC benefit if you had not received the lump-sum payment.

How to Claim the Credit

To claim the credit, complete Form 8885 and attach it to your Form 1040. Include your credit in the total for Form 1040, line 71, and check box d. You cannot claim the credit on Form 1040A or Form 1040EZ.

You must attach invoices and proof of payment for any amounts you include on line 2 of Form 8885 for which you did not receive an advance payment.

REFUNDABLE CREDIT FOR PRIOR YEAR MINIMUM TAX

If you paid the alternative minimum tax for 2010 or you had a minimum tax credit carryforward to 2011, you may be able to take a credit for prior year minimum tax. For information about the nonrefundable credit for prior year minimum tax you may be able to take, see *Nonrefundable Credit for Prior Year Minimum Tax*, earlier. However, for 2011, you may qualify for a refundable credit for prior year minimum tax if you have any unused minimum tax credit carryforward from 2008 or earlier years, even if the total amount of your current year credit is more than your total tax liability. To figure the amount of any 2011 refundable credit, complete Part IV of Form 8801. Include any refundable credit on Form 1040, line 71, and check box c. You can carry forward any unused credit for prior year minimum tax to later years.

CREDIT FOR EXCESS SOCIAL SECURITY TAX OR RAILROAD RETIREMENT TAX WITHHELD

Most employers must withhold social security tax from your wages. If you work for a railroad employer, that employer must withhold tier 1 railroad retirement (RRTA) tax and tier 2 RRTA tax.

If you worked for two or more employers in 2011, you may have had too much social security or tier 1 RRTA tax withheld from your pay. You can claim the excess social security or tier 1 RRTA tax as a credit against your income tax. The following table shows the maximum amount of wages subject to tax and the maximum amount of tax that should have been withheld for 2011.

Type of tax	Maximum wages subject to tax	Maximum tax that should have been withheld
Social security of RRTA tier 1	$106,800	$4,485.60
RRTA tier 2	$79,200	$3,088.80

Caution: *All wages are subject to Medicare tax withholding.*

Tip: *Use Form 843, Claim for Refund and Request for Abatement, to claim a refund of excess tier 2 RRTA tax. Be sure to attach a copy of all of your W-2 forms. See the worksheet in Publication 505, Tax Withholding and Estimated Tax, to help you figure the excess amount.*

Employer's error. If any one employer withheld too much social security or tier 1 RRTA tax, you cannot take the excess as a credit against your income tax. The employer should adjust the tax for you. If the employer does not adjust the overcollection, you can file a claim for refund using Form 843.

Joint return. If you are filing a joint return, you cannot add the social security or tier 1 RRTA tax withheld from your spouse's wages to the amount withheld from your wages. Figure the withholding separately for you and your spouse to determine if either of you has excess withholding.

How to figure the credit if you did not work for a railroad. If you did not work for a railroad during 2011, figure the credit as follows:

1. Add all social security tax withheld (but not more than $4,485.60 for each employer). Enter the total here	________
2. Enter any uncollected social security tax on tips or group-term life insurance included in the total on Form 1040, line 60	________
3. Add lines 1 and 2. If $4,485.60 or less, stop here. You cannot take the credit.	________
4. Social security tax limit	$4,485.60
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 69 (or Form 1040A, line 44)	________

Example. You are married and file a joint return with your spouse who had no gross income in 2011. During 2011, you worked for the Brown Technology Company and earned $60,000 in wages. Social security tax of $2,520 was withheld. You also worked for another employer in 2011 and earned $55,000 in wages. $2,310 of social security tax was withheld from these wages. Because you worked for more than one employer and your total wages were more than $106,800, you can take a credit of $344.40 for the excess social security tax withheld.

1. Add all social security tax withheld (but not more than $4,485.60 for each employer). Enter the total here	$4,830.00
2. Enter any uncollected social security tax on tips or group-term life insurance included in the total on Form 1040, line 60	-0-
3. Add lines 1 and 2. If $4,485.60 or less, stop here. You cannot take the credit.	$4,830.00
4. Social security tax limit	$4,485.60
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 69 (or Form 1040A, line 44)	$344.40

How to figure the credit if you worked for a railroad. If you were a railroad employee at any time during 2011, figure the credit as follows:

1. Add all social security and tier 1 RRTA tax withheld (but not more than $4,485.60 for each employer). Enter the total here	
2. Enter any uncollected social security and tier 1 RRTA tax on tips or group-term life insurance included in the total on Form 1040, line 60	
3. Add lines 1 and 2. If $4,485.60 or less, stop here. You cannot take the credit.	
4. Social security and tier 1 RRTA tax limit	$4,485.60
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 69 (or Form 1040A, line 44)	

How to take the credit. Enter the credit on Form 1040, line 69, or include it in the total for Form 1040A, line 44.

CHAPTER 37 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Qualifying adoption expenses do not include the costs for adoption of your spouse's child.

    a) true
    b) false

CHAPTER 37 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** Adoption of your spouse's child is not a qualifying adoption event. Qualifying adoption expenses also do not include expenses that violate state or federal law, for carrying out any surrogate parenting arrangement, paid using funds received from any federal, state or local program, or paid or reimbursed by your employer or any other person or organization.

   B: False is incorrect. Qualifying adoption expenses are reasonable and necessary adoption fees, court costs, attorney fees, traveling expenses while away from home, and other expenses directly related to, and whose principal purpose is for, the legal adoption of an eligible child. Your spouse's child is not considered an eligible child.

Glossary

Term	Definition
401(k) plan	A deferred compensation plan, authorized by Section 401(k) of the Internal Revenue Code, under which a percentage of an employee's salary is withheld and placed in a savings account or the company's profit-sharing plan. Income accumulates on the deferred amount until withdrawn by the employee at age 59½ or when the employee retires or leaves the company.
Accelerated cost recovery system (ACRS)	A statutory method of depreciation allowing accelerated rates for most types of property used in business and income-producing activities during the years 1981 through 1986. It has been superseded by the modified accelerated cost recovery system (MACRS) for assets placed in service after 1986.
Accelerated death benefit	Certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death.
Accelerated depreciation	A method of *depreciation* that allows a person to deduct the cost of property more rapidly than *straight-line depreciation.* Accelerated depreciation rates are included in *ACRS* rates and most Modified Accelerated Cost Recovery System *(MACRS)* rates if a person wants to use them.
Accountable plan	An employer's plan for reimbursing employees for business – related expenses, under which the employees are required to substantiate each business expense to the employer and return any reimbursement in excess of the substantiated expenses. Reimbursements received under an accountable plan are generally excluded from wages and are not subject to employment taxes.
Accrual method	A business method of accounting requiring income to be reported when earned and expenses to be deducted when incurred. However, deductions generally may not be claimed until economic performance has occurred.
Acquisition debt	Debt used to buy, build, or construct a principal residence or second home and that generally qualifies for a full interest expense deduction.
Active participation	The level of activity necessary to claim rental losses up to $25,000 from real estate rental activities.
Adjusted basis	A statutory term describing the cost used to determine your profit or loss from a sale or exchange of property. It is generally your original cost, increased by capital improvements, and decreased by depreciation, depletion, and other capital write-offs.
Adjusted gross income (AGI)	Important tax term representing gross income less allowable adjustments, such as IRA, alimony, and Keogh deductions. AGI determines whether various tax benefits are phased out, such as personal exemptions, itemized deductions, and the rental loss allowance. Also see modified adjusted gross income (MAGI).
Administrator	Person who is usually appointed by the court if no will exists, if no executor was named in the will, or if the named executor cannot or will not serve. The administrator will have to administer the estate (property or debts left by the decedent) and distribute properties as the decedent has directed.
Alimony	Payments made to a separated or divorced spouse as required by a decree or agreement. Qualifying payments are deductible by the payor and taxable to the payee.
Alternate payee	The recipient of qualified retirement benefits under a court order, judgment, decree, or approved property settlement constituting a qualified domestic relations order.

Term	Definition
Alternative Depreciation System (ADS)	A way of depreciating assets using the straight-line depreciation method and longer recovery period than are available under *MACRS*. Mandatory for such items as foreign assets, luxury automobiles, and tax-exempt use property.
Alternative Minimum Tax (AMT)	A tax that may apply in lieu of income tax when a taxpayer has *tax preference items* or certain deductions allowed in determining regular taxable income.
Amended return	Filed on Form 1040X within a three-year period to correct a mistake made on an original or previously amended return.
American Opportunity credit	The maximum credit is generally $2,500 per student, and it is allowed for the first four years of post-secondary education. The phaseout of the credit applies if modified adjusted gross income is between $80,000 and $90,000, or between $160,000 and $180,000 on a joint return.
Amortization	A deductible expense allowed as a means of recovering the investment in an intangible asset. Compare with *depreciation.*
Amount realized	The *fair market value* of property, including money (at face value), received in a sale or an exchange.
Amount recognized	The amount of gain reportable and subject to tax. On certain tax-free exchanges of property, gain is not recognized in the year it is realized.
Annual gift tax exclusion	An exclusion that applies to gifts of present interests on a per donee basis.
Annualized rate	A rate for a period of less than a year computed as though for a full year.
Annuity	A sum of money paid periodically that includes the return of the invested capital plus income generated by it. An annuity is frequently purchased by an individual for investment purposes and is used by retirement plans to pay *pensions.*
Applicable federal rate	Interest rate fixed by the Treasury for determining imputed interest on transactions providing for below-market interest.
Archer Medical Savings Account (MSA)	A type of medical plan combining high deductible medical insurance protection with an IRA-type savings account fund to pay unreimbursed medical expenses.
Assessment	The IRS action of fixing tax liability that sets in motion collection procedures, such as charging interest, imposing penalties, and, if necessary, seizing property.
At-risk limitations	Generally, partnership losses are deductible up to the amount you have a risk in the activity. The amount at risk is your basis in the activity and any amounts borrowed for use in the activity for which you are personally liable.
At-risk rules	Rules limiting loss deductions to cash investments and personal liability notes. An exception for real estate treats certain nonrecourse commercial loans as amounts “at risk.”
Audit	An IRS examination of your tax return, generally limited to a three-year period after you file.
Average cost method	A method of figuring the basis of shares in mutual funds for purposes of determining gain or loss on the sale of less than one’s entire holdings in a fund.
Bad Debt	An amount owed you representing a cash outlay or an item already included in income that you are unable to collect.
Basis	Generally, the amount paid for property or the cost of an *asset.* Needed to figure gain or loss on a sale.

Term	Definition
Below market loans	Demand loans on which interest is payable at a rate below the applicable federal rate or term loans where the amount loaned exceeds the present value of all payments due under the loan (using a discount rate equal to the applicable federal rate).
Boot	Generally, the receipt of cash or its equivalent accompanying an exchange of property. In a tax-free exchange, boot is subject to immediate tax.
Cafeteria Plan	A plan that allows employees to choose between cash and certain qualified benefits.
Calendar year	A year that begins on January 1st and ends on December 31st . Most individual taxpayers are required to file their returns on the basis of such a year. Compare to *fiscal year.*
Cancellation of debt	Release of a debt without consideration by a creditor. Cancellations of debts are generally taxable.
Capital asset	In general, property held for personal purposes or investment, rather than for business purposes. Property subject to capital gain or loss treatment. Almost all assets you own are considered capital assets except for certain business assets or works you created.
Capital expenses	Costs that are not currently deductible and that are added to the basis of property. A capital expense generally increases the value of property. When added to depreciable property, the cost is deductible over the life of the asset.
Capital gain dividend (capital gain distribution)	A distribution to shareholders in a *mutual fund* of a *capital gain* realized by the fund on the sale of a part of its investment portfolio.
Capital gain or loss	A gain or loss arising from the sale or exchange of *capital assets.* Computed by comparing the amount realized on the sale or exchange of an *asset* with the *adjusted basis* of the asset.
Capital loss carryover	The excess of *capital losses* over *capital gains* that cannot be deducted in a particular year and must be carried over to the succeeding year.
Capitalization	Adding a cost or expense to the basis of the property.
Carryback	A tax technique for receiving a refund of back taxes by applying a deduction or credit from a current tax year to a prior tax year. For example, a business net operating loss may be carried back for two years.
Carryforward	A tax technique of applying a loss or credit from a current year to a later year. For example, a business net operating loss may be carried forward 20 years instead of being carried back.
Cash method	Reporting income when actually or *constructively received* and deducting expenses when paid. Certain businesses may not use the cash method.
Casualty loss	Loss from an unforeseen and sudden event that is deductible, subject to a 10% income floor and $100 reduction for personal losses.
Charitable contributions	An itemized deduction is allowed for donations to qualifying charities. For property donations, the deductible amount depends on the type of property and donee organization, the holding period, and in some cases how the property is used.
Child and dependent care credit	A credit of up to 30% based on certain care expenses incurred that allow the taxpayer to work.

Term	Definition
Child support	Payments to support a minor child generally to a custodial parent under a divorce or separation decree or agreement. The payments cannot be deducted from *gross income* and are not taxable to the recipient parent. Starting in 1985, the parent with custody of the child is generally entitled to the dependency *exemption* unless such a right is expressly waived.
Child tax credit	For tax years beginning after 1997, a tax credit is allowed against income with respect to each qualifying child for taxpayers with modified adjusted gross income below certain thresholds.
Community income	Income earned by persons domiciled in community property states and treated as belonging equally to husband and wife.
Community property	Property that belongs equally to husband and wife. This concept of property ownership is currently used in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.
Condemnation	The seizure of property by a public authority for a public purpose. Tax on gain realized on many conversions may be deferred.
Constructive receipt	Income you are taxed on because it was made available to you to draw on, even if it has not yet been physically transferred to you.
Coverdell Education Savings Account	A special account set up to fund education expenses of a student.
Credit	A tax credit directly reduces tax liability, as opposed to a deduction that reduces income subject to tax.
Declining balance depreciation	A method of *accelerated depreciation* by which each year's *depreciation* is a percentage of the reduced *basis* of the *asset.*
Deductions	Items directly reducing income. Personal deductions such as for mortgage interest, state and local taxes, and charitable contributions are allowed only if deductions are itemized on Schedule A, but deductions such as for alimony, capital losses, moving expenses to a new job location, business losses, student loan interest, and IRA and Keogh deductions are deducted from gross income even if itemized deductions are not claimed.
Deferred compensation	A portion of earnings withheld by an employer or put into a retirement plan for distribution to the employee at a later date. If certain legal requirements are met, the deferred amount is not taxable until actually paid, for example, after retirement.
Deferred gain	A gain realized but not recognized as taxable income *until a later time.*
Deficiency	The excess of the tax assessed by the IRS over the amount reported on your return.
Defined benefit plan	A retirement plan that pays fixed benefits based on actuarial projections.
Defined contribution plan	A retirement plan that pays benefits based on contributions to individual accounts, plus accumulated earnings. Contributions are generally based on a percentage of salary or earned income.
Dependency exemption	A fixed deduction allowed to every taxpayer, except those who may be claimed as a dependent by another person. Extra exemption deductions are allowed for a spouse on a joint return and for each qualifying dependent.
Dependent	A person supported by another person. If certain tests are met, a dependency exemption may be claimed for the dependent.
Depletion	A deductible expense that reflects the decrease of a depletable natural resource, such as oil and gas, as it is extracted.
Depreciable property	A business or income-production asset with a useful life exceeding one year.

Term	Definition
Depreciation	Writing off the cost of depreciable property over a period of years, usually its class life or recovery period specified in the tax law.
Depreciation recapture	An amount of gain on the sale of certain depreciable property that is treated as ordinary income in the case of personal property. Recapture is computed on Form 4797.
Designated beneficiary	A person, trust, tax-exempt organization or estate named to receive qualified plan benefits or IRAs after a taxpayer's death. In some cases, the designated beneficiary enables a taxpayer to figure required minimum distributions over joint lives (or joint life expectancy).
Direct rollover	An eligible rollover distribution that is paid directly to an eligible retirement plan for the benefit of the distributee.
Disaster losses	Casualty losses, such as from a storm, in areas declared by the President to warrant federal assistance. An election may be made to deduct the loss in the year before the loss or the year of the loss.
Dividend	A distribution made by a corporation to its shareholders generally of company earnings or surplus. Most dividends are taxable but exceptions do exist.
Domicile	The place that an individual intends to be his or her permanent residence.
Dual-status alien	An individual who is a *nonresident alien* for part of the year and a *resident alien* or U.S. citizen for the rest of the year.
Earned Income	Compensation for performing personal services. You must have earned income for a deductible IRA, or to claim the earned income credit. Earned income does not include amounts received from an *annuity* or a *pension.*
Earned income credit	A credit allowed to taxpayers with earned income or adjusted gross income (AGI) below certain thresholds.
Education credits	There are two education credits: the American opportunity credit and the lifetime learning credit.
Education savings account	A trust or custodial account created for the purpose of paying the qualified higher education expenses of the designated beneficiary of the account.
Electronic Federal Tax Payment System (EFTPS)	A tax deposit method using electronic transfers of funds from bank accounts that must be used by certain businesses with substantial employment tax liability.
Eligible retirement plan	A qualified retirement plan, an individual retirement account, or an individual retirement annuity.
Estate tax	A tax imposed on the value of a decedent's taxable estate, after deductions and credits.
Estimated tax	Advance payment of current tax liability based either on wage withholdings or installment payments of your estimated tax liability. To avoid penalties, you generally must pay to the IRS either 90% of your final tax liability, or either 100% or 110% of the prior year's tax liability, depending on your adjusted gross income.
Exclusion	An amount that is excluded from *gross income.*
Executor	Person named in the decedent's will to administer the estate (property or debts left by the decedent) and distribute properties as the decedent has directed.
Fair market value (FMV)	What a willing buyer would pay to a willing seller when neither is under any compulsion to buy or sell.
Fiduciary	A personal or corporation such as a trustee, executor, or guardian who manages property for another person.

Term	Definition
Flexible spending arrangements (FSAs)	A salary reduction plan that allows employees to pay for enhanced medical coverage or dependent care expenses on a tax-free basis.
Foreign earned income exclusion	Foreign earned income exempt from tax if a foreign residence or physical presence test is met.
Foreign tax credit	A credit allowed for income taxes paid to a foreign tax jurisdiction (e.g., a foreign country) to mitigate double taxation.
Gift tax	Gifts in excess of a $13,000 per donee annual exclusion are subject to gift tax, but the tax may be offset by a unified gift and estate tax credit.
Gross income	The total amount of income received from all sources before exclusions and deductions.
Gross receipts	Total business receipts reported on Schedule C or Schedule C-EZ before deducting adjustments for returns and allowances and costs of goods sold.
Group-term life insurance	Employees are not taxed on up to $50,000 of group-term coverage.
Head of Household	A taxpayer who is unmarried and pays more than 50% of the cost of maintaining a residence for the entire year for a qualifying individual. If you are a head of household, you qualify for special tax rates.
Hobby loss	Hobby expenses are deductible only up to income from the activity; loss deductions are not allowed.
Holding period	The length of time an *asset* is held. The holding period of a capital asset determines whether a sale or an exchange results in a *long-term* or a *short-term capital gain* or *loss.*
Home equity debt	Debt secured by a principal residence or second home to the extent of the excess of fair market value over acquisition debt.
Home sale exclusion	The tax-free amount of gain on the sale of a principal residence where certain ownership and use tests are satisfied.
Imputed interest	Interest deemed to have been earned or charged on a debt if the stated interest rate is below the rate set by law.
Incentive Stock Option	A type of stock option that can be received and exercised without recognition of income until the option stock is sold, if certain statutory requirements are met.
Income in respect of a decedent	Income earned by a person before death but taxable to an estate or heir who receives it.
Income shifting	A strategy to direct income to a taxpayer in a lower tax bracket to produce an overall tax savings for both parties involved in the shift.
Independent contractor	One who controls his or her own work and reports as a self-employed person.
Individual retirement account (IRA)	A retirement account to which a specific amount may be contributed annually, but deductions for the contribution are restricted if you are covered by a company retirement plan. Earnings accumulate tax free.
Innocent spouse relief	Reduction or forgiveness of joint and several liability for the tax on a joint return for the requesting spouse who meets certain requirements.
Installment sale	A sale of property that allows for tax deferment if at least one payment is received after the end of the tax year in which the sale occurs. The installment method does not apply to year-end sales of publicly traded securities. Dealers may not use the installment method. Investors with very large installment balances could face a special tax.
Intangible assets	Intangible assets that come within Section 197, such as goodwill, are amortizable over a 15-year period.
Internal Revenue Service	The division of the U.S. Treasury Department that is responsible for the enforcement of the tax laws.

Term	Definition
Investment interest	Interest on debt used to carry investments, but not including interest expenses from a passive activity. Deductions are limited to net investment income.
Involuntary conversion	Forced disposition of property due to condemnation, theft, or casualty. Upon conversion, you usually receive cash through insurance proceeds or condemnation awards. Tax on gain from involuntary conversion may be deferred if replacement property is purchased.
Itemized Deductions	Items, such as interest, state and local taxes, charitable contributions, and medical deductions, claimed on Schedule A for Form 1040. Itemized deductions are subtracted from *adjusted gross income* to arrive at taxable income. The amount of itemized deductions is also subject to a reduction when adjusted gross income exceeds certain limits.
Joint Return	A return filed by a married couple reporting their combined income and deductions. Joint return status provides tax savings to many couples.
Joint tenants	Ownership of property by two persons. When one dies, the decedent's interest passes to the survivor.
Keogh plan	Retirement plan set up by a self-employed person that provides tax-deductible contributions, tax-free income accumulations until withdrawal, and favorable averaging for qualifying lump-sum distributions.
Kiddie tax	The tax on the investment income in excess of $1,900 (2011) of a dependent child, based on the parent's marginal tax rate and computed on Form 8615.
Legally separated	A husband and wife who are required to live apart from each other by the terms of a decree of separate maintenance. Payments under the decree are deductible by the payor and taxable to the payee as alimony.
Lifetime learning credit	20% credit for up to $10,000 of qualified tuition and related expenses for undergraduate or graduate level courses.
Like-kind exchange	An exchange of similar assets used in a business or held for investment on which gain may be deferred.
Long-term capital gain or loss	Gain or loss on the sale or exchange of a *capital asset* that has been held for a legislatively mandated *holding period.*
Long-term care	A type of medical care for chronically ill individuals which generally is not covered by Medicare.
Long-term care insurance contract	Insurance contract that only provides coverage for qualified long-term care services.
Lump-sum distribution	Payments within one tax year of the entire amount due to a participant in a qualified retirement plan. Qualifying lump-sums may be directly rolled over tax fee, or, in some cases, are eligible for current tax under a favorable averaging method.
Marginal tax rate	The tax rate at which each additional dollar of income over a specified ceiling is taxed.
Marital deduction	An estate tax and gift tax deduction for assets passing to a spouse. It allows estate and gift transfers completely free of tax.
Market discount	The difference between face value of bond and lower market price, attributable to rising interest rates. On a sale, gain on the bond is generally taxed as ordinary income to the extent of the discount.
Material participation	The level of participation required to deduct losses from trade or business activities otherwise subject to the passive activity loss limitations.

Term	Definition
Miscellaneous itemized deductions	A class of itemized deductions (e.g., investment expenses, fee for tax advise, union dues) that is deductible only to the extent that the total exceeds 2% of adjusted gross income.
Modified ACRS (MACRS)	Depreciation methods applied to assets placed in service after 1986.
Modified adjusted gross income (MAGI)	This is generally adjusted gross income increased by certain items such as tax-free foreign earned income. MAGI usually is used to determine phaseouts of certain deductions and credits.
Mortgage interest	Fully deductible interest on up to two residences if acquisition debt secured by a home is $1 million or less, and home equity debt is $100,000 or less.
Moving expenses	Certain expenses of moving to a new job location are deductible if distance and time tests are met.
Mutual fund	A company that is in the business of investing its shareholder's funds, usually in stocks or bonds; sometimes known as a *regulated investment company.*
Nominee	Someone who receives income that belongs to another person.
Nonperiodic distributions	A 20% withholding rule apples to nonperiodic distributions, such as lump-sum distributions, paid directly to employees from an employer plan.
Nonqualified stock option	A type of stock option that when exercised creates *ordinary income* for the taxpayer.
Nonrecourse financing	Debt on which a person is not personally liable. In case of non-payment, the creditor must foreclose on property securing the debt. At-risk rules generally bar losses where there is nonrecourse financing, but an exception applies to certain nonrecourse financing for real estate.
Nonresident alien	A person who is not a United States citizen or a permanent resident. Tax is generally limited to income from U.S.
Nontaxable exchange	An exchange of property in which no gain or loss is recognized for tax purposes.
Offers in compromise	Arrangements in which the IRS agrees to accept less than full payment of taxes because it realizes that full payment may never be made.
Ordinary gain or loss	A gain or loss other than a *capital gain or loss*.
Ordinary income	Income that does not arise from the sale or exchange of a *capital asset* or a *Section 1231 asset* and is not subject to any preferential tax treatment.
Ordinary loss	A loss other than a capital loss.
Original issue discount (OID)	The difference between the face value of a bond and its original issue price. OID is reported on an annual basis as interest income.
Owner-employee	An *employee* who is the *proprietor* of a business. Also, a partner who owns more than 10% of either the capital or the profit interest in a partnership.
Partnership	An unincorporated business or income-producing entity organized by two or more persons. A partnership is not subject to tax but passes through to the partners all income, deductions, and credits, according to the terms of the partnership agreement.
Passive activity loss	A loss from a trade or a business in which the taxpayer is not a *material participant.* Passive activity losses are subject to deduction limitations. Passive activities include rental activities and investments in limited partnerships.
Pension	Payments to employees from an employer-funded retirement plan for past services.

Term	Definition
Percentage depletion	A method of calculating *depletion* that applies a fixed percentage to the *gross income* generated by the mineral property.
Personal exemption	An automatic exemption given to a taxpayer unless he or she may be claimed as a dependent by another taxpayer. Exemptions are phased out for certain high income taxpayers.
Personal interest	Tax term for interest on personal loans and consumer purchases. Such interest is not deductible.
Personal-use property	Property that is not held for investment or use in a trade or a business.
Placed in service	The time when a depreciable asset is ready to be used. The date fixes the beginning of the depreciation period.
Points	Certain charges paid by a borrower, calculated as a percentage of the loan proceeds; each point is 1%. They are also called loan origination fees, maximum loan charges, or premium charges. Depending on the type of loan, points may be currently deductible or amortized over the life of the loan.
Pooled income funds	Charitable vehicles that provide donors with an income for life similar to a charitable remainder trust but without the need (and cost) of setting up a separate trust.
Premature distributions	Withdrawals before age 59½ from qualified retirement plans are subject to penalties unless specific exceptions are met.
Profit-sharing plan	A defined contribution plan under which the amount contributed to the employee's accounts is based on a percentage of the employer's profits.
Proprietor	An individual who is the sole owner of his or her trade or business.
Qualified charitable organization	A nonprofit philanthropic organization specifically approved by the U.S. Treasury as a recipient of charitable contributions that are deductible for tax purposes.
Qualified domestic relations order (QDRO)	A court order, judgment, decree or approved property agreement which specifies the amount of qualified plan benefits to be paid to an alternate payee and which are not taxable to the plan participant.
Qualified plan	An *employee* benefit plan established by an employer that meets certain requirements and therefore qualifies for certain tax benefits.
Qualified tuition programs	State-sponsored plans to allow for higher education savings on a tax-advantaged basis. While there is no federal tax deduction for contributions to these programs, states may provide a deduction from state income tax.
Qualifying widow or widower	A filing status entitling the taxpayer with dependents to use joint tax rates for up to two tax years after the death of a spouse.
Real estate professionals	Taxpayers who are exempt from the passive activity loss limitations because of their level of involvement with real estate activities.
Real property (real estate)	Physical property that is permanent and nonmovable in nature. Two examples are land and buildings.
Realized gain or loss	The difference between the amount you are entitled to receive on a sale or exchange of property and the *adjusted basis* of the property.
Recognized gain or loss	The amount of gain or loss to be reported on a tax return. Gain may not be recognized on certain exchanges of property.
Refundable tax credit	A credit that entitles you to a refund even if you owe no tax for the year.
Regulated investment company	An investment company subject to Security and Exchange Commission regulations. If the investment company distributes its income to its shareholders, it does not pay any taxes.
Remainder interest	An interest in property or a *trust* that is left after the income beneficiaries have received their income interest.

Term	Definition
Required minimum distributions	Distributions from qualified plans and IRAs that generally must commence at age 70½ to avoid a 50% penalty.
Resident alien	An individual who is not a citizen of the United States but is a permanent resident of the United States.
Residential rental property	Real property in which 80% or more of the gross income is from dwelling units. Under MACRS, depreciation is claimed over 27.5 years under the straight-line methods.
Return of capital	A distribution of your investment that is not subject to tax unless the distribution exceeds your investment.
Rollover	A distribution from a qualified plan that is reinvested tax-free in another qualified plan or IRA within 60 days of the date of receipt.
Roth IRA	Contributions to a Roth IRA are nondeductible, and, if certain specified conditions are met, distributions are tax free. The contribution may be limited by certain threshold amounts.
Royalty income	Income received for the use of certain kinds of property (e.g., mineral and literary properties, patents).
Salvage value	The estimated value of an *asset* at the end of its *useful life*. Salvage value is ignored by ACRS and MACRS rules.
Scholarships	Grants to degree candidates receive tax-free treatment if awarded after August 16, 1986 and used for tuition and course-related expenses, but not room and board.
Section 1231 assets	Generally, *depreciable assets* used in a trade or a business and held for the required long-term holding period. Net gains from the sale or exchange of Section 1231 assets (after recapture of *depreciation*), are treated as *capital gains;* net losses are treated as *ordinary losses.*
Section 457 plan	Deferred compensation plan set up by a state or local government, or tax-exempt organization, which allows tax-free deferrals of salary.
Section 529 plans	Qualified tuition plans set up by states or private institutions as either prepaid tuition plans or savings-type plans. While contributions are not deductible for federal income tax purposes, distributions used to pay qualified higher education costs are tax free.
Self-canceling installment notes (SCINs)	Installment obligations that are forgiven automatically (such as under the terms of the seller's will or as a gift by the seller) to the extent they have not yet been paid.
Self-employed person	An individual who operates a business or profession as a proprietor or independent contractor and reports self-employment income on Schedule C.
Self-employment tax	Tax paid by self-employed persons to finance Social Security coverage.
Separate maintenance payments	Payments made from one spouse to another when they are living apart. The payments are made in accordance with a court order or an agreement between the parties.
Separate return	Return filed by a married person who does not file a joint return. Filing separately may save taxes where each spouse has separate deductions, but certain tax benefits require a joint return.
Short-term capital gain or loss	A gain or loss on the sale or exchange of a *capital asset* that has been held for less than the legislatively mandated *holding period.*
SIMPLE plans	Qualified retirement plans restricted to small employers that can be either SIMPLE IRAs or SIMPLE 401(k) plans. These plans have easy nondiscrimination rules and no heavy reporting requirements.
Simplified Employee Pension (SEP)	IRA-type plan set up by an employer, rather than the employee.

Term	Definition
Single	The filing status of an individual who is not married on December 31 of the year for which a return is filed.
Standard deduction	A *deduction* used to reduce income by taxpayers who do not itemize their deductions. The amount of the deduction depends on ones filing status, whether they are 65 or older or blind, and whether they can be claimed as a *dependent* on another taxpayer's return. Adjusted annually for inflation since 1989.
Standard mileage rate	An IRS-approved optional amount used to claim a *deduction* for business transportation expenses in lieu of deducting actual expenses (not including parking, tolls, interest, and taxes).
Statute of limitations	The time period within which the IRS can assess and collect taxes and taxpayers can file for refunds.
Statutory employees	Certain employees, such as full-time life insurance salesperson, who may report income and deductions on Schedule C, rather than on Schedule A as miscellaneous itemized deductions.
Stock Appreciation Right (SAR)	A right granted to an *employee* for additional compensation based on the amount of the appreciation in the company's stock between the date on which the right is granted and the date on which the right is exercised.
Stock dividend	A distribution of additional shares of a corporation's stock to its shareholders.
Stock option	A right to buy stock at a fixed price.
Straight-line depreciation	A method of *depreciation* in which the cost or other *basis* of the *asset* is deducted in equal amounts over the property's *useful life.*
Sum of the years' digits depreciation	A method of *accelerated depreciation* that is based on a formula developed from the expected *useful life* of the property.
Support	Payments made for the care and maintenance of a *dependent.* Expenditures for support include payments for food, lodging, medical expenses and so on.
Tax attributes	When debts are canceled in bankruptcy cases, the canceled amount is excluded from gross income. Tax attributes are certain losses, credits, and property basis that must be reduced to the extent of the exclusion.
Tax credit carryforward (or carryover)	Tax credit that you were unable to use to reduce previous year's tax and that can be applied to offset future tax.
Tax deferral	Shifting income to a later year, such as where you defer taxable interest to the following year by purchasing a T-bill or savings certificate maturing after the end of the current year. Investments in qualified retirement plans provide tax deferral.
Tax identification number	For an individual, his or her Social Security number; for businesses, fiduciaries, and other non-individual taxpayers, the employer identification number.
Tax loss carryforward (or carryover)	Generally, a *net operating loss* that you were not able to apply against your income during the 2-year carryback period and that may now be applied against future income. The tax benefit of the loss expires if it is not utilized within a 20-year carryover period.
Tax preference items	Items that may subject a taxpayer to the alternative minimum tax (AMT). Two examples are *accelerated depreciation* of *real property* and *percentage depletion.*
Tax rate schedules	Schedules issued by the IRS that must be used in figuring individual income tax for persons who may not use *Tax Tables* i.e., persons with taxable income of at least $100,000.
Tax year	A period (generally 12 months) for reporting income and expenses.

Term	Definition
Taxable income	Net income after claiming all deductions from *gross income* and *adjusted gross income*, such as IRA *deductions*, itemized *deductions*, or the standard deduction, and personal *exemptions*.
Tax-exempt income	Income that is not subject to federal income tax. An example is income for state and municipal bonds.
Tax-sheltered annuity	A type of retirement annuity offered to employees of charitable organizations and educational systems, generally funded by employee salary-reduction contributions.
Tip Reporting Alternative Commitment Program (TRAC)	A voluntary IRS program for tip reporting by food and beverage establishments. The program was established to increase tip reporting and compliance levels by both employees and employers.
Trade date	The date on which a purchase or sale of securities occurs. The trade date is used in determining the *holding period* of a security.
Trust	An arrangement under which one person transfers legal ownership of assets to another person or corporation (the trustee) for the benefit of one or more third persons (beneficiaries).
Undistributed capital gains	Capital gains that investors in mutual funds must report but for which they can claim a tax credit for their share of tax paid by the fund.
Useful life	For property not depreciated under ACRS and MACRS, the estimate of time in which a depreciable asset will be used.
Wash sales	Sales on which losses are disallowed because you recover your market position within a 61-day period.
Withholding	An amount taken from income as pre-payment of an individual's tax liability for the year. In the case of wages, the employer withholds part of every wage payment. Backup withholding from dividend or interest income is required if you do not provide the payer with a correct taxpayer identification number. Withholding on pensions and IRAs is automatic unless you elect to waive withholding.

Index

U

W