2017 Annual Federal Tax Refresher (AFTR) Course

Domain 2 – General Review

Domain 2 of the Annual Federal Tax Refresher (AFTR) course provides a high-level review of basic tax provisions for individuals for the 2017 filing season.

Domain 2 is divided into four general review sections:

Part 1 Filing Statuses and Exemptions
Part 2 Income
Part 3 Subtractions from Income
Part 4 Credits, Payments, and Refunds

Domain 2, Part 1 – General Review of Filing Statuses and Exemptions

Domain 2 of this course provides a general review of the individual tax return. Part 1 provides a review information of filing statuses, exemptions, and other related material.

Sections in Part 1 of Domain 2 include:

- Tax-Related Identity Theft
- ITINs
- Filing Requirements
- Filing Status
- Exemptions
- Skill Check

Domain 2, Part 1 Objectives

Domain 2 of the Annual Federal Tax Refresher (AFTR) Course reviews important concepts and guidelines to preparing individual tax returns.

After completing Domain 2 Part 1, participants should be able to:

- Recall warning signs of tax-related identity theft
- Describe the process for applying for an ITIN
- Select a taxpayer's filing status
- Recognize best practices for correct names and SSNs on tax returns
- Identify who is eligible to be claimed as a dependent

Tax-Related Identity Theft

Tax return preparers should be especially diligent in recognizing fraud and abuse, reporting it to the IRS, and preventing it when possible. Fraudulent returns are sometimes filed by individuals using someone else's name or SSN or by presenting fabricated or forged documents.

The IRS issued Publication 5199, Tax Preparer Guide to Identity Theft to inform practitioners of the potential warning signs of identity theft and provide resources to assist victims.

Verification of Taxpayer Identification Numbers

In order to safeguard taxpayer information and prevent fraud and abuse, it is critical that EROs and tax return preparers confirm identities and identification numbers of taxpayers, spouses and dependents listed on returns. Preparers should confirm Social Security Numbers (SSNs), Employer Identification Numbers (EINs), Adoption Taxpayer Identification Numbers (ATINs) and Individual Taxpayer Identification Numbers (ITINs).

To verify the identities, preparers should ask taxpayers to provide two forms of identification, with at least one being photo ID. Preparers should verify the taxpayer's name and current address against the identification supplied. Viewing Social Security cards and ITIN letters for everyone listed on the tax return also helps prevent filing returns with incorrect ID numbers.

Fraudulent Returns

Tax return preparers should be especially diligent in recognizing fraud and abuse, reporting it to the IRS, and preventing it when possible. Fraudulent returns are sometimes filed by individuals using someone else's name or SSN, or by presenting fabricated or forged documents.

The IRS has identified questionable Forms W-2 as a source of abuse. Tax preparers should be on the lookout for irregular or non-standard Forms W-2 that are suspicious or altered. It is also important to verify the identification number entered on Form W-2, Wage and Tax Statement. The identification number should match that of the respective taxpayer or spouse on the tax return.

Warning Signs of Tax-Related Identity Theft

In tax-related identity theft, thieves usually use stolen SSNs to file false tax returns to claim a fraudulent refund. These criminals generally try to file the fraudulent return early in the filing season. Taxpayers may be unaware that their identity has been compromised until attempting to file their return.

Warning signs of tax-related identity theft for individual clients include:

- A rejected return with IRS reject codes which indicate the taxpayer's SSN has already been used on a previously accepted return
- A taxpayer received unexpected IRS notices that do not correlate to tax returns filed.
- An IRS notice indicating a taxpayer received wages from an employer who is unknown to them.

Assisting Victims of Tax-Related Identity Theft

If a taxpayer's SSN has been compromised or it is suspected that he or she is a victim of tax-related identity theft, the following steps are recommended:

- File a report with local police
- File a complaint with the Federal Trade Commission (FTC) at www.identitytheft.gov or the FTC Identity Theft Hotline at 1-877-438-4338.
- Contact one or more of the three major credit bureaus to place a fraud alert on credit records
    - Equifax.com 1-800-525-6285
    - Experian.com 1-888-397-3742
    - TransUnion.com 1-800-680-7289
- Close any accounts opened fraudulently
- Respond immediately to any IRS notice by calling the number provided
- Complete IRS Form 14039, Identity Theft Affidavit, then mail or fax it according to the instructions
- Continue to file return and pay tax if needed; even if it is necessary to paper-file returns.

If a taxpayer has contacted the IRS but has no resolution, call the Identity Protection Specialized Unit at 1-800-908-4490.

NOTE: Preparers must have power of attorney on file before an IRS customer service representative can provide tax return preparers with any taxpayer information.

Remind taxpayers that the IRS does not initiate contact with individuals by email or text messages to request personal or financial information.

ITINs

An Individual Taxpayer Identification Number (ITIN) is a tax processing number issued by the IRS to taxpayers who do not have, or are not eligible for, a Social Security Number (SSN). ITINS help taxpayers comply with U.S. tax laws regardless of immigration status.

An ITIN is a nine-digit number which begins with the number 9 and has a range of 70-88, 90-92, and 94-99 in the fourth and fifth digits.

ITINs should be used for federal tax reporting and are not intended to be used for any other purpose. An ITIN does not authorize work in the U.S. or provide eligibility for Social Security Benefits.

ITIN Application

To apply for an ITIN, individuals should complete Form W-7, Application for IRS Individual Taxpayer Identification Number. Form W-7 can be attached and mailed along with the federal tax return to the IRS. Services of an IRS-authorized Form W-7 Acceptance Agent or some IRS Taxpayer Assistance Center can also be used to submit Form W-7.

ITINs are usually issued within seven weeks of the receipt of complete, qualified applications.

Filing with an ITIN

If a taxpayer files a return with an ITIN and reports wages, he or she is required to show the SSN under which the wages were earned. This scenario creates an ITIN/SSN mismatch when e-filing. Even though these returns have been rejected when sent via e-file in the past, the IRS system now accepts returns with as ITIN/SSN mismatch. The ITIN should only show at the top of Form 1040 as the identifying number.

If the primary taxpayer, spouse, or both have ITINS, they are not eligible for EIC even if the dependents have valid SSNs.

Form **W-7**
(Rev. August 2013)
Department of the Treasury
Internal Revenue Service

Application for IRS Individual Taxpayer Identification Number

▶ **For use by individuals who are not U.S. citizens or permanent residents.**
▶ **See instructions.**

OMB No. 1545-0074

FOR IRS USE ONLY

An IRS individual taxpayer identification number (ITIN) is for federal tax purposes only.

Before you begin:

• ***Do not submit*** *this form if you have, or are eligible to get, a U.S. social security number (SSN).*
• *Getting an ITIN does not change your immigration status or your right to work in the United States and does not make you eligible for the earned income credit.*

Reason you are submitting Form W-7. Read the instructions for the box you check. **Caution:** If you check box **b, c, d, e, f,** or **g, you must file a tax return with Form W-7 unless you meet one of the exceptions** (see instructions).

a ☐ Nonresident alien required to get ITIN to claim tax treaty benefit
b ☐ Nonresident alien filing a U.S. tax return
c ☐ U.S. resident alien **(based on days present in the United States)** filing a U.S. tax return
d ☐ Dependent of U.S. citizen/resident alien } Enter name and SSN/ITIN of U.S. citizen/resident alien (see instructions) ▶
e ☐ Spouse of U.S. citizen/resident alien
f ☐ Nonresident alien student, professor, or researcher filing a U.S. tax return or claiming an exception
g ☐ Dependent/spouse of a nonresident alien holding a U.S. visa
h ☐ Other (see instructions) ▶
Additional information for **a** and **f**: Enter treaty country ▶ and treaty article number ▶

Name (see instructions)
1a First name | Middle name | Last name

Name at birth if different ▶
1b First name | Middle name | Last name

Applicant's mailing address
2 Street address, apartment number, or rural route number. **If you have a P.O. box, see separate instructions.**
City or town, state or province, and country. Include ZIP code or postal code where appropriate.

Foreign (non-U.S.) address (if different from above) (see instructions)
3 Street address, apartment number, or rural route number. **Do not use a P.O. box number.**
City or town, state or province, and country. Include ZIP code or postal code where appropriate.

Birth information
4 Date of birth (month / day / year) | Country of birth | City and state or province (optional) | **5** ☐ Male ☐ Female

Other information
6a Country(ies) of citizenship | **6b** Foreign tax I.D. number (if any) | **6c** Type of U.S. visa (if any), number, and expiration date

6d Identification document(s) submitted (see instructions) ☐ Passport ☐ Driver's license/State I.D.
☐ USCIS documentation ☐ Other
Issued by: No.: Exp. date: / / Date of entry into the United States (MM/DD/YYYY) / /

6e Have you previously received a Internal Revenue Service Number (IRSN) or employer identification number (EIN)?
☐ **No/Do not know.** Skip line 6f.
☐ **Yes.** Complete line 6f. If more than one, list on a sheet and attach to this form (see instructions).

6f Enter: IRSN or EIN ▶ and
Name under which it was issued ▶

6g Name of college/university or company (see instructions)
City and state Length of stay

Sign Here

Under penalties of perjury, I (applicant/delegate/acceptance agent) declare that I have examined this application, including accompanying documentation and statements, and to the best of my knowledge and belief, it is true, correct, and complete. I authorize the IRS to disclose to my acceptance agent returns or return information necessary to resolve matters regarding the assignment of my IRS individual taxpayer identification number (ITIN), including any previously assigned taxpayer identifying number.

Signature of applicant (if delegate, see instructions) | Date (month / day / year) / / | Phone number

Keep a copy for your records.

Name of delegate, if applicable (type or print) | Delegate's relationship to applicant ▶ ☐ Parent ☐ Court-appointed guardian ☐ Power of Attorney

Acceptance Agent's Use ONLY

▶ Signature | Date (month / day / year) / / | Phone | Fax
▶ Name and title (type or print) | Name of company | EIN | PTIN | Office Code

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 10229L Form **W-7** (Rev. 8-2013)

Filing Requirements

Who Must File

Whether or not a U.S. citizen or resident alien is required to file a federal income tax return depends upon his or her gross income, filing status, age, and if the person a dependent of another.

NOTE: The filing requirements apply even if the taxpayer owes no tax. Taxpayers might have to pay a penalty if they are required to file a return but fail to do so. Taxpayer willfully failing to file a return could be subject to criminal prosecution.

Filing Requirements for Most Taxpayers

Generally, if a taxpayer's gross income is at least the amount shown on the table below for age and filing status, he or she is required to file a 2016 tax return.

2016 Filing Requirements for Most Taxpayers

Filing Status	Age	Gross Income
Single	under 65	$10,350
	65 or older	$11,900
Married Filing Jointly	under 65 (both spouses)	$20,700
	65 or older (one spouse)	$21,950
	65 or older (both spouses)	$23,200
Married Filing Separately	any age	$4,050
Head of Household	under 65	$13,350
	65 or older	$14,900
Qualifying Widow(er)	under 65	$16,650
	65 or older	$17,900

Some exceptions to the filing requirements listed above:

- If a taxpayer can be claimed as a dependent of another, the income threshold is generally less than the amounts shown on the above chart.
- Self-employed taxpayers must file a tax return (and pay SE tax) if net income is more than $400.
- Special rules apply for dependent children with investment income and taxpayers who are blind.
- Any member of the tax household enrolled in health coverage through the Health Insurance Marketplace and received advanced payments of the premium tax credit must file a return.

Example: George and Barbara are married and plan to file a joint return. George is 47 and had a gross income of $15,000 for the year. Barbara is 44 and her gross income was $2,500 for the year. Since their combined gross income is $17,500, they are not required to file a tax return.

Example: Bernard, age 36, is single with no dependents. His gross income for 2016 is $10,500. He must file a tax return because his gross income exceeds the threshold of $10,350 for the Single filing status.

Taxpayers Who Should File Even Though Not Required

Even if a taxpayer is not required to file, he or she can still file a tax return just to claim a refund. For example, taxpayers should file a tax return if one of the following applies:

- Income tax was withheld from pay
- Estimated tax payments were made for the year or taxpayers had any of their overpayment for last year applied to this year's estimated tax
- Taxpayer is eligible for the Earned Income Credit
- Taxpayer qualifies for the Additional Child Tax Credit
- Taxpayer qualifies for the Premium Tax Credit

Filing Status

Introduction to Filing Status

It is important the correct filing status is selected when filing individual tax returns. Several tax credits, deductions, and the amount of taxes paid are dependent upon the filing status selected. Sometimes more than one filing status might apply to a taxpayer, in which case the status with the greatest tax advantage should be selected.

There are five filing statuses:

1. Single
2. Married Filing Jointly
3. Married Filing Separately
4. Head of Household
5. Qualifying Widow(er) with Dependent Child

Marital Status

In general, a taxpayer's filing status depends upon marital status.

Taxpayers are considered married for the whole year, if, on the last day of the year, any one of the following is true:

1. Taxpayers are legally married and living together as a married couple
2. Taxpayers are living together in a common-law marriage recognized in the state of residence or the state where the common-law marriage began
3. Taxpayers are married and living apart, but not legally separated under a decree of divorce or separate maintenance
4. Taxpayers are separated under an interlocutory (not final) decree of divorce

For federal tax purposes, individuals of the same sex are considered married if they were lawfully married in a domestic or foreign jurisdiction which authorizes the marriage of two individuals of the same sex. The term "spouse" refers to a person whether of the opposite sex or same sex, who is legally married to the taxpayer.

If a spouse died during the tax year, the taxpayer is considered married for the whole year for filing status purposes.

Taxpayers are considered unmarried for the whole year if, on the last day of the tax year, they are unmarried or legally separated from their spouse under a divorce or separate maintenance decree.

State law governs whether a taxpayer is married or legally separated under a divorce or separate maintenance decree.

Divorced persons. If a taxpayer is divorced under a final decree by the last day of the year, he or she is considered unmarried for the whole year.

Annulled marriages. If the taxpayer obtains an annulment, which holds that no marriage ever existed, the taxpayer is considered unmarried. The taxpayer might be required to file amended returns claiming Single or Head of Household status for all years affected by the annulment not closed by the statute of limitations for filing a return.

Selecting a Filing Status

Single

A taxpayer must file as Single if considered unmarried and he or she does not qualify for any other filing status.

Married Filing Jointly

Taxpayers can file as Married Filing Jointly if considered married and the spouses agree to file a joint return.

Joint Responsibility

Both taxpayers can be held responsible, jointly and individually, for the tax and any interest or penalty due on their joint return. One spouse can be held responsible for all the tax due even if all the income was earned by the other spouse. Taxpayers who file a joint return must combine their income and deductions on the same return.

Both husband and wife:

- Must sign the return
- Are responsible for any tax owed on the return

Married Filing Separately

Taxpayers who are considered married can file as Married Filing Separately if desired or if the spouses cannot agree to file a joint return. If filing separately, each spouse reports his or her own income and deductions on separate returns even if one spouse had no income.

Head of Household

A taxpayer can file as Head of Household if he or she meets all the following requirements:

- Unmarried or considered unmarried on the last day of the year
- Paid more than half the cost of keeping up a home for the year
- A “qualifying person” lived in the taxpayer’s home for more than half the year (except for temporary absences, such as school). If, however, the “qualifying person” is a dependent parent, the qualifying person does not have to have lived with taxpayer.

Head of Household (continued)

Keeping up a home includes costs such as rent, mortgage interest, real estate taxes, insurance on the home, repairs, utilities, and food eaten in the home. It does not include such expenses as clothing, education, medical treatment, vacations, life insurance, or transportation. If the taxpayer used payments received under Temporary Assistance for Needy Families (TANF) or other public assistance programs to pay part of the cost of home upkeep, it is not considered to be money paid by the taxpayer.

Table 4 describes who is a qualifying person for Head of Household.

Table 4. **Who Is a Qualifying Person Qualifying You To File as Head of Household?**[1]

CAUTION *See the text of this publication 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*, later, **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*, later, **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 under *Exemptions for Dependents*, later. **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*, later. 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 under *Exemptions for Dependents*, later.

[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*.

[6] See *Special rule for parent*.

Qualifying Widow(er) with Dependent Child

A widow or widower with one or more dependent children might be able to use the Qualifying Widow(er) with Dependent Child filing status.

This filing status is available for only two years following the year of the spouse's death. If the taxpayer's spouse died during 2016, and the taxpayer does not remarry, the taxpayer might be able to claim this filing status for 2017 and 2018.

NOTE: This filing status entitles taxpayers to use joint return tax rates and the highest standard deduction amount (if deductions are not itemized). It does not entitle taxpayers to file a joint return.

Example: Anika is single and has two children under the age of 18. Both children lived with her all year and she provided all their support. Anika can file as Head of Household.

Example: Dan and Vera are married and lived together all year; however, Vera does not want to file a joint return with Dan. They must file as Married Filing Separately, since they cannot agree to file a joint return.

Example: Armando is divorced and has no children or other dependents. He lives alone and supports himself and pays all the expenses for his household. Armando must file as single because he does not qualify for any other filing status.

Example: Two men, Nate and Jeremiah, were legally married in March 2013 in a state that recognizes same-sex marriage. Since they agree to do so, Nate and Jeremiah, can file as Married Filing Jointly for the 2016 tax year.

Exemptions

Exemption Types

Exemptions reduce taxable income. Generally, a taxpayer can deduct $4,050 for each exemption claimed in 2016.

There are two types of exemptions a taxpayer can deduct:

- Personal exemptions for a taxpayer and spouse
- Exemptions for dependents (dependency exemptions)

While each is worth the same amount ($4,050 for 2016), different rules apply to each type.

Personal Exemptions

Taxpayers are generally allowed one personal exemption for themselves. If married, a taxpayer might be allowed one exemption for his or her spouse.

Taxpayers (or spouses) who can be claimed as dependents, cannot take an exemption for themselves, even if the other taxpayer does not actually claim them as a dependent.

A taxpayer can claim an exemption for his or her spouse in any of the following cases:

- Taxpayer and spouse were considered married on the last day of the year
- Spouse died during the tax year and the taxpayer did not remarry before the end of the year
- Taxpayer filing Married Filing Separately can claim an exemption for his or her spouse only if the spouse has no income for the year

Deceased Spouse

The following considerations apply when there is a deceased spouse:

- If a taxpayer's spouse died during the year and the taxpayer files a joint return with the deceased spouse, the taxpayer generally can claim the spouse's exemption. If filing as Married Filing Separately return for the year, the taxpayer might be able to claim his or her spouse's exemptions under the rule for filing a separate return.
- If a taxpayer remarried during the tax year, he or she cannot take an exemption for the deceased spouse.
- If the taxpayer is a surviving spouse without gross income and is remarried in the tax year the spouse died, the taxpayer can be claimed as an exemption on both the final Married Filing Separately return of the deceased spouse and the separate return of the new spouse for that year.
- If the taxpayer files a joint return with a new spouse, the taxpayer can be claimed as an exemption only on that return.

Claiming Dependents

A taxpayer can take one exemption for each person who can be claimed as a dependent. Dependents are either a **qualifying child** or a **qualifying relative** of the taxpayer**.**

Some examples of dependents include a child, stepchild, brother, sister, or parent. A taxpayer can claim one exemption for each qualified dependent, which may reduce the taxable income. If a taxpayer can claim another person – even if the taxpayer does not actually do so – the dependent cannot take a personal exemption on his or her tax return.

The taxpayer's spouse cannot be claimed as a dependent, but can be claimed as a personal exemption.

Dependency Exemption Tests

For a taxpayer to qualify to take a dependency exemption, the following tests must be met:

- Dependent Taxpayer Test – If the taxpayer can be claimed as a dependent by another person, then the taxpayer can claim no dependents on his or her return.
- Joint Return Test – A taxpayer generally cannot claim a married person as a dependent if filing a joint return; however, a taxpayer can claim an exemption for a person who files a joint return if that person and his or her spouse file the joint return only to claim a refund of income tax withheld or estimated tax paid.
- Citizen or Resident Test – A taxpayer 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. Certain exceptions are allowed. For more information, see Publication 501.

Qualifying Child Tests

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

- Relationship
- Age
- Residency
- Support
- Joint return

Relationship Test

To meet this test, a child must be the taxpayer's:

- Son, daughter, foster child, stepchild, or a descendant of any of them
- Brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendent of any of them

Adopted Child

An adopted child is always treated as the taxpayer's own child. The term "adopted child" includes a child who was lawfully placed with the taxpayer for legal adoption.

Foster Child

A foster child is an individual placed with the taxpayer 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 the age of 19 at the end of the tax year and be younger than taxpayer (or spouse if filing jointly)
- A student under the age of 24 at the end of the tax year and be younger than the taxpayer (or spouse if filing jointly)
- Permanently and totally disabled at any time during the year, regardless of age

Residency Test

To meet this test, the child must have lived with the taxpayer for more than half the year. There are some exceptions for temporary absences, children who were born or died during the year, kidnapped children, and children of divorced or separated parents. See Publication 501 for more details.

A child is considered to have lived with the taxpayer during periods of time when either the taxpayer or dependent are temporarily absent due to special circumstances such as:

- Illness
- Education
- Business
- Vacation
- Military Service

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 non-custodial parent if certain requirements are met. Rules for this test are complicated. See Publication 504 Divorced or Separated Individuals, for more information or examples.

Special Circumstances

Death or Birth of Child

A child who was born or died during the year is treated as having lived with the taxpayers all year if the taxpayer's home was the child's home the entire time he or she was alive during the year.

Child Born Alive

A taxpayer can claim an exemption for a child 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 the taxpayer's qualifying child or qualifying relative, and all the other tests to claim an exemption for a dependent must be met.

Stillborn Child

A taxpayer cannot claim an exemption for a stillborn child.

Kidnapped Child

A taxpayer might be able to treat his or her child as meeting the residency test even if the child has been kidnapped. See Publication 501 for details.

Children of Divorced or Separated Parents or 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 non-custodial parent if certain requirements are met. Rules for this test are complicated. See Publication 504, Divorced or Separated Individuals for more information.

Special Circumstances (continued)

Custodial Parent and Non-custodial 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.

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

- At that parent's home, even if the parent is not present
- In the company of the parent, when the child does not sleep at a parent's home

If the child lived with both parents for an equal number of nights, the parent with the higher AGI is considered the custodial parent.

Support Test

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

Joint Return Test

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

Example: Peggy supported her 18 year-old daughter, who lived with her all year while her husband (Peggy's son-in-law) was in the armed forces. The daughter and son-in-law file a joint return. Even though Peggy's daughter is her qualifying child, Peggy 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.

Special Rules for Qualifying Children of More Than One Person

Sometimes, a child meets the relationship, age, residency, support, and joint return tests to be a qualifying child of more than one person. Although the child meets the conditions to be 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, the taxpayer 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):

- Exemption for the child
- Child Tax Credit
- Head of Household filing status
- Credit for child and dependent care expenses
- Exclusion from income for dependent care benefits
- Earned Income Credit

The other person cannot take any of these benefits based on this qualifying child. In other words, both the taxpayer and other person cannot agree to divide these tax benefits between them. 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 claims 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 Publication 504, Divorced or Separated Individuals for more information.

Example: Heidi and her three-year-old daughter, Helene, lived with Heidi's mother all year. Heidi is 25 years old, unmarried, and her AGI is $9,000. Her mother's AGI is $15,000. Helene's father did not live with Heidi or her daughter.

Helene is a qualifying child of both Heidi and her mother because she meets the relationship, age, residency, support, and joint return tests for both; however, only Heidi or her mother can claim Helene. Helene is not a qualifying child of anyone else, including her father.

<u>Qualifying Relative Tests</u>

There are four tests that must be met for a person to be the qualifying relative of the taxpayer(s).

- Not a Qualifying Child Test
- Member of Household or Relationship Test
- Gross Income Test
- Support Test

NOTE: There is no age test for a qualifying relative.

Not a Qualifying Child Test

To meet this test, the relative cannot be the qualifying child of the taxpayer or anyone else.

Member of Household or Relationship Test

To meet this test, the relative must either:

- Live with the taxpayer all year as a member of the household
- Be related to the taxpayer in one of the following ways:
    - Child, stepchild, foster child or descendent of any of them
    - Brother, sister, half-brother, half-sister, stepbrother, or stepsister
    - Father, mother, grandparent, or other direct ancestor, but not a foster parent
    - Stepfather or stepmother
    - Son or daughter of brother, sister, half-brother, or half-sister
    - Brother or sister of mother or father
    - Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

Gross Income Test

To meet this test, the relative's gross income for the year must be less than $4,050.

Support Test

To meet this test, the taxpayer must generally provide more than half of the relative's total support during the year.

To determine if support test is met, figure whether the taxpayer provided more than half of a person's total support by comparing the amount he or she 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.

Total Support

To figure if the taxpayer provided more than half of a person's support, 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 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.

Use Worksheet 3-1 in figuring whether the taxpayer provided more than half of a person's support. Detailed information about each component of the support calculation can be found in Publication 17.

Worksheet 3-1. **Worksheet for Determining Support** *Keep for Your Records*

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. Do not include funds provided by the state; include those amounts on line 23 instead	**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):		
a. Enter the total rent paid	**6a.**	______
b. Enter the fair rental value of the home. If the person you supported owned the home, also include this amount in line 21	**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, the support test for children of divorced or separated parents, or the special rule for kidnapped children. See *Multiple Support Agreement* or *Support Test for Children of Divorced or Separated Parents (or Parents Who Live Apart)*, or *Kidnapped child* under *Qualifying Relative*.

Death or Birth of Qualifying Relative

If a person died during the year, but lived with the taxpayer as a member of the household until death, that person meets the Residency test. The same is true for a child who was born during the year and lived with the taxpayer as a member of the household for the rest of the year. The test is also met if a child lived with the taxpayer as a member of the household except for any required hospital stay following birth.

If the dependent died during the year and the taxpayer otherwise qualifies to claim an exemption for the dependent, the taxpayer can still claim the exemption.

Example: Richard and Adele, a married couple, have a five-year-old daughter, Misty. Their three-year-old niece, Monica, came to live with them in February and continued to live with them for the remainder of the year. Richard and Adele provide 100% of the support for their niece. They can claim both Misty and Monica as dependents on their tax return because both children meet all the tests for qualifying children.

Example: Christina's elderly mother lives alone but has no income. Christina provides 100% of the support of her mother during the year and pays all her expenses. Christina can claim a dependency exemption for her mother on her tax return because she meets all the tests to be a qualifying relative.

Example: John and Christy's 17-year-old son Lukas bought a car for himself for $3,500 using money he earned at a part-time job. John and Christy provided the rest of Lukas' support for the tax year which totaled $3,000. The fair market value of his car, which is $3,500, must be considered when determining Lukas' total support. The total support for the year is $6,500 ($3,500 + $3,000). Since half of Lukas' total support is $3,250 ($6,500 ÷ 2), John and Christy did not provide more than half if Lukas' total support. John and Christy cannot claim an exemption for their son.

Skill Check Domain 2, Part 1

1. A tax return preparer should be on the lookout for questionable, irregular, or non-standard tax forms. The IRS has specifically identified which of the following?

A. Form W-4
B. Form W-7
C. Form W-2
D. Form 1095-A

2. If a taxpayer suspects he or she is a victim of tax-related identity theft, he or she should do which of the following?

A. Not file a tax return
B. Move out of the country
C. Nothing
D. File a complaint with the Federal Trade Commission (FTC)

3. Which one of the following would be considered a best practice to safeguard taxpayer information and prevent fraud and abuse?

A. Require taxpayers to complete a fingerprint card
B. Require taxpayers to provide two forms of photo identification
C. Ask taxpayer to complete simple arithmetic problems to verify he or she is human
D. Use taxpayer's last paycheck stub instead of Form W-2 to complete the tax return

4. ITINs can be used for which of the following?

A. Provide an identifying number for filing a federal tax return
B. Authorize individuals for work in the U.S.
C. Qualify individuals for Social Security Benefits
D. Provide proof of U.S. citizenship

5. Which of the following taxpayers are considered unmarried for federal tax purposes for the 2016 tax year?

A. Hank and Marie were married in 1995. In August 2016, the couple experienced some marital problems and Hank moved out of their home.

B. Kenny and Renee were legally married in October 2016; however, they obtained an annulment in December 2016.

C. Ellen and Ann, two women, were married in Georgia in December 2016.

D. Lexie's husband of two years passed away on February 1, 2016. During 2016, Lexie did not remarry.

6. Carlos and Lupita are married, file a joint return, and have four children. Based on the information below, how many exemptions can they claim on their 2016 tax return?

Carlos and Lupita's children:

- Ana, age 4, lives in the home and attends preschool.
- Diego, age 12, lives in the home and attends middle school.
- Marian, age 19, lives in the home and has a job at the local pizza parlor. She earned $16,000 in 2016. She pays for all her expenses and pays rent of $350 per month to her parents. Marian is not a student.
- Alex, age 22, is a full-time student at the local university, lives in the home, and has a summer job. In 2016, he earned $1,500.

A. 6
B. 5
C. 4
D. 2

7. What is the minimum amount of a person's support a taxpayer must provide in order to claim that person as a qualifying relative for dependency purposes?

A. 0%
B. 25%
C. 51%
D. 100%

8. If filing a joint return for the year, both spouses must_________.

   A. Have earned income
   B. Sign the tax return
   C. Keep up the cost of the home
   D. Have dependents

9. The gross income for the year must be less than which of the following to meet the gross income test for a qualifying relative?

   A. $4,050
   B. $3,000
   C. $11,000
   D. $6,500

Skill Check Domain 2, Part 1 – Answer Key

1. A tax return preparer should be on the lookout for questionable, irregular, or non-standard tax forms. The IRS has specifically identified which of the following?

A. Form W-4
Incorrect. Form W-4 is the Employee's Withholding Allowance Certificate and has not been identified as a source of abuse causing identity theft.
B. Form W-7
Incorrect. Form W-7 is the Application for IRS individual Taxpayer Identification Number and has not been identified as a source of abuse causing identity theft.
C. Form W-2
Correct! Form W-2, Wage and Tax Statement has been identified by the IRS as a source of abuse. Tax preparers should be on the lookout for irregularities on Form W-2.
D. Form 1095-A
Incorrect. Form 1095-A, Health Insurance Marketplace Statement, has not been identified as a source of abuse causing identity theft.

2. If a taxpayer suspects he or she is a victim of tax-related identity theft, he or she should do which of the following?

A. Not file a tax return
Incorrect. Taxpayers should continue to file and pay any tax due even if they are a victim of identity theft.
B. Move out of the country
Incorrect. It is not necessary for taxpayers to move outside the country if they become a victim of tax-related identity theft.
C. Nothing
Incorrect. A taxpayer should take immediate action if he or she becomes the victim of tax-related identity theft.
D. File a complaint with the Federal Trade Commission (FTC)
Correct! Taxpayers should file a complaint with the FTC immediately upon becoming aware of any tax-related identity theft.

3. Which one of the following would be considered a best practice to safeguard taxpayer information and prevent fraud and abuse?

A. Require taxpayers to complete a fingerprint card
Incorrect. Collecting fingerprints is not considered a best practice.
B. Require taxpayers to provide two forms of photo identification
Correct. Verifying identities of taxpayers is an important step in preventing fraud.
C. Ask taxpayer to complete simple arithmetic problems to verify he or she is human
Incorrect. This method is usually used on websites to protect against bots.
D. Use taxpayer's last paycheck stub instead of Form W-2 to complete the tax return
Incorrect. The taxpayer's last paycheck stub should not be used in lieu of Form W-2.

4. ITINs can be used for which of the following?

A. Provide an identifying number for filing a federal tax return
Correct! ITINS are tax processing numbers used to help taxpayers comply with U.S. tax laws
B. Authorize individuals for work in the U.S.
Incorrect. An ITIN cannot be used to authorize eligibility for work in the U.S.
C. Qualify individuals for Social Security Benefits
Incorrect. ITINs cannot provide eligibility for Social Security Benefits
D. Provide proof of U.S. citizenship
Incorrect. ITINs should be used for federal tax reporting and not intended to be used for any other purpose.

5. Which of the following taxpayers are considered unmarried for federal tax purposes for the 2016 tax year?

A. Hank and Marie were married in 1995. In August 2016, the couple experienced some marital problems and Hank moved out of their home.
   Incorrect. Hank and Marie are considered married even if living apart unless legally separated.
B. Kenny and Renee were legally married in October 2016; however, they obtained an annulment in December 2016.
   Correct. If a marriage is annulled, it is as if no marriage existed and the taxpayers are considered unmarried.
C. Ellen and Ann, two women, were married in Georgia in December 2016.
   Incorrect. Individuals of the same sex are considered married if lawfully married in a jurisdiction that recognizes same-sex marriage
D. Lexie's husband of two years passed away on February 1, 2016. During 2016, Lexie did not remarry.
   Incorrect. If a spouse passes away during the tax year, the taxpayer is considered married for the full calendar year.

6. Carlos and Lupita are married, file a joint return, and have four children. Based on the information below, how many exemptions can they claim on their 2016 tax return?

Carlos and Lupita's children:

- Ana, age 4, lives in the home and attends preschool.
- Diego, age 12, lives in the home and attends middle school.
- Marian, age 19, lives in the home and has a job at the local pizza parlor. She earned $16,000 in 2016. She pays for all her expenses and pays rent of $350 per month to her parents. Marian is not a student.
- Alex, age 22, is a full-time student at the local university, lives in the home, and has a summer job. In 2016, he earned $1,500.

A. 6
   Incorrect. While Carlos and Lupita can claim an exempt for themselves, they cannot claim a dependency exemption for all four children.
B. 5
   Correct. Carlos and Lupita can claim an exemption for themselves and for Ana, Diego, and Alex. They cannot claim a dependency exemption for Marian because she is over 18 and not a student. Marian also provided more than 50% of her own support during the year and her gross income is more than $4,050.
C. 4
   Incorrect. Carlos and Lupita can claim an exemption for themselves but they can claim more than 4 exemptions.
D. 2
   Incorrect. Carlos and Lupita can claim more than two exemptions on their 2016 tax return.

7. What is the minimum amount of a person's support a taxpayer must provide in order to claim that person as a qualifying relative for dependency purposes?

A. 0%
Incorrect. Support is a factor in determining if a person is a qualifying relative.
B. 25%
Incorrect. The taxpayer must provide more than 25% of a person's support to claim that person as a dependent.
C. 51%
Correct. The taxpayer must provide more than half of a person's support to claim that person as a dependent.

D. 100%
Incorrect. 100% is not the minimum amount of support necessary to claim a qualifying relative.

8. If filing a joint return for the year, both spouses must_________.

A. Have earned income
Incorrect. It is not required that both spouses have earned income to file a joint return.
B. Sign the tax return
Correct. If taxpayers choose to file a joint return, both spouses must sign the return.
C. Keep up the cost of the home
Incorrect. Both spouses keeping up the cost of a home is not a requirement to file as Married Filing Jointly.
D. Have dependents
Incorrect. To file as Married Filing Jointly, taxpayers are not required to claim dependents.

9. The gross income for the year must be less than which of the following to meet the gross income test for a qualifying relative?

A. $4,050
Correct. To meet the gross income test, the qualifying relative must have gross income less than $4,050.
B. $3,000
Incorrect. The gross income test allows more than $3,000 in gross income during the year.
C. $11,000
Incorrect. The gross income allowed for a qualifying relative is much less than $11,000.
D. $6,500
Incorrect. The gross income allowed for a qualifying relative is much less than $6,500.

Domain 2, Part 2 – General Review of Income

Domain 2 of this course provides a general review of the individual tax return. Part 2 provides a review of income information.

Sections in Part 2 of Domain 2 include:

Domain 2, Part 2: Objectives
Income Overview
Employee Compensation
Tip Income
Interest Income
Dividend Income
Taxable Refunds
Self-Employment Income
Social Security Benefits
Retirement Income
Capital Gains and Losses
Other Income
Skill Check

Domain 2, Part 2 Objectives

Domain 2 of the Annual Federal Tax Refresher (AFTR) Course reviews important concepts and guidelines in preparing individual tax returns.

After completing Domain 2 Part 2, participants should be able to:

- Recognize types of taxable income
- Identify forms used to report income
- Explain self-employment income and allowable deductions on Schedule C
- Determine when Social Security benefits should be taxable
- Distinguish when retirement distributions might be taxable

Income Overview

A tax return preparer must be able to determine all sources of taxable and non-taxable income. This includes items such as wages, salaries, interest, business income, dividends, Social Security benefits, and pension distributions. Income is considered to be either taxable or nontaxable depending on the source of income.

For tax purposes it is important to differentiate between the various terms used to refer to income. Basic definitions of income include:

- **Gross Income:** All income in the form of money, property, and services not exempt from tax.
- **Earned Income**: Salaries, wages, tips, professional fees, and other amounts received as pay for work the taxpayer performs.
- **Investment Income**: Generally, all income other than salaries, wages, and other amounts received as pay for work actually done. Investment income includes taxable interest, dividends, capital gains, unemployment compensation, the taxable part of Social Security and pension payments, and certain distributions from trusts.

Examples of Taxable and Non-taxable Income

Taxable income includes:

- Wages, salaries, bonuses, and commissions
- Partnership income
- Alimony
- IRA distributions
- Awards
- Military pay
- Interest
- Severance pay
- Hobby income
- Pensions
- Gambling winnings
- Unemployment compensation
- Dividends
- Tips and gratuities
- Rewards

Non-taxable income includes:

- Child support
- Dividends on life insurance
- Federal tax refunds
- Temporary Assistance for Needy Families (TANF)
- Veterans' benefits
- Welfare payments
- Rental allowance of clergy
- Worker's compensation

Employee Compensation

Form W-2

Pay an employee received as wages, salaries, tips, and other earnings is considered taxable income. All employed taxpayers should receive Form W-2 from their employer showing the pay received for their services.

Pay is included on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ, even if the taxpayer doesn't receive a Form W-2, it should be included in gross income. If services are performed, not as an independent contractor, and the employer did not withhold Social Security and Medicare taxes from the pay, file Form 8919, Uncollected Social Security and Medicare Tax on Wages, with the Form 1040. These wages must be included on line 7 of Form 1040. See Form 8919 for more information.

Advance Commissions and Other Earnings

Cash-method taxpayers who receive advance commissions of other amounts received for services to be performed in the future must be included in income for the year received. Accrual-method taxpayers do not have to report income in the year it was received.

If unearned commissions or other amounts are repaid in the same year received, reduce the amount included in income by the repayment. If repaid in a later tax year, the repayment can be deducted as an itemized deduction on Schedule A (Form 1040), or the taxpayer may be able to take a credit for the repayment.

Bonuses and Awards

Bonuses or awards received for outstanding work are included in income and should be shown on Form W-2. Bonuses and awards include prizes such as vacation trips for meeting sales goals. If the prize or award received is goods or services, include the fair market value of the goods or services in income. Bonuses or awards are not taxable until received or made available to the taxpayer.

Employee Achievement Award

If the taxpayer received tangible personal property (other than cash, a gift certificate, or an equivalent item) as an award for length of service or safety achievement, its value can generally be excluded from income; however, the amount excluded is limited to the employer's cost and cannot be more than $1,600 ($400 for awards that are not qualified plan awards) for all such awards received during the year.

The exclusion does not apply to the following awards:

- A length-of-service award if received for less than five years of service or if the taxpayer received another length-of-service award during the year or the previous four years
- A safety achievement award if the taxpayer is 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

Severance and Leave Payments

Severance Pay

Include in income amounts received as severance pay and any payment for the cancellation of an employment contract.

Accrued Leave Payment

Federal employees who receive a lump-sum payment for accrued annual leave when he or she retires or resigns must include this amount as wages on Form W-2.

If the taxpayer resigns from one agency and is reemployed by another agency, the lump-sum annual leave payment may have to be partially repaid to the second agency. Reduce gross wages by the amount repaid in the same tax year the taxpayer received the payment. Attach to the tax return a copy of the receipt or statement given by the agency repaid to explain the difference between the wages on the return and the wages on Form W-2.

Sick Pay

Pay received from employers while sick or injured is part of salary or wages. In addition, include in income sick-pay benefits received from any of the following payers:

- A welfare fund
- A state sickness or disability fund
- An association of employers or employees
- An insurance company, if employer paid for the plan

NOTE: If the taxpayer paid premiums on an accident or health insurance policy, the benefits received under the policy are not taxable.

Military Pay

Payments received 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.

Differential Wage Payments

Any payments made by an employer during the time a taxpayer is performing service in the uniformed services are treated as compensation. These wages are subject to income tax withholding and are reported on a Form W-2.

Military Retirement Pay

If the retirement pay is based on age or length of service, it is taxable and must be included in income as a pension on lines 16a and 16b of Form 1040. Do not include in income the amount of any reduction in retirement or retainer pay to provide a survivor annuity for a spouse or children under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan.

Veterans' Benefits

Do not include in income any veterans' benefits paid under any law, regulation, or administrative practice administered by the Department of Veterans Affairs (VA).

Tip Income

All tips received are income and are subject to federal income tax. Include in gross income all tips received directly, charged tips paid by the employer, and the share of any tips received under a tip-splitting or tip-pooling arrangement. The value of noncash tips, such as tickets, passes, or other items of value, is also income and subject to tax.

Tip Recordkeeping

Taxpayers who receive tips should keep a daily record. If using an electronic system provided by the employer to record daily tips, taxpayers should get a paper copy of this record.

Recording tips ensures the taxpayer can accurately report tips to the employer, accurately report tips on his or her tax return, and prove the tip income if the return is ever questioned.

The taxpayer should use the record to track the following on a daily basis:

- Cash tips from customers or from other employees
- Tips from credit and debit cards paid to the taxpayer by the employer
- The value of any noncash tips received, such as tickets, passes, or other items of value
- The amount of tips paid out to other employees through tip pools, tip splitting, or other arrangements, and the names of the employees to whom the tips were paid

Tips Reported to Employer

Taxpayers can use Form 4070 to report tips if the employer doesn't provide a different method of reporting. Tip reports must be submitted to employers by the 10th of the next month (or the next day that is not a Saturday, Sunday, or legal holiday).

Taxpayers should follow these guidelines for reporting tips to employers:

- Report only cash, check, debit card, and credit card tips received
- For tip-splitting or tip-pooling arrangements, report only the tips received and retained
- All tips received from other employees must be reported
- It's not necessary to report the value of any noncash tips, tickets, or passes to the employer
- If the total tips for any one month from any one job are less than $20, the tips do not need to be reported

Taxpayers who do not report tips are subject to a penalty equal to 50% of the Social Security and Medicare taxes or railroad retirement tax owed on the unreported tips. The penalty amount is in addition to taxes owed.

If the taxpayer's regular pay is not enough for the employer to withhold all the taxes owed on the pay or the reported tips, taxpayers have until the close of the calendar year to pay the rest of the taxes.

Tips on Tax Return

Tips are reported as wages on Form 1040, line 7; Form 1040A, line 7; or Form 1040EZ, line 1.

All tips received during the year must be reported on the tax return, including both cash tips and noncash tips. Tips reported to the employer by the taxpayer for the tax year are included in the wages shown in box 1 of Form W-2. Add to the amount in box 1 any tips not reported to the employer.

If the employer could not collect all the Social Security and Medicare taxes or railroad retirement tax owed on tips reported for the year, the uncollected taxes are shown in box 12 of Form W-2 (codes A and B). These amounts must be reported as other tax on the return.

To report these uncollected taxes, file a return even if the taxpayer would not have to otherwise file. Include the taxes in the total tax amount on Form 1040, line 60, and write "UT" and the total of the uncollected taxes in the space next to line 60. A Form 1040EZ or Form 1040A cannot be filed in this case.

Allocated Tips

Allocated tips are shown separately in box 8 of Form W-2. These tips are not included in box 1 with wages and reported tips.

All allocated tips must be reported on the tax return, including both cash and non-cash tips. Any tips the taxpayer reported to the employer are included in box 1 of the W-2. Any unreported tips, plus allocated tips from box 8, must be added to wages on Form 1040, line 7.

No income, Social Security, or Medicare taxes are withheld on allocated tips. Complete Form 4137 and include the allocated tips on line 1 of the form.

Example: Jerry began working at the Diamond Restaurant on June 30 and received $10,000 in wages during the year. Jerry 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.

Jerry's Form W-2 from Diamond Restaurant shows $17,000 ($10,000 wages plus $7,000 reported tips) in box 1. Add the $18 of unreported tips to that amount and report $17,018 as wages on his tax return.

Interest Income

In general, interest received or credited to an account is taxable; however there are some exceptions. In addition to keeping any forms showing the amount of interest income received, taxpayers should keep a record of all sources of interest and amounts received during the year.

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, 28% of the amount paid.

Reporting Interest

Interest income is generally reported on Form 1099-INT or a similar statement by banks, savings and loans, and other payers of interest. This form shows the amount of interest received during the year. If backup withholding is deducted from interest, Form 1099-INT shows the amount withheld as "Federal income tax withheld."

All taxable interest income must be reported, even if the taxpayer didn't receive Form 1099-INT.

Reportable interest income also may be shown on Form 1099-OID, Original Issue Discount.

If a taxpayer received any tax-exempt interest such as from municipal bonds, it should be reported on line 8b on Form 1040.

General Rules for Interest

Individual Retirement Arrangements (IRAs)

Interest on a Roth IRA generally is not taxable. Interest on a traditional IRA is tax deferred and generally not included in income until withdrawals are made from the IRA.

Beneficiary of an Estate or Trust

Interest received as a beneficiary of an estate or trust is generally taxable income. The taxpayer should receive Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc., from the fiduciary.

Exempt Interest Dividends

Exempt-interest dividends received from a mutual fund or other regulated investment company are not included in taxable income. Basis is not reduced for distributions that are exempt-interest dividends. Exempt-interest dividends are shown in box 8 of Form 1099-DIV.

Although exempt-interest dividends are not taxable, these dividends must be reported if the taxpayer is required to file a tax return. This is an information-reporting requirement and does not change the exempt-interest dividends into taxable income.

Interest on VA Dividends

Interest on insurance dividends left on deposit with the VA is not taxable. This includes interest paid on dividends on converted United States Government Life Insurance and on National Service Life Insurance policies.

Taxable Interest

Taxable interest includes interest received from bank accounts, loans made to others, and other sources.

Dividends That Are Actually Interest

Certain distributions commonly called dividends are actually interest. 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
- Mutual savings banks

Money Market Funds

Money market funds pay dividends and are offered by nonbank financial institutions, such as mutual funds and stock brokerage houses. Generally, amounts received from money market funds should be reported as dividends, not as interest.

Gift for Opening an Account

Report as interest the value of non-cash gifts or services received for making deposits or for opening an account in a savings institution.

For deposits of less than $5,000, gifts or services valued at more than $10 must be reported as interest. For deposits of $5,000 or more, gifts or services valued at more than $20 must be reported as interest. The value is determined by the cost to the financial institution.

Example: Irene and her husband Greg each open a savings account. Irene deposits $2500 and receives a pen valued at $15. Greg deposits $5200 and receives a pen and leather bound notebook valued at $35. Both Irene and Greg must report the value of the gifts as interest.

Certificates of Deposit (Deferred Interest Accounts)

Interest is usually paid at fixed intervals of one year or less during the term of the account. Include this interest in income when it's received or when the interest is entitled to be received without receiving a substantial penalty. The same is true for accounts that mature in one year or less and pay interest in a single payment at maturity. If interest is deferred for more than one year, see "Original Issue Discount (OID)," later in this course.

- If penalized for early withdrawal, report the total amount of interest paid or credited to the account during the year, without subtracting the penalty.
- If money is borrowed to invest in a certificate of deposit, still report the total interest earned on the certificate in income. Taxpayers who itemize can deduct the interest paid as investment interest, up to the amount of the net investment income.

Example: Pilar deposited $3,000 with a bank and borrowed $2,000 from the bank so she could purchase a $5000 certificate of deposit. The certificate earned $325 at maturity in 2014, but Pilar received only $214, which represented the $325 she earned minus $111 interest charged on the $2,000 loan. Pilar received a 1099-INT from the bank showing the $325 earned for the certificate of deposit and another statement showing the $111 paid in interest for the loan. Pilar must include $325 in income, and can deduct the $111 if she itemizes on her return.

Other Sources of Interest

Interest on Tax Refunds

Interest received on tax refunds is taxable income.

Interest on Condemnation Award

If the condemning authority pays interest to compensate for a delay in payment of 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 it's received. If little or no interest is provided in a deferred payment contract, part of each payment might be treated as interest.

Interest on Annuity Contracts

Accumulated interest on annuity contracts sold before maturity 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.

U.S Savings Bonds

If the taxpayer is using the accrual method of accounting, interest from U.S. savings bonds must be reported each year as it accrues. Taxpayers cannot postpone reporting interest until it's received or until the bonds mature. If using the cash method of accounting (as most individual taxpayers do), U.S. savings bond interest is generally reported when it's received.

Series HH Bonds

Series HH Bonds were issued at face value. Interest is paid twice a year by direct deposit to the taxpayer's bank account. If using the cash method, report interest on these bonds as income on the taxpayer's return the year it was received.

These bonds were first offered in 1980 and last offered in August 2004. Before 1980, series H bonds were issued. Series H bonds are treated the same as series HH bonds.

Series H bonds have a maturity period of 30 years. Series HH bonds mature in 20 years. The last series H bonds matured in 2009.

Series EE and Series I Bonds

Interest on series EE and series I bonds is payable when the bonds are redeemed. The difference between the purchase price and the redemption value is taxable interest.

Series I Bonds

Series I bonds were first offered in 1998. These inflation-indexed bonds are issued at their face amount with a maturity period of 30 years. The face value plus all accrued interest is payable at maturity.

Series EE bonds

Series EE bonds were first offered in January 1980 and 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.
- Paper series EE and series E bonds are issued at a discount. The face value is payable at maturity.
- Electronic series EE bonds are issued at their face value. The face value plus accrued interest is payable at maturity.

Owners of paper series EE bonds can convert them to electronic bonds. These converted bonds do not retain the denomination listed on the paper certificate but are posted at their purchase price (with accrued interest).

Taxpayers using the cash method of reporting income should report the interest on series EE, series E, and series I bonds using one of the following two methods:

Method 1 - Postpone reporting the interest until the year the bond is cashed or disposed of or the year of maturity, whichever is earlier.

NOTE: Series EE bonds issued in 1983 matured in 2013. If method 1 has been used, the taxpayer generally must report the interest on these bonds on the 2013 return. The last series E bonds were issued in 1980 and matured in 2010. If using method 1, generally the interest should have been reported on the 2010 return.

Method 2 - Choose to report the increase in redemption value as interest each year.

Choose the same reporting method for all series EE, series E, and series I bonds being reported for the taxpayer. If method 2 is not chosen, method 1 must be used.

Example: Serena owns a $500 U.S. Series EE Savings Bond. She paid $250 for the bond. When the bond matures, Serena will receive $500. At the end of the first year, the bond is worth $265.

Serena can report interest income in one of two ways. She can:

- Report $250 of interest income only once when the bond matures

  This is the difference between the $500 value at maturity and the $250 she paid for the bond

- Report $15 of interest income at the end of the first year

  This is the increase in value at the end of the year ($265 minus $250); Serena would report interest income each year until maturity.

__Changing Reporting Options (Series EE and Series I)__

Change from Method 1

If changing the method of reporting the interest from method 1 to method 2, it is not necessary to get permission from the IRS. In the year of change, report all interest accrued to date and not previously reported for all the bonds.

Once the method has changed to where the interest is reported each year, all series EE, series E, and series I bonds must be reported this way on all future returns, unless permission is granted to change (explained next).

Change from Method 2

To change from Method 2 to Method 1, permission must be granted by the IRS. Permission is requested by either filing Form 3115, Application for Change in Accounting Method, or by submitting a statement to the IRS.

Submitted statements, must include the following criteria:

- "131" typed or printed at the top of the page
- Taxpayer's name and SSN located under the "131"
- The year of change (both the beginning and ending dates)
- The identification of savings bonds for which the change is being requested

The taxpayer must also agree 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.

The statement must be attached to the tax return for the year of change, and the return must be filed by the due date (including extensions). If necessary, an amended return can be filed.

Bonds with Co-Owners

If a U.S. savings bond is issued in the names of co-owners, such as the taxpayer, the child, or the taxpayer and spouse, interest on the bond is generally taxable to the co-owner who bought the bond.

If funds of one taxpayer are used to purchase the bond, taxes must be paid on the interest. This is true even if the taxpayer let the other co-owner redeem the bond and keep all the proceeds. Under these circumstances, the co-owner who redeemed the bond will receive a Form 1099-INT at the time of redemption and must provide the other co-owner with another Form 1099-INT showing the amount of interest from the bond taxable to them.

If each co-owner contributes part of the bond's purchase price, the interest is generally taxable to each co-owner, in proportion to the amount each paid.

If the taxpayer and spouse live in a community property state and hold bonds as community property, one-half of the interest is considered received by each of them. If filing separate returns, each taxpayer generally must report one-half of the bond interest.

If the taxpayer bought series E, series EE, or series I bonds entirely with his or her own funds and had them reissued in a co-owner's name or beneficiary's name alone, include in gross income for the year of reissue all interest earned on these bonds not previously reported. But, if the bonds were reissued in the taxpayer's name alone, the interest accrued does not have to be reported at that time. This same rule applies when bonds (other than bonds held as community property) are transferred between spouses or incident to divorce.

If the co-owners contributed funds to buy series E, series EE, or series I bonds jointly and later had the bonds reissued in one co-owner's name alone, taxpayers must include in gross income for the year of reissue the share earned on the bonds not previously reported.

The former co-owner does not have to include in gross income at the time of reissue 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 a former co-owner and a new co-owner. In this scenario, the new co-owner reports his or her share of the interest earned after the transfer. If bonds that a taxpayer and a co-owner bought jointly are reissued to each separately in the same proportion as his or her contribution to the purchase price, neither co-owner has to report at that time the interest earned before the bonds were reissued.

Bonds Transferred to a Trust

Taxpayers who own series E, series EE, or series I bonds and transfer them to a trust, giving up all rights of ownership, must include in income for that year the interest earned to the date of transfer if it's not already been reported. If, however, the taxpayer is considered the owner of the trust and if the increase in value both before and after the transfer continues to be taxable to him or her, the reporting of interest earned each year can be deferred. In this case, include the total interest in income in the year the taxpayer cashes or disposes of the bonds or the year the bonds finally mature, whichever is earlier.

Example: Bart and Lilly spent an equal amount to buy a $1,000 series EE savings bond as co-owners. They both postpone reporting interest on the bond. Later, they have the bond reissued as two $500 bonds, one in each of their names. At that time, neither Bart nor Lilly has to report the interest earned to the date of reissue.

Form 1099-INT for U.S. Savings Bonds Interest

When a bond is cashed, the bank or other payer that redeems it must give the taxpayer Form 1099-INT if the interest part of the payment received is $10 or more. Box 3 of Form 1099-INT should show the interest as the difference between the amounts received and the amount paid for the bond; however, Form 1099-INT might show more interest than what has to be included on the income tax return.

Examples of when there can be more interest on the 1099-INT than what must be reported include:

- The taxpayer chose to report the increase in the redemption value of the bond each year. The interest shown on Form 1099-INT will not be reduced by amounts previously included in income.
- The taxpayer received the bond from a decedent. The interest shown on the 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.
- Ownership of the bond was transferred. The interest shown on Form 1099-INT will not be reduced by interest that accrued before the transfer.
- The taxpayer was named as a co-owner, and the other co-owner contributed funds to buy the bond. The interest shown on the Form 1099-INT is not reduced by the amount received as nominee for the other co-owner.

If a taxpayer received the bond in a taxable distribution from a retirement or profit-sharing plan, the interest shown on Form 1099-INT will not be reduced by the interest portion of the amount taxable as a distribution from the plan and not taxable as interest.

Education Savings Bond Program

All or part of the interest received on the redemption of qualified U.S. savings bonds during the year can be excluded if the taxpayer paid for qualified higher educational expenses during the same year. This exclusion is known as the Education Savings Bond Program.

Married Filing Separately taxpayers do not qualify for this exclusion.

Form 8815 is used to figure the exclusion and must be attached to Form 1040 or Form 1040A.

What makes the bond qualified?

- The U.S. savings bond is a series EE bond issued after 1989 or a series I bond
- The bond is issued either in the taxpayer's name (sole owner) or in the taxpayer and spouse's names (co-owners)
- The taxpayer is at least 24 years old before the bond's issue date

Any individual (including a child) can be the beneficiary of the bond.

Qualified Higher Education Expenses

Qualified higher educational expenses are tuition and fees required for the taxpayer, the spouse, or their dependent (if claimed as an exemption) to attend an eligible educational institution. Qualified expenses include any contribution made 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

Eligible educational institutions include most public, private, and nonprofit universities, colleges, and vocational schools that are accredited and eligible to participate in student aid programs run by the U.S. Department of Education.

Reduction for Certain Benefits

Qualified higher educational expenses must be reduced by all of the following tax-free benefits:

- Tax-free part of scholarships and fellowships
- Expenses used to figure the tax-free portion of distributions from a Coverdell ESA
- Expenses used to figure the tax-free portion of distributions from a qualified tuition program
- Any tax-free payments (other than gifts or inheritances) received for educational expenses, such as veterans' educational assistance benefits, qualified tuition reductions, or employer-provided educational assistance
- Any expense used in figuring the American Opportunity and Lifetime Learning credits

If the total proceeds (interest and principal) from the qualified U.S. savings bonds redeemed during the year are not more than the adjusted qualified higher educational expenses for the year, the taxpayer might be able to exclude all of the interest.

If the proceeds are more than the expenses, the taxpayer might be able to exclude only part of the interest.

To determine the excludable amount, divide the qualified higher education expenses by the proceeds received during the year, then multiply that amount by the interest.

Interest x (Qualified expenses ÷ Proceeds received during the year)

= Amount to exclude from income

Example: Andy and Bonnie cashed a qualified series EE U.S. savings bond and received $8,000, of which $5,000 was principal and $3,000 was interest. During the tax year, they paid $4,000 of their son's college tuition. They are not claiming an education credit for that amount, and their son does not have any tax-free educational assistance. They can exclude $1,500 of interest and must pay tax on the remaining $1,500 interest.

Interest x (Qualified expenses ÷ Proceeds received during the year)

= amount to exclude from income

$3,000 × ($4,000 ÷ $8,000) = $1500
$3,000 - $1,500 (amount of interest to exclude) = $1,500

Interest Exclusion Amounts

The interest exclusion is limited if the taxpayer(s) modified adjusted gross income (modified AGI) begins at:

- $77,550 for taxpayers filing Single or Head of Household,
- $116,300 for taxpayers filing as Married Filing Jointly or Qualifying Widow(er) with Dependent Child.

Taxpayers do not qualify for the interest exclusion if their modified AGI is equal to or more than the upper limit for his or her filing status.

Modified AGI, for purposes of this exclusion, is adjusted gross income (Form 1040, line 37) figured before the interest exclusion, and modified by adding back any:

- Foreign earned income exclusion
- Foreign housing exclusion and deduction
- Exclusion of income for *bona fide* residents of American Samoa
- Exclusion for income from Puerto Rico
- Exclusion for adoption benefits received under an employer's adoption assistance program
- Deduction for tuition and fees
- Deduction for student loan interest
- Deduction for domestic production activities

Reporting Interest Income

The reporting of interest income depends on the taxpayer and the method used to report income. Most individuals use the cash method of income reporting, however some do use the accrual method.

Cash Method

In general, interest income is reported in the year it is actually or constructively received. Income is constructively received when it is credited to the taxpayer's account or made available to them.

Accrual Method

Interest income is reported when it is earned, not when it is received. Interest is earned over the term of the debt instrument.

Example: In August of 2014, Sandy loaned Terry $3,500 at 10%, compounded annually. The note stated that principal and interest would be due on August 31, 2016. In 2016, Sandy received $4,222.20 ($3,500 principal and $722.20 of interest). If using the cash method, include in income on the 2016 return the $722.20 interest Sandy received that year.

If Sandy is using the accrual method, include the interest as it is earned. For example, in 2014 - $350; 2015 - $244.26; and 2016 - $127.94.

Generally, report all taxable interest income on Form 1040, line 8a; Form 1040A, line 8a; or Form 1040EZ, line 2.

Form 1040EZ cannot be used if the interest income is more than $1,500. Instead, use Form 1040A or Form 1040.

Schedule B

If Schedule B, Interest and Ordinary Dividends, is required, list each payer's name and the amount of interest income received from each payer on line 1. If Form 1099-INT or Form 1099-OID is received from a brokerage firm, list the brokerage firm as the payer.

Form 1040A, Schedule B

When reporting interest income, complete Schedule B if filing Form 1040A and any of the following are true:

- Taxable interest income is more than $1,500
- Taxpayer is claiming the interest exclusion under the Education Savings Bond Program
- Taxpayer received interest from a seller-financed mortgage, and the buyer used the property as a home
- Taxpayer received Form 1099-INT for U.S. savings bond interest and includes amounts reported before current tax year
- Taxpayer received, as a nominee, interest that actually belongs to someone else
- Taxpayer received Form 1099-INT for interest on frozen deposits
- Taxpayer is reporting OID in an amount less than the amount shown on Form 1099-OID
- Taxpayer received Form 1099-INT for interest on a bond bought between interest payment dates
- Taxpayer acquired taxable bonds after 1987 and chose to reduce interest income from the bonds by any amortizable bond premium

Form 1040

1040 must be used when reporting interest income, instead of Form 1040A or Form 1040EZ if any in the following circumstances:

- The taxpayer forfeited interest income because of the early withdrawal of a time deposit
- The taxpayer acquired taxable bonds after 1987, and chose to reduce interest income from the bonds by any amortizable bond premium, and is deducting the excess of bond premium amortization for the accrual period over the qualified stated interest for the period
- The taxpayer received tax-exempt interest from private activity bonds issued after August 7, 1986

Complete Schedule B if filing Form 1040 and any of the following apply:

- Taxable interest income is more than $1,500
- Taxpayer is claiming the interest exclusion under the Education Savings Bond Program
- Taxpayer received interest from a seller-financed mortgage, and the buyer used the property as a home
- Taxpayer received Form 1099-INT for U.S. savings bond interest that includes amounts reported in the current tax year
- Taxpayer received, as a nominee, interest that actually belongs to someone else
- Taxpayer received Form 1099-INT for interest on frozen deposits
- Taxpayer received Form 1099-INT for interest on a bond bought between interest payment dates
- Taxpayer is reporting OID in an amount less than the amount shown on Form 1099-OID
- The taxpayer acquired taxable bonds after 1987, chose to reduce interest income from the bonds by any amortizable bond premium, and is deducting the excess of bond premium amortization for the accrual period over the qualified stated interest for the period

Reporting Tax-Exempt Interest

Total all tax-exempt interest and exempt-interest dividends from a mutual fund as shown in box 8 of Form 1099-INT.

Add this amount to any other tax-exempt interest received. Report the total on line 8b of Form 1040A or 1040. If filing Form 1040EZ, enter “TEI” and the amount in the space to the left of line 2. Do not add tax-exempt interest in the total on Form 1040EZ, line 2.

Box 9 shows the tax-exempt interest subject to the alternative minimum tax on Form 6251, Alternative Minimum Tax—Individuals. It is already included in the amount in box 8. Do not add the amount in box 9 to, or subtract from, the amount in box 8.

Dividend Income

Dividends are distributions of money, stock, or other property paid to a person by a corporation or by a mutual fund. Most distributions are paid in cash (or check). Distributions can consist of more stock, stock rights, other property, or services.

Most corporations and mutual funds distribute Form 1099-DIV, Dividends and Distributions, to show the distributions made during the year and any tax withheld from the dividend income.

If another person receives distributions as a nominee for the taxpayer, that person will provide a Form 1099-DIV to the taxpayer, which will show distributions received on his or her behalf.

General Rules for Dividend Income

Backup Withholding

Dividend income is generally not subject to regular withholding, but could 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, 28% of the amount paid.

Beneficiaries of an Estate or Trust

Dividends and other distributions received as a beneficiary of an estate or trust are generally taxable income. The taxpayer should receive Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc., from the fiduciary. Schedule K-1 and its instructions discuss how and where to report this income.

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's share of any dividends from the stock is determined by local law.

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.

Dividends Received in January

If a mutual fund (or other regulated investment company) or real estate investment trust (REIT) declares a dividend (including any exempt-interest dividend or capital gain distribution) in October, November, or December that is payable to shareholders of record on a date in one of those months but actually pays the dividend during January of the next calendar year, the dividend is considered received on December 31. Report the dividend in the year it was declared.

Ordinary Dividends

Ordinary Dividends

Ordinary dividends are the most common type of distribution from a corporation or a mutual fund. These distributions are paid out of earnings and profits and are ordinary income to the taxpayer and are not capital gains. Ordinary dividends are shown in box 1a of Form 1099-DIV.

Qualified Dividends

Qualified dividends are the ordinary dividends subject to the same 0% or 15% maximum tax rate that applies to net capital gain. Qualified dividends should be shown in box 1b of Form 1099-DIV.

Qualified Dividends

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.

- The dividends must have been paid by a U.S. corporation or a qualified foreign corporation
- The dividends are not of the type listed later under Dividends that are not qualified dividends
- The holding period is met

The taxpayer 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 is not entitled to receive the next dividend payment. Instead, the seller will get the dividend.

When counting the number of days the taxpayer held the stock, include the day the stock was disposed of, but not the day it was acquired.

In the case of preferred stock, the taxpayer 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 due to periods totaling more than 366 days. If the preferred dividends are due to periods totaling less than 367 days, the holding period in the previous paragraph applies.

When determining whether the taxpayer met the holding periods, do not count any day during which any of the following conditions are met:

- The taxpayer had the option to sell, was under a contractual obligation to sell, or had made (and not closed) a short sale of substantially identical stock or securities
- The taxpayer was a grantor (writer) of an option to buy substantially identical stock or securities
- The taxpayer's risk of loss is diminished by holding one or more other positions in substantially similar or related property

Dividends that are Not Qualified Dividends

The following dividends are not qualified dividends, even if 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 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 the person is 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 it's known or if there is reason to know the payments are not qualified dividends
- Payments shown in Form 1099-DIV, box 1b, from a foreign corporation to the extent of knowing or having reason to know that the payments are not qualified dividends

Capital Gain Distributions

Capital gain distributions (also called capital gain dividends) are paid to or credited to an account by mutual funds (or other regulated investment companies) and real estate investment trusts (REITs). These distributions are shown in box 2a of Form 1099-DIV. Report capital gain distributions as long-term capital gains.

Other Distributions

Taxpayers could receive any of the following distributions during the year.

Exempt-Interest Dividends

Exempt-interest dividends received from a mutual fund or other regulated investment company are not included in taxable income. Exempt-interest dividends should be shown in box 10 of Form 1099-DIV.

While not taxable, these dividends must be reported on the return.

Exempt-interest dividends paid from specified private activity bonds may be subject to the alternative minimum tax.

Dividends on Insurance Policies

Insurance policy dividends the insurer keeps and uses to pay the taxpayer's premiums are not taxable; however, the interest that is paid or credited on dividends left with the insurance company must be reported as taxable interest income. Dividends on an insurance contract (other than a modified endowment contract) distributed to the taxpayer are a partial return of the premiums paid. Do not include in gross income until distributions are more than the total of all net premiums paid for the contract.

Report any taxable distributions on insurance policies on Form 1040, line 21

Dividends on Veterans' Insurance

Neither dividends received on veterans' insurance policies nor interest on dividends left with the Department of Veterans Affairs is taxable.

Patronage Dividends

Generally, patronage dividends received in money from a cooperative organization are included in income. Do not include in income patronage dividends received on property bought for personal use, or capital assets or depreciable property bought for business use. The basis (cost) of the items bought, however, must be reduced. If the dividend is more than the adjusted basis of the assets, report the excess as income.

Alaska Permanent Fund Dividends

Do not report these amounts as dividends. Instead, report these amounts on Form 1040, line 21, Form 1040A, line 13, or on Form 1040EZ, line 3.

Reporting Dividend Income

Report dividend income on Form 1040 or Form 1040A.

Report the total of ordinary dividends on line 9a of Form 1040 or Form 1040A. Report qualified dividends on line 9b of Form 1040 or Form 1040A. If the taxpayer received non-dividend distributions required to be reported as capital gains, Form 1040 must be used.

Form 1040EZ cannot be used for reporting dividend income.

Taxpayers who own stock on which he or she received $10 or more in dividends and other distributions, should receive Form 1099-DIV. Regardless of whether or not a 1099-DIV is received, the taxable dividend income must be reported.

Complete Schedule B, Part II, and attach it to Form 1040A or 1040, if either of the following is true:

- Ordinary dividends (Form 1099-DIV, box 1a) are more than $1,500
- The taxpayer received, as a nominee, dividends that actually belonged to someone else

If ordinary dividends are more than $1,500, also complete Schedule B, Part II.

Report qualified dividends on line 9b of Form 1040 or Form 1040A.

Do not include any of the following on line 9b:

- Qualified dividends received as a nominee
- Dividends on stock for which the holding period was not met
- Dividends on any share of stock to the extent the taxpayer is 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 known or there is 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 it is known or there is reason to know, that the payments are not qualified dividends

Schedule B, Part III Foreign Account Interest Income

Parts I and II of Schedule B are for reporting interest and dividend income. Part III is used to report any financial interest or signature authority a taxpayer had over a financial account located in a foreign country.

A financial account includes, but is not limited to, these types of accounts maintained with a financial institution or other person performing the services of a financial institution:

- Securities
- Brokerage
- Savings
- Demand
- Checking
- Deposit
- Time deposit

A financial account also includes a commodity futures or options account, an insurance policy with a cash value, an annuity policy with a cash value, and shares in a mutual fund or similar pooled fund.

A financial account is considered to be located in a foreign country if the account is physically located outside of the United States. For example, an account maintained with a branch of a United States bank that is physically located outside of the United States is a foreign financial account. An account maintained with a branch of a foreign bank that is physically located in the United States is not a foreign financial account.

Example: Ruby, a U.S. citizen, moved to Japan to teach English to elementary students. She opened a checking and savings account in a Japanese bank located in Tokyo. Ruby has a foreign financial account.

Schedule B, Part III must be completed if one of the following applies:

- The taxpayer has over $1,500 of taxable interest or ordinary dividends
- The taxpayer has a foreign account
- The taxpayer received a distribution from or was a grantor of, or a transferor to, a foreign trust

If a taxpayer does have a foreign account, he or she may be required to file Financial Crimes Enforcement Network (FinCEN) Form 114, Report of Foreign Bank and Financial Accounts (FBAR) to report financial interest or signature authority. Generally United States persons with a financial interest in or signature authority over at least one financial account located outside of the United States and the aggregate value of all for foreign financial accounts exceeded $10,000 at any time during the calendar year are required to file an FBAR. Exceptions to filing requirements can be found in the FinCEN FBAR instructions.

Taxable Refunds

Taxable Refunds, Credits, or offsets of State and Local Taxes

If a taxpayer received a state or local income tax refund (or credit or offset) in the tax year, it must generally be included in income if it was deducted in an earlier tax year. The taxpayer should receive Form 1099-G, Certain Government Payments, reporting amounts from the payer.

Use the State and Local Income Tax Refund Worksheet to determine if the state or local refund is taxable. Taxable amounts should be reported on Form 1040, line 10.

Self-Employment Income

Self-employed taxpayers must file Schedule C to report their profit or loss from a business. Taxpayers are considered self-employed if he or she is:

- Carrying on a trade or business as a sole proprietor
- An independent contractor
- A member of a partnership
- In business for themselves in any other way

Self-employment can include work in addition to regular full-time business activities, such as certain part-time work done at home or in addition to a regular job.

For taxpayers who owned more than one business, a separate Schedule C must be completed for each business.

Use Schedule C to report the following gross receipts:

- Income received from business activity
- Goods or services received through bartering
- Wages and expenses received as a statutory employee
- Income and deductions of certain qualified joint ventures
- Certain Form 1099-MISC, Miscellaneous Income

Small businesses and statutory employees with business expenses of $5,000 or less may be able to file Schedule C-EZ instead of Schedule C.

Statutory Employees

If the taxpayer received a Form W-2 with the "Statutory employee" box checked, report the income and expenses related to that income on Schedule C or C-EZ. Because Social security and Medicare tax should have been withheld from those earnings, no self-employment tax on these earnings is owed.

Note: If there was both self-employment income and statutory employee income, two Schedules C must be filed. Do not use Schedule C-EZ or combine these amounts on a single Schedule C.

Qualified Joint Venture

A taxpayer and spouse who each materially participate as the only members of a jointly owned and operated business and file a joint return for the tax year can elect to be taxed as a qualified joint venture instead of a partnership. By making the election, the taxpayers are not required to file Form 1065 and will instead report the income and deductions directly on the joint return.

To make this election, divide all items of income, gain, loss, deduction, and credit attributable to the business between the taxpayer and spouse in accordance with respective interests in the venture. Each taxpayer must file a separate Schedule C, C-EZ, or F. Each must also file a separate Schedule SE to pay self-employment tax, as applicable.

1099-MISC Income

Form 1099-MISC generally reports payments made in the course of a trade or business. Usually payers will not issue Form 1099-MISC for payments less than $600; however, taxpayers must report all income earned as an independent contractor or from informal side jobs as self-employment income even if Form 1099-MISC is not received.

Payments reported on Form 1099-MISC and any other amounts received in trade or business should be included in gross receipts on Schedule C.

Material Participation

On Schedule C, taxpayers should indicate if they “materially participated” in the operation of the business. The taxpayer materially participated in the business if he or she was involved on a regular, continuous, and substantial basis in its operations.

If the taxpayer did not materially participate in the business, the losses and credits from the business may be used, with certain exceptions, only against income from other passive activities. In that case, complete Form 8582, Passive Activity Loss Limitations, to figure the amount of the loss to enter on the Schedule C.

Business Income vs Hobby Income

Taxpayers should be aware of guidelines when determining whether engagement in an activity is a hobby or for profit, such as a business or investment activity.

In order to make this determination, taxpayers should consider the following factors:

- Does the time and effort put into the activity indicate an intention to make a profit?
- Does the taxpayer depend on income from the activity?
- If there are losses, are they due to circumstances beyond the taxpayer's control or did they occur in the start-up phase of the business?
- Has the taxpayer changed methods of operation to improve profitability?
- Does the taxpayer or his/her advisors have the knowledge needed to carry on the activity as a successful business?
- Has the taxpayer made a profit in similar activities in the past?
- Does the activity make a profit in some years?
- Can the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?

The IRS considers an activity for-profit if it makes a profit at least three of the last five tax years (including the current year) and at least two of the last seven years for activities that are primarily breeding, showing, training, or racing horses.

Taxpayers who realize a loss incurred in the operation of an activity or business are allowed to deduct the loss from income; however, if the business or activity is considered a hobby, taxpayers cannot use a loss to offset income.

Hobby expenses may be limited and can be deducted on Schedule A by taxpayers who itemize. See IRS Publication 535, Business Expenses for details on hobby expense deductions.

Self-Employment Expenses

Certain allowable expenses incurred carrying out a trade or business can be deducted from the gross profits on Schedule C.

These expenses include but are not limited to:

- Car and Truck Expenses
- Contract Labor
- Depreciation
- Insurance Premiums
- Legal and Professional Fees
- Offices Expenses
- Rents
- Repairs and Maintenance
- Supplies
- Taxes and Licenses
- Utilities
- Business Use of Home
- Advertising
- Commissions and Fees

Car and Truck Expenses

Taxpayers who use a car or truck for business purposes can usually deduct car expenses. Generally, one of the two following methods can be used to calculate deductible expenses:

- Standard mileage rate
- Actual expenses

The standard mileage rate is a flat rate per mile that can be used to figure the deductible cost of operating a car or truck for business. For 2016, the standard mileage rate is 54 cents per mile. If the standard mileage rate is used, actual expenses cannot be deducted for the same year.

There are some circumstances where the standard mileage rate is not allowed. See IRS Publication 463 for more details.

If taxpayers do not use the standard mileage rate, they may be able to deduct actual expenses. Some taxpayers may qualify to use either the standard mileage rate or actual expenses and in that case, it may be best to calculate both methods in order to optimize the deduction and use the most advantageous deduction.

Actual car expenses include:

- Depreciation
- Licenses
- Gas
- Oil
- Tolls
- Lease payments
- Insurance
- Garage rent
- Parking fees
- Registration fees
- Repairs
- Tires

If an automobile has been fully depreciated, taxpayers may continue to deduct other actual expenses while the car or truck is in service. For more detailed information and stipulations, please reference IRS Publication 463.

In order to deduct expenses for a car or truck used for a business purpose taxpayers must prove the expenses. Timely and accurate recordkeeping is required to support any deduction for expenses. Amounts deducted cannot be approximate or estimates. Written evidence is generally considered the most adequate way to keep records for car and truck expenses.

Written evidence should include the amount of the expenditure, the date of time of use, place or description of the expenditure, and business purpose and relationship. Written evidence should also include a detailed, written, daily mileage log. Generally, documentary evidence such as receipts, cancelled checks, or bills, are required to support deductions.

Business Use of Home

Self-employed taxpayers, and some employees, may be able to deduct certain expenses for a part of their home used for business.

In order to deduct expenses for business use of the home, the taxpayer’s home must be used as one of the following:

- Exclusively and regularly as taxpayer’s principal place of business for trade or business
- Exclusively and regularly as a place where the taxpayer meets and deal with patients, clients, or customers in the normal course of the trade or business
- A separate structure used exclusively and regularly in connection with a trade or business that is not attached to the taxpayer’s home
- On a regular basis for storage of inventory or product samples used in a trade or business of selling products at retail or wholesale
- For rental use
- As a daycare facility

If the part of the taxpayer's home used is a separate structure, qualifying for a home-office deduction for its use requires that the separate structure be used exclusively and regularly in connection with the taxpayer's trade or business. However, the structure does not have to be the taxpayer's principal place of business or where he or she meets patients, clients, or customers. Additional tests apply to an employee's use of part of his or her home for business purposes.

Exclusive Use Requirement

Deductions for expenses for any part of the home that is used for both personal and business purposes are not allowed. The general rule that applies to qualifying for a home-office deduction requires that the taxpayer use a specific area of the home ***only*** for the trade or business.

Thus, the general rule mandates that the portion of the home used:

- Be a specific area, i.e. a room or other separately identifiable space; and
- Must be used ***solely*** in the taxpayer's trade or business.

Despite the requirement for a specific area, the space used need not be marked off by a permanent partition. However, under the general rule requiring exclusive use, a taxpayer will not qualify for a home-office deduction if the area is used for both business and personal purposes.

Example: Holly's Use Qualifies under Exclusive Use Requirement

Holly engages in the practice of law and uses a room in her home exclusively for writing legal briefs, preparing documents, and meeting with clients. The room is used for no other purpose. Since the room in Holly's house is a separately identifiable space and is used only in her legal practice, it meets the exclusive use requirement and may qualify for a home-office deduction under the general rule.

Example: Jose's Use Does Not Meet Exclusive Use Requirement

Jose recently graduated from law school and uses a room in his home to prepare tax returns for his clients. When he is not using the room to prepare tax returns, he and his wife use it as a place to watch television. Because the room Jose uses as his office is also used for personal purposes by the family-as a TV room, in this case - Jose would not qualify for a home-office deduction since the room is not used exclusively in Jose's business; in other words, it fails to meet the exclusive use requirement.

Exceptions to Exclusive Use Requirement

Although the general rule requiring exclusive use in a taxpayer's trade or business in order to take a home-office deduction for business use applies to all other uses, two exceptions to that exclusive use requirement exist.

Those exceptions apply to the taxpayer's use of part of the home:

- For the storage of inventory or product samples
- As a daycare facility

Except for these two uses, any part of the taxpayer's home used for business purposes must meet the exclusive use test in order to qualify for a home office deduction. Let's consider the requirements that apply to each of these uses.

Storage of Inventory or Product Samples

Selling occupies a large part of the civilian population in the United States. According to the 2012 Statistical Abstract, 15.4 million people-about 11% of the employed U.S. population age 16 or older-work in sales and related occupations. Many of those involved in sales are likely to store product samples or inventory in their homes and doing so may entitle them to a home-office deduction without the requirement that the space used for such storage meet the exclusive use test.

In order for a taxpayer to be able to deduct expenses for the business use of his or her home for storage of inventory or product samples, without the need to satisfy the general rule requiring exclusive use of the space, the taxpayer (and the space) must meet ***all*** the following tests:

- The taxpayer sells products at wholesale or retail as a trade or business;
- The taxpayer keeps the inventory or product samples in his or her home for use in the trade or business;
- The taxpayer's home is the only fixed location of his or her trade or business;
- The taxpayer uses the storage space on a regular basis; and
- The space used by the taxpayer is separately identifiable and suitable for storage.

Use as Daycare Facility

The second exception to the exclusive use requirement normally applicable to taking the home-office deduction for business use of a taxpayer's home applies to the taxpayer's use of space in the home for providing daycare. In order for a taxpayer to qualify for the daycare exception to the exclusive use rule, the taxpayer must:

1. Be in the trade or business of providing daycare for -
    - children
    - persons age 65 or older, or
    - persons who are physically or mentally unable to care for themselves; ***and***
2. Have applied for, been granted, or be exempt from having a license, certification, registration, or approval as a daycare center or as a family or group daycare home under state law.

It is important to understand that in order for a taxpayer to qualify for the home-office deduction as a daycare provider even though the space is not used exclusively for business purposes, the taxpayer must meet both of the previous requirements. Thus, if the taxpayer's application was rejected or license or other authorization was revoked, the exception to the exclusive use rule does not apply.

Example: Sherry is licensed by the state to operate an adult daycare business. She provides care during daylight hours to persons age 65 or older in a large, airy room of her home. When the room is not being used for her adult daycare business, it is used by her and other family members as a television and game room. Even though the room Sherry uses to conduct her adult daycare business is not used exclusively for the business, she may take a home-office deduction since operation as a daycare facility constitutes an exception to the exclusive use rule applicable to the home-office deduction for business use of a taxpayer's home.

Regular Use Requirement

In addition to the exclusive use requirement generally applicable to a taxpayer's ability to take a home-office deduction for business use of the home, the taxpayer must also meet the requirements that the space be used:

- For business on a regular basis; and
- In connection with a trade or business.

If either of these requirements is not met, no home-office deduction for business use is permitted.

In order for a taxpayer using part of his or her home for business purposes to qualify for a home-office deduction, the specific area of the home used for business must be used on a regular basis. Thus, space in a home that is used for business purposes only on an occasional or irregular basis would not qualify the taxpayer for a home office deduction. In order to determine if part of a taxpayer's home is used on a regular basis for business purposes, all facts and circumstances surrounding the business use of the space should be considered.

Although the exclusive use rule and its exceptions are fairly straightforward and simple to apply, the requirement that a taxpayer use the space on a regular basis in order to qualify for the home-office deduction is far less straightforward.

A taxpayer can generally rely on two types of information to prove his or her regular use of a home office for purposes of the deduction:

1. A contemporaneous log of time spent in the office; and
2. Documents corroborating time spent in the office, such as:
    - emails sent,
    - a guest log signed by clients, or
    - telephone billing statements indicating the taxpayer made telephone calls from the home office during the times indicated in the log.

A taxpayer may maintain a home office as a place in which to engage in various types of activities. However, those activities may or may not entitle the taxpayer to a home-office deduction. It is important, in order for the taxpayer to qualify for a home-office deduction, that the home office be used in a trade or business. If the office is used for some function other than as a place in which to engage in a trade or business, including engaging in a profit-seeking activity that does not constitute a trade or business, no home-office deduction is permitted.

Consider the use of a home office that does not qualify for a home-office deduction in the following example:

Example: No Trade or Business means No Home-Office Deduction

James retired last year and received a substantial early retirement buyout that he uses for investment purposes. Although he does not operate as a broker or dealer, he spends several hours each day in his home office reading financial periodicals, deciding on various strategies for increasing his wealth and making trades for his own account. While James clearly is engaged in a profit-making activity and uses his home office to further that objective, the fact he is not engaged in a trade or business means that no home-office deduction is permitted.

Principal Place of Business Requirement

As noted earlier, in order for a taxpayer to be able to take the home-office deduction for business use of a home, the home office normally must be used exclusively and regularly as the taxpayer's principal place of business. We have already looked at the exclusive and regular use requirements and will turn our attention now to the principal place of business test.

A taxpayer may have more than one business location at which he or she engages in a single trade or business. Despite having multiple locations, however, a taxpayer may still qualify for a home-office deduction. Qualifying to deduct the expenses for the business use of a home under the principal place of business test requires that the taxpayer's home must be the principal place of business for the trade or business.

Making the determination as to whether the taxpayer's home is his or her principal place of business requires consideration of:

- The relative importance of the activities performed at each place where the taxpayer conducts business; and
- The amount of time the taxpayer spends at each place where he or she conducts business.

A taxpayer's home office qualifies as his or her principal place of business if the taxpayer:

- Uses the home-office exclusively and regularly for administrative or management activities of the trade or business; and
- Has no other fixed location where he or she conducts substantial administrative or management activities of the trade or business.

If the taxpayer's home cannot be identified as the principal place of business after considering the relative importance of the activities performed in it and the amount of time spent there, and the home-office deduction is not otherwise allowed as a place to meet patients, clients, or customers or as a separate structure, no home-office deduction is permitted.

Administrative or Management Activities

Note that a home office may qualify as a taxpayer's principal place of business if it is used for administrative or management activities of the trade or business. But, what constitutes administrative or management activities?

Although other functions may be considered administrative or management activities, the following activities, when performed in connection with the trade or business, are examples:

- Billing customers, clients, or patients
- Keeping books and records
- Ordering supplies
- Setting appointments
- Forwarding orders or writing reports

Exceptions to Principal Place of Business Rule

In certain limited cases, a home office may qualify for a home-office deduction even though the space used for the home office is not the taxpayer's principal place of business. Those exceptions apply to the following situations:

- Part of the taxpayer's home is used to meet with patients, clients or customers; or
- The premises is a free-standing, separate structure that is used exclusively and regularly for the taxpayer's business.

Figuring the Deduction

Taxpayers can use one of two methods to figure their home office deduction:

- Regular Method (or Actual Expense Method)
- Simplified Options

Taxpayers using the regular method must determine the actual expenses of their home office. Generally taxpayers who use the regular method base deductions on the percentage of the home used as the office in home. These expenses include items such as real estate taxes, mortgage interest, insurance, utilities, repairs, maintenance, and depreciation.

Example: Paula operated a handmade soap business. She has a room in her home dedicated to the soap business. She exclusively operates her business from the home office and the space is not used for any other purpose.

Her home is 2000 square feet of which 200 square feet is used as her home office. Therefore, Paula may deduct 10% (200/2000) of her home owner's insurance as a home office expense.

The simplified option can significantly reduce record keeping burdens for small business owners by allowing taxpayers to apply a prescribed rate by the allowable square footage of the home office instead of deducting the actual expenses. Using the simplified method does not change the criteria for who may claim a home office deduction.

Regular or Actual Expense Method

The actual expense method of figuring a home-office deduction uses the actual expenses incurred by the taxpayer as the basis for determining the deduction allowable for business use of the taxpayer's home. Bear in mind when using the actual expense method to figure the home-office deduction that a taxpayer cannot deduct expenses for the business use of a home incurred during any part of the year he or she did not use the home for business purposes. Thus, a taxpayer who begins using part of his or her home for business purposes beginning on July 1st of the year and who qualifies for a home-office deduction cannot consider expenses for the period prior to July 1st. Instead, the taxpayer may consider only those expenses for the period July 1 through December 31 in figuring the allowable deduction.

When using the actual expense method for figuring the home-office deduction for a client, a tax return preparer must determine:

- The nature of the expense; and
- The percentage of the home used for business purposes.

When determining the nature of the taxpayer's expense, expenses are placed into one of the following three categories:

- Direct expenses
- Indirect expenses
- Unrelated expenses

Nature of the expense

Direct expenses are expenses applicable to and affecting only the business part of the taxpayer's home. Except for daycare facility expenses that may be only partially deductible as discussed later under Daycare Facility, these expenses are deductible in full, subject to any applicable deduction limit. (See Deduction Limit later in this unit.)

Examples of direct expenses that may be deductible in full, subject to the deduction limit, include expenses for:

- Painting
- Making needed repairs
- Cleaning carpets

…but only in the area used for business purposes.

Indirect expenses are those expenses the taxpayer incurs for keeping up and running his or her entire home. Such indirect expenses are deductible under the home-office deduction in an amount based on the percentage of the taxpayer's home used for business purposes. Similar to direct expenses, the deduction of indirect expenses is subject to the applicable deduction limit.

Examples of indirect expenses that may be deductible in part, based on the percentage of the home used for business purposes and subject to applicable deduction limits, include expenses for:

- Insurance
- Utilities
- General repairs
- Homeowner association dues

The third category of taxpayer expenses-expenses that are unrelated-are expenses applicable only to the parts of the taxpayer's home that are not used for business purposes. These unrelated expenses are not deductible.

Unrelated expenses incurred by a taxpayer whose business use of a home qualifies for a home-office deduction for direct and allocable indirect expenses include expenses for:

- Lawn maintenance
- Painting of rooms not used for business purposes

Such unrelated expenses are not deductible for purposes of the home-office deduction.

Although direct expenses attributable to business purposes are deductible under the home-office deduction irrespective of the percentage of the home actually used by the taxpayer for business purposes, indirect expenses are not. Instead, indirect expenses are deductible under the home-office deduction only in an amount equal to the total of such indirect expenses multiplied by the percentage of the home used for business.

Suppose a taxpayer's indirect expenses amounted to $5,000 and 10% of the home was used for business purposes. The amount of the indirect expense attributable to business purposes would then be $500. ($5,000 x 10% = $500)

Calculating Percentage of Home Used for Business

A taxpayer is permitted to use any reasonable method to determine the percentage of his or her home used for business purposes. Two methods commonly used for determining the applicable percentage of a home for purposes of the home-office deduction are:

1. Dividing the square footage of the home used for business purposes by the total square footage of the home; and
2. Dividing the number of rooms used for business by the total number of rooms in the taxpayer's home.

Percentage Based on Square Footage

To determine the percentage of a taxpayer's home used for business purposes based on square footage, simply divide the square footage of the space used for business by the square footage of the entire house. For example, suppose the size of the entire house is 2,000 sq. ft. and the taxpayer uses a single room measuring 12' x 12' for business purposes. Since the space used for business purposes is 144 sq. ft. (calculated by multiplying 12' x 12'), determining the percentage of the home used for business requires only that 144 be divided by 2,000. In this case, the applicable percentage is 7.2%. (144 ÷ 2,000 = .072 = 7.2%)

Percentage Based on Number of Rooms

Determining the percentage of a taxpayer's home used for business purposes by dividing the number of rooms used for business by the total number of rooms in the house should be used only if the rooms in the house are all of approximately the same size.

To determine the percentage of a taxpayer's home used for business purposes based on the number of rooms in the house compared with the number of rooms used for business purposes generally produces approximately the same result. To make the calculation requires only that the number of rooms used for business be divided by the total number of rooms in the home. For example, suppose the entire house has eleven rooms of approximately equal size and the taxpayer uses one of those rooms for business purposes. The percentage of the house used for business purposes would be 9.1%. (1 ÷ 11 = .0909 = 9.1%)

Deductible Expenses for Home-Office Deduction

Expenses that are deductible under the home-office deduction fall into two categories and include the following:

- Expenses that are deductible by the taxpayer whether or not the taxpayer uses the home for business purposes, i.e. they are deductible by all homeowners; and
- Expenses that are deductible by the taxpayer only if the taxpayer uses the home for business purposes.

We can see how the home-office deduction is determined for the expenses deductible by all homeowners. Suppose a taxpayer who qualifies for a home-office deduction and has no casualty losses for the year pays the following amounts:

- Real estate taxes - $2,000
- Qualified mortgage insurance premiums - $400
- Deductible mortgage interest - $1,600

The total of such expenses is $4,000. ($2,000 + $400 + $1,600 = $4,000) If the percentage of the home used for business purposes was 10%, the portion of the home-office deduction derived from expenses deductible by all homeowners would be $400. ($4,000 x 10% = $400) The balance of these expenses, $3,600, would be deductible by the homeowner-taxpayer in the usual manner.

In addition to those expenses that are deductible by all homeowners, many additional expenses are deductible by homeowners who use their homes for business purposes. These are expenses that would not normally be deductible by the homeowner.

Principal among those expenses that are deductible by a homeowner who uses the home for business purposes, in an amount determined by the percentage of the home used for business, are the following:

- Depreciation
- Insurance
- Rent paid for the use of unowned property used in the taxpayer's trade or business
- Repairs
- Security system maintenance and monitoring expenses
- Expenses for utilities and services

Although these expenses are deductible by a taxpayer using his or her home for business purposes, it is important to keep in mind that only the business percentage of these expenses is deductible.

Deduction Limit

The home-office deduction is not unlimited. Instead, if a taxpayer uses the actual expense method for claiming a home-office deduction, the deduction of otherwise nondeductible expenses, expenses such as insurance, utilities, and depreciation allocable to the business, is limited to the taxpayer's gross income from the business use of the home minus the sum of the following:

1. The business portion of expenses the taxpayer could deduct even if he or she did not use the home for business purposes. Such expenses include mortgage interest, real estate taxes, and casualty and theft losses allowable as itemized deductions on Schedule A (Form 1040); and
2. The business expenses that relate to the business activity in the home but not to the home itself. Such expenses include the costs of business telephone, supplies, and equipment depreciation. A self-employed taxpayer should not include in the business expenses that must be subtracted from gross income the one-half of self-employment tax the taxpayer is permitted to deduct.

In applying the deduction limit to a taxpayer's home-office deduction, the depreciation deduction should be taken last. If the taxpayer's home-office deduction in any year is reduced by the deduction limit, the taxpayer may carry over the excess to the next year in which he or she uses the actual expense method in claiming a home-office deduction. The carried-over expenses are subject to the deduction limit for the year to which they are carried over, whether or not the taxpayer lives in the same home during that year.

Deducting and Recordkeeping

After qualifying for a home-office deduction and determining the deduction amount, a taxpayer must report the deduction on IRS Form 1040 and retain sufficient evidence for a specified period of time to support it. In this unit, we will examine the rules related to where the expenses of a home office are deducted and the recordkeeping requirements applicable to taking and supporting such a deduction.

Self-Employed Taxpayer & Statutory Employee Deduction of Home Office Expenses

If a self-employed taxpayer or statutory employee uses his or her home in a trade or business and files Schedule C, the entire deduction for business use of the taxpayer's home should be reported on Schedule C, line 30. If the taxpayer who files Schedule C uses the actual expense method of determining the home office deduction, Form 8829 should be attached to Schedule C.

If the taxpayer uses a home in his or her farming business and files Schedule F, the entire deduction for business use of the home should be reported on line 32 of Schedule F. The words "business use of home" should be entered on the adjacent dotted line.

Some expenses related to the taxpayer's use of a home are deductible, whether or not the taxpayer uses the home for business purposes. Such expenses include mortgage interest, qualified mortgage insurance premiums, real estate taxes, and casualty losses. Where these expenses are deducted depends on how the taxpayer figures the deduction for business use of the home.

If the taxpayer uses the simplified method of determining the home-office deduction, these expenses are simply treated as personal expenses and do not figure into the deduction allowed for business use of the taxpayer's home. However, if the taxpayer uses the actual expense method of figuring the home-office deduction, the tax return preparer should deduct the business portion of these expenses on Schedule C or Schedule F, as appropriate. If the taxpayer itemizes deductions, he or she will deduct the personal portion of these expenses on Schedule A.

If a taxpayer files Schedule C and has deductible mortgage interest, all of the deductible mortgage interest (both the personal and business portions) should be entered on line 10 of Form 8829. After entering the total of the deductible mortgage interest on line 10, the business part of the deductible mortgage interest must be figured on lines 12 and 13 of Form 8829 by multiplying the amount on line 10 by the percentage entered on line 7. Subtract the amount shown on line 13 from the amount previously entered on line 10. The difference between the two numbers is deductible on Schedule A, line 10 or line 11.

If the taxpayer files Schedule F rather than Schedule C, the business part of the deductible home mortgage would be entered on line 32 of Schedule F, and the nonbusiness part of the deductible mortgage interest would be entered on Schedule A, line 10 or line 11.

If the taxpayer files Schedule C and has deductible qualified mortgage insurance premiums, all of those premiums should be entered on line 10 of Form 8829. After determining the business part of the qualified mortgage insurance premiums on line 12 and 13 by multiplying the amount on line 10 by the percentage on line 7, subtract that amount from the qualified mortgage insurance premiums included on line 10. The remainder is deductible on Schedule A, line 13. (Note: if the premiums the taxpayer deducts on Schedule A are limited, include the excess with any excess mortgage interest and enter the total on line 16 of Form 8829.)

If the taxpayer files Schedule F, include the business part of the deductible qualified mortgage insurance premiums with the total business use of the home expenses on line 32 of Schedule F. Enter "business use of home" on the dotted line adjacent to the entry. Enter the nonbusiness part of the qualified mortgage insurance premiums on Schedule A, line 13.

If the taxpayer files Schedule C and has paid deductible real estate taxes, all of those deductible real estate taxes should be entered on line 11 of Form 8829. After determining the business part of the real estate taxes on line 12 and 13 by multiplying the amount on line 11 by the percentage on line 7, subtract that amount from the real estate taxes included on line 11. The remainder is deductible on Schedule A, line 6.

If the taxpayer files Schedule F, include the business part of the real estate taxes with the total business use of the home expenses on line 32 of Schedule F. Enter "business use of home" on the dotted line adjacent to the entry. Enter the nonbusiness part of the real estate taxes on Schedule A, line 6.

Expenses Deductible Only When Home is Used for Business

While the deductible expenses already discussed are deductible by a taxpayer whether or not the taxpayer's home is used for business, certain other expenses are generally deductible only when the taxpayer's home is used for business purposes. Those expenses that are deductible by a taxpayer using the actual expense method only to the extent related to the business use of the taxpayer's home include:

- Insurance
- Maintenance
- Utilities
- Depreciation of the home

Accordingly, the personal portion of any of these expenses remains nondeductible. If the taxpayer uses the simplified method of determining the home-office deduction, these expenses do not figure into the deduction allowed for business use of the taxpayer's home.

Where the taxpayer using the actual expense method deducts the business portion of the above expenses depends on the method used by the taxpayer to figure the deduction for business use of the home.

Actual Expense Method

A taxpayer who files Schedule C and claims a home-office deduction using the actual expense method should report the home expenses that would not be allowable if the home were not used for business on the appropriate lines of Form 8829. If these expenses exceed the deduction limit, the taxpayer should carry over the excess to the next year in which the actual expense method is used, and the carryover will be subject to the following year's deduction limit.

If the taxpayer files Schedule F, the otherwise nondeductible expenses for insurance, maintenance, utilities, depreciation, etc. should be included with the taxpayer's total business use of the home expenses on Schedule F, line 32, and the notation "business use of home" should be entered on the adjacent dotted line.

Irrespective of how the taxpayer figures the home-office deduction, the taxpayer should deduct business expenses that are not for the use of the taxpayer's home on the appropriate lines of Schedule C or Schedule F in full. Since these expenses are not for the use of the taxpayer's home, they are not subject to the deduction limit for business use of the home expenses.

Recordkeeping Requirements

Taxpayers are required to keep records that provide information needed to figure the deduction for business use of the taxpayer's home. Thus, a taxpayer should keep canceled checks, receipts, and other evidence of expenses he or she paid. In connection with the home-office deduction, the taxpayer's records must show the following information:

The part of the taxpayer's home used for business purposes;

That the taxpayer used part of the home exclusively (unless its use constituted an exception from the exclusive use requirement) and regularly for business as:

A. The taxpayer's principal place of business, or

B. The place where the taxpayer meets or deals with clients or customers in the normal course of business.

In addition, the taxpayer must keep records to prove the home's depreciable basis, including records evidencing:

- When and how the taxpayer acquired the home
- The home's original purchase price
- Any improvements made to the home
- Any depreciation the taxpayer is allowed because of maintaining an office in the home

Taxpayers must keep the records required to support their deduction for business use of a home for as long as they are important for any tax law. Accordingly, applicable records should normally be kept until the later of:

- Three years from the tax return due date or the date filed
- Two years after the tax was paid

Net Profit or Loss from Schedule C / Schedule SE

Any net profit or loss calculated on Schedule C should be reported on Form 1040, line 12. These amounts should be included in gross income.

Schedule SE

Use Schedule SE (Form 1040) to figure self-employment tax for the taxpayer. Self-employment tax is comparable to the Social Security and Medicare tax withheld from an employee's wages. For more information about this tax, see Publication 334, Tax Guide for Small Business.

NOTE: Statutory employees typically have Social Security and Medicare tax withheld from their earnings and therefore do not need to file a Schedule SE.

Form 1040 and Schedule SE (Form 1040), Self-Employment Tax, must be filed if either:

- Net earnings from self-employment (excluding church employee income) were $400 or more
- Church employee income was received for $108.28 or more

A return must be filed for the self-employed individual when gross income is at least as much as the filing requirement amount for their filing status and age.

Example: Elizabeth, a single taxpayer, works part-time as a retail clerk and also works for herself as a wedding photographer. In the tax year, she earned $9,500 (after expenses) taking wedding photos. Elizabeth must file Form 1040, a Schedule C, and a Schedule SE.

Example: Ellen received income as a statutory employee reported on a W-2 for her cosmetic sales, and 1099-MISC for her work maintaining the network at a local attorney's office. When filing her return, include two Schedule C's: one for her IT contracting and one for her cosmetic sales. She will also need to file Schedule SE to report Social Security and Medicare tax for her work as an IT contractor.

Schedule C Record Keeping

It is important for self-employed individuals to keep diligent, accurate records. Good recordkeeping can help taxpayers:

- Monitor progress of the business
- Prepare financial statements
- Identify the source of receipts
- Track deductible expenses
- Prepare tax returns
- Support items reported on their tax return

The taxpayer's type of business may determine the type of records kept; however, the recordkeeping system should include a summary of all business transactions. This summary is usually made in the taxpayer's books (accounting journals, ledgers, etc). Books should show gross income, deductions, and credits.

As part of recordkeeping, it is important that a taxpayer retain support documents such as sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks. Support documents help support entries on the taxpayer's tax return. These documents should be kept in an orderly fashion and in a safe place.

Any record should be kept as long as they may be necessary for the administration of any provision of the Internal Revenue Code. Generally, taxpayers should keep records that support an item of income or deduction on a tax return until the periods of limitation for the return run out.

The period of limitations is the period of time in which a taxpayer can amend a return to claim a credit or refund or the IRS can assess additional tax. Review the table from IRS Publication 583 to see the period of limitations.

Table 3. **Period of Limitations**

IF you...	THEN the period is...
1. Owe additional tax and situations (2), (3), and (4), below, do not apply to you	3 years
2. Do not report income that you should report and it is more than 25% of the gross income shown on the return	6 years
3. File a fraudulent return	Not limited
4. Do not file a return	Not limited
5. File a claim for credit or refund after you filed your return	Later of: 3 years or 2 years after tax was paid
6. File a claim for a loss from worthless securities or a bad debt deduction	7 years

Unemployment Compensation

Unemployment compensation includes amounts received under the employment compensation laws of the United States or of a state including:

- State unemployment insurance benefits
- Benefits paid to a taxpayer by a state or the District of Columbia from the Federal Unemployment Trust Fund
- Railroad unemployment compensation benefits
- Disability benefits paid as a substitute for unemployment compensation
- Trade readjustment allowances under the Trade Act of 1974
- Unemployment assistance under the Disaster Relief and Emergency Assistance Act of 1974

Amounts received as unemployment compensation must be included in gross income. Unless federal tax is withheld from payments, it is sometimes necessary for the taxpayer to pay quarterly estimated tax payments. Generally taxpayers should receive Form 1099-G showing the amounts paid and any amount of tax withheld.

Social Security Benefits

Social Security benefits, including monthly retirement, survivor, and disability benefits, might be taxable. Most taxpayers will receive Form SSA-1099, which will report the total benefits.

Several factors determine if any portion of the Social Security benefits are taxable. If the only income the taxpayer received during the tax year is Social Security benefits or equivalent railroad retirement benefits, the benefits might not be taxable and the taxpayer might not be required to file a tax return.

If a taxpayer received income from other sources, the benefits will generally not be taxable unless the taxpayer's modified adjusted gross income (MAGI) is more than the base amount for the taxpayer's filing status.

Calculating Taxable Portion of Social Security Benefits

To figure the taxable portion of the benefits, compare the base amount for the taxpayer's filing status with the total of:

1. One-half of the benefits
2. All other income, including tax-exempt interest.

When making this comparison, do not reduce other income by any exclusion for:

- Interest from qualified U.S. savings bonds
- Employer-provided adoption benefit
- Foreign earned income or foreign housing
- Income earned by bona fide residents of American Samoa or Puerto Rico

To figure the taxable portion of Social Security benefits, compare the base amount for the taxpayer's filing status. The base amounts are:

- $25,000 if filing Single, Head of Household, or Qualifying Widow(er)
- $25,000 if filing Married Filing Separately and lived apart from the spouse for all of the tax year
- $32,000 if filing Married Filing Jointly
- $-0- if Married Filing Separately and lived with the spouse at any time during the year

Complete Social Security Benefits Worksheet 11-1 to determine if benefits are taxable. Taxable benefits must be included in gross income, reported on Form 1040, line 20b.

Example: Jay and Marsha (both over age 65) are married and filing a joint return for 2016 and both received Social Security benefits during the year. In January 2017, Jay received Form SSA-1099, showing net benefits of $7,500 in box 5. Jay also has a taxable pension of $23,000 and interest income of $500, but has no tax-exempt interest income. Marsha received Form-SSA, showing new benefits of $3,500 in box 5.

To figure their taxable benefits, complete Worksheet 11-1. Then compare the amount on line E to the base amount for their filing status.

Jay and Marsha's benefits are not taxable for 2016 because the amount calculated on line E ($28,000) is less than the base amount ($32,000) for Married Filing Jointly.

Even though their benefits are not taxable, they must file a return for 2016 because their taxable gross income ($23,500) exceeds the minimum filing requirement for their filing status.

Social Security Benefits Worksheet—Lines 20a and 20b

Keep for Your Records

Before you begin:
- ✓ Complete Form 1040, lines 21 and 23 through 32, if they apply to you.
- ✓ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36).
- ✓ If you are married filing separately and you lived apart from your spouse for all of 2013, enter "D" to the right of the word "benefits" on line 20a. If you do not, you may get a math error notice from the IRS.
- ✓ Be sure you have read the **Exception** in the line 20a and 20b instructions to see if you can use this worksheet instead of a publication to find out if any of your benefits are taxable.

1.	Enter the total amount from **box 5** of **all** your **Forms SSA-1099** and **Forms RRB-1099.** Also, enter this amount on Form 1040, line 20a **1.** $11,000		
2.	Enter one-half of line 1	**2.**	$5,500
3.	Combine the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21	**3.**	$22,500
4.	Enter the amount, if any, from Form 1040, line 8b	**4.**	$0
5.	Combine lines 2, 3, and 4	**5.**	$28,000
6.	Enter the total of the amounts from Form 1040, lines 23 through 32, plus any write-in adjustments you entered on the dotted line next to line 36	**6.**	
7.	Is the amount on line 6 less than the amount on line 5? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. ☒ **Yes.** Subtract line 6 from line 5	**7.**	$28,000
8.	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 2013, enter $25,000 • Married filing separately and you lived with your spouse at any time in 2013, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17	**8.**	$32,000
9.	Is the amount on line 8 less than the amount on line 7? ☒ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b. If you are married filing separately and you **lived apart** from your spouse for all of 2013, be sure you entered "D" to the right of the word "benefits" on line 20a. ☐ **Yes.** Subtract line 8 from line 7	**9.**	
10.	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 2013	**10.**	
11.	Subtract line 10 from line 9. If zero or less, enter -0-	**11.**	
12.	Enter the **smaller** of line 9 or line 10	**12.**	
13.	Enter one-half of line 12	**13.**	
14.	Enter the **smaller** of line 2 or line 13	**14.**	
15.	Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	**15.**	
16.	Add lines 14 and 15	**16.**	
17.	Multiply line 1 by 85% (.85)	**17.**	
18.	**Taxable social security benefits.** Enter the **smaller** of line 16 or line 17. Also enter this amount on Form 1040, line 20b	**18.**	

TIP *If any of your benefits are taxable for 2013* ***and*** *they include a lump-sum benefit payment that was for an earlier year, you may be able to reduce the taxable amount. See Pub. 915 for details.*

Retirement Income

IRAs, Pensions, and Annuities

Distributions from IRAs, pensions, annuities and other retirement plans are usually reported to the taxpayer on Form 1099-R and might be fully or partially taxable.

Retirement income is generally classified as one of the following types:

- Pension
- Annuity
- IRA

Distributions from IRAs, pensions, and annuities are fully taxable if the taxpayer has no investment in the contract because any of the following situations could apply:

- Taxpayer did not contribute anything nor was considered to have contributed anything for the pension or annuity
- Employer did not withhold contributions from employee's salary
- Taxpayer received all of their contributions tax free in prior years

If the taxpayer contributed after-tax dollars to his or her pension or annuity, the distributions are partially taxable. Tax will not be imposed upon the part of the distribution which represents a return of after-tax amounts paid into the plan.

If a distribution was made before the taxpayer reached age 59 ½, it is considered to be an early distribution. An addition 10% tax is imposed upon early distributions unless qualified for an exception.

Pension
A pension is generally a series of definitely determinable payments made to a taxpayer after he or she retires from work. Pension payments are made regularly and are based on such factors as years of service and prior compensation.

Annuity
An annuity is a series of payments under a contract made at regular intervals over a period of more than one full year. Annuities can be either fixed (under which the taxpayer receives a definite amount) or variable (not fixed). Taxpayers can buy the contract alone or with the help of their employer.

Pensions and annuities include the following types:

- **Fixed-period annuities -** Taxpayers receive definite amounts at regular intervals for a specified length of time.
- **Annuities for a single life -** Taxpayers receive definite amounts at regular intervals for life. The payments end at death.
- **Joint and survivor annuities -** The first annuitant receives a definite amount at regular intervals for life. After he or she dies, a second annuitant receives a definite amount at regular intervals for life. The amount paid to the second annuitant might or might not differ from the amount paid to the first annuitant.
- **Variable annuities -** Taxpayers receive payments that may vary in amount for a specified length of time or for life. The amounts received might depend upon such variables as profits earned by the pension or annuity funds, cost-of-living indexes, or earnings from a mutual fund.
- **Disability pensions -** Taxpayers receive disability payments because he or she has retired on disability but has not reached the minimum retirement age.

Individual Retirement Arrangements (IRAs)

An Individual Retirement Arrangement, or IRA, is a personal savings plan that allows taxpayers to set aside money for retirement, while offering them tax advantages. Taxpayers might be able to deduct some or all of their contributions to an IRA and could also be eligible for a tax credit equal to a percentage of their contribution. Amounts in an IRA, including earnings, generally are not taxed until distributed. IRA's cannot be owned jointly, but any amounts remaining in an IRA upon the taxpayer’s death can be paid to a named beneficiary or beneficiaries.

There are four kinds of IRAs, each with different tax implications:

- **Traditional IRA** - Distributions from traditional IRAs are fully taxable unless nondeductible contributions have been made.
- **Roth IRA -** Distributions from a Roth IRA are tax-free and can be excluded from income if certain requirements are met.
- **Savings Incentive Match Plans for Employees (SIMPLE) IRA** - Generally, SIMPLE IRA contributions are not included in an employee’s income when paid into an IRA and the distributions are fully taxable when the employee receives them in later years.
- **Simplified Employee Pension (SEP) IRA** - Generally, SEP IRA contributions are not included in an employee’s income when paid into the IRA. Distributions are generally fully taxable when the employee receives them in later years.

Example: Louise did not have a retirement plan at her job. Every year she contributed $500 to a traditional IRA. Each year Louise deducted her traditional IRA contribution from her income. This year, she received her first distribution from the traditional IRA which is fully taxable. Louise will pay income tax on the distribution she receives (which represents the contributions she made and deducted) and the earnings on the contributions.

Retirement Income Reporting Statements

Payers of retirement income report benefits on various forms such as:

- Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
- Form CSA 1099-R, Statement of Annuity Paid (civil service retirement payments)
- Form CSF 1099-R, Statement of Survivor Annuity Paid

General Information about Retirement Plans

Receiving Benefits from More than One Program

For taxpayers who received benefits from more than one program under a single trust or plan of his or her employer, such as a pension plan and a profit-sharing plan, figure the taxable part of each pension or annuity contract separately.

Section 457 Deferred Compensation Plans

Taxpayers who work at a state or local government or tax-exempt organization might be able to participate in a section 457 deferred compensation plan, if eligible. Eligible plans 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. Amounts deferred in an eligible state or local government plan are taxed only when distributed from the plan, and only when made available to the taxpayer.

Disability Pensions

Generally, taxpayers who retire on disability must include in income any disability pension received under a plan paid for by the employer. Report taxable disability payments as wages on line 7 of Form 1040 or Form 1040A until the taxpayer reaches the minimum retirement age. Once the minimum retirement age is reached, payments received are taxable as a pension or annuity on the 1040.

Retired Public Safety Officers

An eligible retired public safety officer can elect to exclude from income distributions of up to $3,000 made directly from a government retirement plan to the provider of accident, health, or long-term disability insurance.

Withholding and Estimated Tax

The payer of the pension, profit-sharing, stock bonus, annuity, or deferred compensation plan withholds income tax on the taxable parts of amounts paid to the taxpayer. Taxpayers may choose how much to withhold, by filing Form W-4P. If no tax or not enough tax is withheld, it may be necessary for the taxpayer to pay estimated tax.

Generally, a 20% tax is withheld from an eligible rollover distribution. In this case, the taxpayer can't choose to have the tax withheld. No tax is withheld on a direct rollover of an eligible rollover distribution.

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. Plans can cover self-employed persons, such as the sole proprietor, partners, and regular (common-law) employees.

Distributions from a qualified plan are usually fully taxable because most recipients have no cost basis. If the taxpayer has an investment (cost) in the plan, however, the pension or annuity payments from a qualified plan are taxed under the Simplified Method, covered later in this course.

Purchased Annuities

In most cases, the General Rule (covered later) is used to figure the tax-free part of annuity payments from a privately purchased annuity contract from a commercial organization, such as an insurance company.

Loans

If money is borrowed from the retirement plan, treat the loan as a nonperiodic distribution from the plan unless certain exceptions apply. Include in income all or part of the amount borrowed.

Tax-Free Exchange

No gain or loss is recognized on an exchange of an annuity contract for another annuity contract if the insured or annuitant remains the same. If, however, an annuity contract is exchanged for a life insurance or endowment contract, any gain due to interest accumulated on the contract is ordinary income.

Figuring Cost of Plan

Before figuring how much, if any, of a distribution from a pension or annuity plan is taxable, the cost in the pension or annuity must be determined.

The cost is the investment the taxpayer has made in the contract, and includes the total premiums, contributions, or other amounts paid. This also includes employer contributions taxable to the taxpayer when paid. Cost does not include any amounts deducted or excluded from income.

From this total cost, subtract any refunds of premiums, rebates, dividends, unrepaid loans not included in income, or other tax-free amounts received by the later of the annuity starting date or the date on which the first payment was received.

The annuity starting date is the later of the first day of the first period for which a payment is received and the date the plan's obligations became fixed.

Designated Roth Accounts

The cost in these accounts is the designated Roth contributions included in income as wages subject to applicable withholding requirements. The cost also includes any in-plan Roth rollovers included in income.

Foreign Employment Contributions

If the taxpayer worked in a foreign country and contributions were made to his or her retirement plan, special rules apply in determining cost. See Publication 575.

Fully Taxable Payments

Generally, if the taxpayer did not pay any part of the cost of an employee pension or annuity and the employer did not withhold part of the cost from the taxpayer's pay, the amounts received each year are fully taxable and must be reported as income on the tax return.

<u>Taxation of Periodic Payments</u>

Partly Taxable Payments

If the taxpayer paid part of the cost of the pension or annuity, the part of the pension or annuity received which represents a return of the cost is not taxable. The rest of the amount received is generally taxable. Figure the tax-free part of the payment using either the Simplified Method or the General Rule (both covered later). The annuity starting date and whether or not the plan is qualified determines which method to use.

- If the annuity starting date is after November 18, 1996 and payments are from a qualified plan, use the Simplified Method.
- Generally, the General Rule must be used if the annuity is paid under a nonqualified plan. It is not used if the annuity is paid under a qualified plan.
- If the annuity is paid under a qualified plan and the annuity starting date is after July 1, 1986, and before November 19, 1996, use either the General Rule or the Simplified Method.
- For taxpayers with more than one taxable pension or annuity, figure the tax-free part and the taxable part of each separately.

Exclusion Limit

The annuity starting date determines the total amount of annuity payments that can be excluded from taxable income over the years. Once the annuity starting date is determined, it does not change.

If calculating the taxable portion of annuity payments using the simplified method worksheet, the annuity starting date determines the recovery period for the taxpayer's cost. That recovery period begins on the annuity starting date.

Exclusion limited to cost - If the annuity starting date is after 1986, the total amount of annuity income that can be excluded over the years as a recovery of the cost cannot exceed the total cost. Any unrecovered cost at the taxpayer's (or the last annuitant's) death is allowed as a miscellaneous itemized deduction on the final return of the decedent.

Exclusion not limited to cost - If the annuity starting date is before 1987, the taxpayer can continue to take a monthly exclusion for as long as the annuity is received. For a joint and survivor annuity, the survivor can continue to take the survivor's exclusion figured as of the annuity starting date. The total exclusion may be more than the cost.

Calculating Taxable Portion

Taxpayers should use either the Simplified Method or the General Rule to calculate the taxable portion of annuity payments.

The Simplified Method should be used if the annuity starting date is after November 18, 1996, and both of the following are true:

- Taxpayer receives pension or annuity payments from a qualified employee plan, qualified employee annuity, or a tax-sheltered annuity (403(b)) plan
- On the annuity starting date the taxpayer was either under age 75 or entitled to fewer than five years of guaranteed payments

The General Rule is generally used to determine the tax treatment of pension and annuity income from nonqualified plans. The General Rule generally can be used only for qualified plans if the annuity start date was before November 19, 1996. For more information on the General Rule, see Publication 939, General Rule for Pensions and Annuities.

Simplified Method

Under the Simplified Method, figure the taxable and tax-free parts of annuity payments by completing the Simplified Method Worksheet, which divides the cost by the total number of anticipated monthly payments.

Cost ÷ Number of monthly payments = monthly tax-free portion

For an annuity that is payable for the lives of the annuitants, the number of payments 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.

Taxation on Nonperiodic Payments

Nonperiodic distributions are also known as amounts not received as an annuity and include all payments other than periodic payments and corrective distributions.

Examples of nonperiodic payments are cash withdrawals, distributions of current earnings, certain loans, and the value of annuity contracts transferred without full and adequate consideration.

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.

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, is received under certain life insurance or endowment contracts, or is allocable to an investment made before August 14, 1982.

Taxation on Nonperiodic Payments

The annuity starting date is either the first day of the first period for which an annuity payment is received under the contract or the date on which the obligation under the contract becomes fixed, whichever is later.

Distribution on or after annuity starting date - If a nonperiodic payment is received from an annuity contract on or after the annuity starting date, all of the payment is generally included in gross income.

Distribution before annuity starting date - If a nonperiodic distribution is received before the annuity starting date from a qualified retirement plan, allocate only part of it to the cost of the contract. Exclude from gross income the part allocated to the cost and include the remainder in gross income.

Lump-Sum Distributions

NOTE: The following information about lump-sum distributions applies only if the plan participant was born before January 2, 1936. If the plan participant was born after January 1, 1936, the taxable amount of this nonperiodic payment is reported as discussed earlier.

A lump-sum distribution is the distribution or payment in one 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 cannot qualify as a lump-sum distribution.

Use Form 4972, Tax on Lump Sum Distributions, 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 in as other income. This could result in a smaller tax than would normally be paid by including the taxable amount of the distribution as ordinary income in figuring regular tax.

The taxable portion of a lump-sum distribution can be treated in one of the following ways (if the taxpayer qualifies):

- Report the part of the distribution from participation before 1974 as a capital gain and the part from participation after 1973 as ordinary income.
- Report the part of the distribution from participation before 1974 as a capital gain and use the 10-year tax option to figure the tax on the part from participation after 1973.
- Use the 10-year tax option to figure the tax on the total taxable amount.
- Roll over all or part of the distribution, discussed later in this course. 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 the tax return.

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 the account. Recover the cost in the lump sum and any net unrealized appreciation (NUA) in employer securities tax free.

In general, the taxpayer’s cost is the sum of:

- The plan participant's nondeductible contributions to the plan
- The plan participant's taxable costs of any life insurance contract distributed
- Any employer contributions that were taxable to the plan participant
- Repayments of any loans which were taxable to the plan participant

These costs must be reduced 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. Elect this treatment only once for any plan participant, and only if the plan participant was born before January 2, 1936.

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. The tax is paid only once, in the year the distribution was received, not over 10 years. Elect this treatment only once for any plan participant, and only if the plan participant was born before January 2, 1936.

IRA Rollovers

Most distributions received from an IRA before retirement age can be “rolled over” by depositing the distribution in another retirement plan or IRA (or depositing back into the same account) within 60 days. Most financial institutions can deposit distributions directly into another plan or IRA. Usually if the distribution is deposited into an IRA within the 60 day limit, it is tax free. If the deadline is missed, taxpayers might owe tax and penalties on the distribution.

Review IRS Publications 590-A and 590-B for specific rules and requirements for IRAs and rollovers.

View this Rollover Chart which summarizes allowable rollover transactions.

ROLLOVER CHART

Roll From \ Roll To	Roth IRA	Traditional IRA	SIMPLE IRA	SEP-IRA	Governmental 457(b)	Qualified Plan[1] (pre-tax)	403(b) (pre-tax)	Designated Roth Account (401(k), 403(b) or 457(b))
Roth IRA	YES[2]	NO	NO	NO	NO	NO	NO	NO
Traditional IRA	YES[3]	YES[2]	NO	YES[2]	YES[4]	YES	YES	NO
SIMPLE IRA	YES,[3] after two years	YES,[2] after two years	YES[2]	YES,[2] after two years	YES,[4] after two years	YES, after two years	YES, after two years	NO
SEP-IRA	YES[3]	YES[2]	NO	YES[2]	YES[4]	YES	YES	NO
Governmental 457(b)	YES[3]	YES	NO	YES	YES	YES	YES	YES[3,5]
Qualified Plan[1] (pre-tax)	YES[3]	YES	NO	YES	YES[4]	YES	YES	YES[3,5]
403(b) (pre-tax)	YES[3]	YES	NO	YES	YES[4]	YES	YES	YES[3,5]
Designated Roth Account (401(k), 403(b) or 457(b))	YES	NO	NO	NO	NO	NO	NO	YES[6]

1 Qualified plans include, for example, profit-sharing, 401(k), money purchase and defined benefit plans
2 Only one rollover in any 12-month period
3 Must include in income
4 Must have separate accounts
5 Must be an in-plan rollover
6 Any amounts distributed must be rolled over via direct (trustee-to-trustee) transfer to be excludable from income
For more information regarding retirement plans and rollovers, visit Tax Information for Retirement Plans.

One-Rollover-Per-Year Rule

The IRS has historically applied an IRA-by-IRA limit on the 60-day rollover which allowed only one rollover per IRA in a 12 month period. Individuals often used rollovers as a “temporary loan” which was to be repaid within 60 days; and often found themselves taking a distribution from another IRA in order to “repay” the first IRA within the 60 days, thus beginning a second 60-day period in order to pay back the “loan”.

Example: Carl has three traditional IRAs: IRA 1, IRA 2, and IRA 3, each with a $15,000 balance. In 2014, Carl found himself in need of a loan. On February 1, 2014, he took a $12,000 distribution from IRA 1 with plans to repay that amount into the same IRA within 60 days.

On March 27, 2014, Carl realized that he would not yet be able to repay the $12,000 into IRA 1. He took a $12,000 distribution from IRA 2 in order to repay the amount in IRA 1 and avoid tax and penalties.

Carl found himself unable to repay IRA 2 in late May 2014. He took a distribution of $12,000 from IRA 3 on May 22, 2014 to repay the “loan” from IRA 2.

Carl was able to repay the “loan” on June 15, 2014 by repaying $12,000 to IRA 3. Since all the distributions were rolled over within the 60-day limit, Carl will not be assessed tax or penalties on the distributions.

Starting in January 2015, the IRS began enforcing new rules which allow taxpayers to rollover only one distribution per year, no matter how many IRAs the taxpayer owns. This comes after a tax court ruling in the case of *Bobrow v. Commissioner*, which expanded the interpretation of the once-per-year rollover rules. The court determined that only one rollover is allowed every 365 days on an aggregate basis rather than an account-by-account basis that had been previously used.

Aggregate of IRAs

The 12-month limit applies by aggregating, or combining, all IRAs owned by an individual, treating them as one IRA for the purpose of the rollover limit. These IRAs include:

- SEP
- SIMPLE
- Traditional
- Roth

Trustee-to-trustee transfers between IRAs are not limited.

Rollovers from traditional to Roth IRAs (conversions) are not limited, but may be subject to income tax, however the conversion will not be subject to the early distribution penalties.

Example: Lilly has two traditional IRAs; IRA 1 and IRA 2. Lilly takes a $5,000 distribution from IRA 1 on March 15, 2016. In order to avoid tax and penalties, Lilly must pay back or "rollover" $5,000 into either IRA within 60 days.

Under the new rules, Lilly cannot take a distribution from IRA 2 to pay back IRA 1 without paying taxes and penalties on the second distribution, even if paid back within 60 days. She must wait 365 days before taking another distribution from either IRA 1 or IRA 2.

Additional Taxes

Additional taxes are imposed on the early distribution of pension funds and on the failure to withdraw pension funds timely. In most cases, taxpayers are not subject to additional taxes if early distributions are rolled over, and the withdrawing of funds begins at a normal retirement age, in reasonable amounts, over their taxpayer's life expectancy.

Special additional taxes are taxes imposed on the following:

- Early distributions
- Excess accumulation (not receiving minimum distributions)

Early Distributions

Most distributions (both periodic and nonperiodic) from qualified retirement plans and nonqualified annuity contracts made before the taxpayer reaches age 59½ are subject to an additional tax of 10%. This tax applies to the part of the distribution that must be included 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
- 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 or from an IRA)

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 could apply instead. A 5% rate applies to distributions under a written election providing a specific schedule for the distribution of the interest in the contract if, as of March 1, 1986, the taxpayer had begun receiving payments under the election.

Distributions from Roth IRAs allocable to a rollover from an eligible retirement plan within the five-year period

If within the five-year period starting with the first day of the tax year in which the taxpayer rolled over an amount from an eligible retirement plan to a Roth IRA, he or she takes a distribution from the Roth IRA, the taxpayer might have to pay the additional 10% tax on early distributions. Generally, 10% additional tax must be paid on any amount attributable to the part of the rollover that was included in income.

The same rule applies to distributions from designated Roth accounts allocable to in-plan Roth rollovers within the five-year period.

Early Distribution Exceptions

Certain early distributions are excluded from the early distribution tax.

In general, the special early distribution tax does not apply to distributions that are:

- Made as part of a series of substantially equal periodic payments (made at least annually) for the life (or life expectancy) or the joint lives (or joint life expectancies) of the beneficiaries (if from a qualified retirement plan, the payments must begin after the separation from service)
- Made because the taxpayer is totally and permanently disabled
- Made on or after the death of the plan participant or contract holder

The early distribution tax does not apply to distributions that are:

- From a qualified retirement plan (other than an IRA) after a separation from service in or after the year the taxpayer reached age 55 (age 50 for qualified public safety employees)
- From a qualified retirement plan (other than an IRA) to an alternate payee under a qualified domestic relations order
- From a qualified retirement plan to the extent the taxpayer has deductible medical expenses (medical expenses that exceed 10% of adjusted gross income, 7.5% if age 65 or older), whether or not he or she itemizes deductions for the year
- From an employer plan under a written election that provides a specific schedule for distribution of the entire interest if, as of March 1, 1986, the taxpayer 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
- From elective deferral accounts under 401(k) or 403(b) plans or similar arrangements that are qualified reservist distributions

Qualified Public Safety Employees

For qualified public safety employees, distributions made from a governmental defined benefit pension plan are not subject to the additional tax on early distributions. Qualified public safety employees provide police protection, firefighting services, or emergency medical services for a state or municipality, and are separated from service in or after the year age 50 is attained.

Qualified Reservist Distributions

A qualified reservist distribution is not subject to 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, or a similar arrangement, (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. The taxpayer must have been ordered or called to active duty after September 11, 2001.

There are additional exceptions for nonqualified annuity contracts. The tax does not apply to distributions from:

- A deferred annuity contract to the extent allocable to investment in the contract before August 14, 1982
- A deferred annuity contract under a qualified personal injury settlement
- A deferred annuity contract purchased by the employer upon termination of a qualified employee plan or qualified employee annuity plan and held by the employer until the taxpayer's separation from service
- 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)

Excess Accumulation

Payments received from qualified retirement plans must begin no later than the required beginning date and the payments each year cannot be less than the required minimum distribution. These rules are in place to make sure that most retirement benefits are paid to the participant during the lifetime of the recipient rather than to the beneficiaries after the recipient's death.

If the actual distributions in any year are less than the minimum required distribution for that year, the taxpayer is 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 qualified employee plan
- A qualified employee annuity plan
- An eligible section 457 deferred compensation plan
- A tax-sheltered annuity plan (403(b) plan for benefits accruing after 1986)

NOTE: The tax might be waived if the taxpayer establishes that the shortfall in distributions was due to reasonable error and that reasonable steps are being taken to remedy the shortfall.

Unless the rule for 5% owners applies, the taxpayer must begin to receive distributions from a qualified retirement plan by April 1 of the year that follows the later of:

- The calendar year in which he or she reaches age 70½
- The calendar year in which her or she retires from employment with the employer maintaining the plan

Some plans require distributions to begin by April 1 of the year that follows the year in which the taxpayer reaches age 70½, even if he or she has yet to retire; 5% owners are required to begin receiving distributions by April 1 of the year that follows the calendar year in which he or she reaches age 70½.

By the required beginning date, the taxpayer must either receive the entire interest in the plan or begin receiving periodic distributions in annual amounts calculated to distribute the entire interest over his or her life or life expectancy or over the joint lives or joint life expectancies of the taxpayer and a designated beneficiary (or over a shorter period).

Capital Gains and Losses

Assets owned and used by the taxpayer for personal or investment purposes are considered capital assets. When a capital asset is sold, the difference between the basis (or investment) and the sales price is the capital gain or capital loss.

Capital gains fall into two categories: long-term and short-term. If an asset was held from more than one year, it is considered long-term; if held for one year or less, it is considered short-term.

Capital gains may be taxed at a lower rate than ordinary income tax rates. Losses from the sale of personal-use property cannot be deducted; however, there are some provisions (with limitations) to deduct net capital losses from investment property.

Capital gains and deductible capital losses are reported on Schedule D and on Form 8949.

Figure a gain or loss by comparing the amount realized with the adjusted basis of the property.

- **Gain** - If the amount realized from a sale or trade is more than the adjusted basis of the property transferred, the difference is a gain.
- **Loss** - If the adjusted basis of the property transferred is more than the amount realized, the difference is a loss.
- **Adjusted basis** - The adjusted basis of property is the original cost or other original basis properly adjusted (increased or decreased) for certain items.
- **Amount realized** - The amount realized from a sale or trade of property is everything received for the property minus the expenses of sale. The amount realized includes the money received plus the fair market value of any property or services received.

If property and cash is traded for other property, the amount realized is the fair market value of the property received. Determine the gain or loss by subtracting the cash paid plus the adjusted basis of the property traded in from the amount realized. If the result is a positive number, it is a gain. If the result is a negative number, it is a loss.

Example: Angie Anders purchased 100 shares of the ABC Company of at $10 a share or $1,000. Eighteen months after she purchased the stock, the share price increased to $20 a share and Angie sold all the stock for $2,000. She had no expenses in the purchase or sale of the stock. Angie has a long-term capital gain of $1,000 ($2,000 sales price - $1,000 investment). The gain is considered long-term because the stock was held for more than one year.

Schedule D and Form 8949

Schedule D is used to report gains and losses as the result of the sale or trade of certain property. Form 8949 is used to report the details on each transaction. Usually taxpayers complete Form 8949 before the Schedule D is completed as the total from Form 8949 flows to Schedule D.

There are some exceptions as to when Form 8949 is required. Review the instructions for Schedule D and Form 8949 to learn more.

Other Income

Taxpayers must report all items of income received in the form of money, property and services, unless tax law states otherwise. Some income received is taxable, some income may be partly taxed, and some income can be excluded from being taxed.

Bartering

Bartering is an exchange of property or services. The fair market value of property or services received in bartering are included in income. If the parties involved agree upon value of the services, that value is accepted as fair market value unless the value can be shown to be otherwise.

Generally, this income is reported on the *Schedule C, Profit or Loss from Business*, or Schedule C-EZ, Net Profit from Business; however, if the barter involves an exchange of something other than services, another form or schedule may have to be used.

Form 1099-B Barter Exchange

Property or services exchanged through a barter exchange are reported to taxpayers on *Form 1099-B, Proceeds From Broker and Barter Exchange Transactions*. It should show the value of cash, property, services, or credits received from exchanges during the tax year.

Canceled Debt

Generally, if a debt owed is canceled or forgiven, other than as a gift or bequest, the cancelled amount must be included in income.

If the debt is a nonbusiness debt, report the canceled amount on Form 1040, line 21.

If it is a business debt, report the amount on Schedule C, C-EZ (Form 1040) or *Schedule F, Profit or Loss from Farming*, if the debt is farm debt and the taxpayer is a farmer.

Form 1099-C

If a Federal Government agency, financial institution, or credit union cancels or forgives a debt of $600 or more, the taxpayer will receive a *Form 1099-C, Cancellation of Debt*. The amount of the canceled debt is shown in box 2.

If any interest is forgiven and included in the amount of canceled debt in box 2, the amount of interest is also shown in box 3. Whether or not to include the interest portion of the canceled debt in income depends on whether the interest would be deductible if the taxpayer paid it.

- If the interest would not be deductible (such as interest on a personal loan), include in income the amount from Form 1099-C, box 2.
- If the interest would be deductible (such as on a business loan), include in income the net amount of the canceled debt (the amount shown in box 2 less the interest amount shown in box 3).

Repayment of Canceled Debt

If the canceled amount is included in income, and later the taxpayer pays the debt, a claim for refund can be filed for the year the amount was included in income.

Other cancelled debts can include the following:
- Discounted mortgage loans
- Mortgage relief upon sale or other disposition
- Stockholder debt

Discounted mortgage loans

If a financial institution offers a discount for the early payment of a mortgage loan, the amount of the discount is canceled debt and the canceled amount must be included in income.

Mortgage relief upon sale or other disposition

If a taxpayer is personally liable for a mortgage (recourse debt), and is relieved of the mortgage, a gain or loss may be realized on 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, discussed later. The income is reported on Form 1040, line 21. For taxpayer's not personally liable for a mortgage (nonrecourse debt) relieved of mortgage debt (such as through foreclosure), that relief is included in the amount realized. There could be a taxable gain if the amount realized exceeds the adjusted basis in the property. Report any gain on nonbusiness property as a capital gain.

Stockholder debt

If a corporation cancels or forgives stockholder's debt, the canceled debt is a constructive distribution that is generally dividend income to the stockholder. If the stockholders cancels a debt owed by the corporation, the stockholder (taxpayer) does not recognize the income. The canceled debt is considered as a contribution to the capital of the corporation equal to the amount of debt principal canceled.

Exceptions

There are several exceptions to the inclusion of canceled debt in income.

> **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 the student works for a certain period of time in certain professions for any of a broad class of employers. The canceled amount is not included in income if this provision is part of a loan made by a qualifying institution.
>
> **Deductible debt –** The cancellation of a debt is not considered income if the payment of the debt would be deductible (for taxpayer's using the cash method of accounting only).
>
> **Price reduced after purchase –** If the seller reduces the amount of debt owed for property purchased, the reduced amount is not included in income. The reduction is treated as a purchase price adjustment and reduces the basis in the property.

Excluded Debt

Do not include a canceled debt in gross income in any of the following situations:

- The debt is canceled in a bankruptcy case under title 11 of the U.S. Code.
- The debt is canceled when the taxpayer is insolvent (exclude only up to the amount by which the taxpayer is 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.

Host or Hostess

If a taxpayer hosts a party or event at which sales are made, any gift or gratuity received for giving the event is payment for helping a direct seller make sales. This item must be reported as income at its fair market value.

The 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 received for giving the party.

Life Insurance Proceeds

Life insurance proceeds paid upon the death of an insured are not taxable unless the policy was turned over 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.

- **Lump sum payment** - If death benefits are paid in a lump sum or other than at regular intervals, include in income only the amount of benefits that are more than the amount payable to at the time of the insured person's death. If the benefit payable at death is not specified, include in income the benefit payments that are more than the present value of the payments at the time of death.

- **Installment payments** – If life insurance proceeds are received in installments, exclude part of each installment from income. To determine the excluded part, divide the amount held by the insurance company by the number of installments to be paid. Include anything over this excluded part in income as interest.

NOTE: If insurance proceeds are paid because of the death of a spouse before October 23, 1986, and those payments are received in installments, exclude up to $1,000 a year of the interest included in the installments, even if the taxpayer remarries.

Surrender of policy for cash

If a life insurance policy is surrendered for cash, include in income any proceeds that are more than the cost of the life insurance policy.
Taxpayer’s should receive Form 1099-R showing the total proceeds and the taxable part. Report these amounts on lines 16a and 16b of Form 1040.

Endowment Contract Proceeds

An endowment contract is a policy under which a specified amount of money is paid on a certain date unless the person dies before that date, and the money is paid to a designated beneficiary. Endowment proceeds paid in a lump sum at maturity are taxable only if the proceeds are more than the cost of the policy.

To determine the cost, subtract the amount previously received under the contract and excluded from income from the total premiums paid for the contract. Include in income the part of the lump sum payment that is more than the total cost.

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.

- Accelerated death benefits are fully excludable if the insured is a terminally ill individual.
- 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.

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 person, or has as a financial interest in the person's business.

Public Safety Officer Killed in the Line of Duty

The survivor of a public safety officer who was killed in the line of duty may be able to exclude from income certain amounts received.

For more information, see *Publication 559, Survivors, Executors, and Administrators*

<u>Recoveries</u>

A recovery is a return of an amount either taken as a deduction or a credit in an earlier year. The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A. A taxpayer can also have a recovery on previously deducted bad debts or a previously claimed a tax credit.

Include a recovery in income the year it’s received up to the amount by which the deduction or credit taken for the recovered amount reduced the taxpayer’s tax in the earlier year. Any increase to an amount carried over to the current year that resulted from the deduction or credit is considered to have reduced tax in the earlier year.

State Tax Refunds

A state or local income tax refund (or credit or offset) received during the tax year must be included in income if the tax was deducted in an earlier year. Taxpayers should receive Form 1099-G, Certain Government Payments. The amount included goes on line 10 of the 1040.

If filing Form 1040, use the *State and Local Income Tax Refund* worksheet in the Form 1040 instructions for line 10 to figure the amount (if any) to include in income.

If choosing to deduct for a tax year either state and local income taxes or state and local general sales taxes, then the maximum amount to include in income is limited to the excess of the tax chosen to be deducted for that year over the tax not chosen to be deducted for that year.

Mortgage Interest Refund

If the taxpayer received a refund or credit of mortgage interest paid in an earlier year, the amount is shown in box 3 of *Form 1098, Mortgage Interest Statement*. Do not subtract the refund amount from the interest paid in the current tax year. Certain rules may require it to be included in income.

- **Interest on recovery -** Interest on any of the amounts recovered must be reported as interest income in the year received. For example, report any interest received on state or local income tax refunds on Form 1040, line 8a.
- **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 the taxpayer received a refund or other recovery that is for amounts paid in 2 or more separate years, allocate, on a *pro rata* basis, the recovered amount between the years in which it was paid. Information on allocating these amounts can be found in the *Recoveries* section of Publication 525.

Itemized Deduction Recoveries

Generally, the full amount recovered from a prior year Schedule A deduction must be included in income the year its received.

Enter state or local income tax refunds on Form 1040, line 10, and the total of all other recoveries as other income on Form 1040, line 21. (Form 1040A or Form 1040EZ cannot be used.)

Only the amount of itemized deductions that are more than the standard deduction are subject to the recovery rule, unless the taxpayer is required to itemize deductions. If the total deductions on the earlier year return were not more than the total income for that year, include in income this year the lesser of the recoveries or the amount by which the itemized deductions exceeded the standard deduction.

If the taxpayer could claim an additional standard deduction for certain taxes or a net disaster loss, increase the standard deduction for that year.

Recovery limited to deduction

Do not include in income any amount of a recovery that is more than the amount deducted in the earlier year. The amount to include in income is limited to the smaller of either the amount deducted on Schedule A (Form 1040), or the amount recovered.

Rents from Personal Property

If the taxpayer rents out personal property, such as equipment or vehicles, the income and expenses required to be reported depends on:

- Whether or not the rental activity is a business, and
- Whether or not the rental activity is conducted for profit.

If the primary purpose of the rental the property is to produce income or profit and the taxpayer is involved in the rental activity with continuity and regularity, the rental activity is a business. The income and expenses are reported on Schedule C or C-EZ. Include the rental expenses in the total amount entered on Form 1040, line 36. Enter amount and “PPR” on the dotted line next to line 36.

If the taxpayer is not in the business of renting personal property, report the rental income on Form 1040, line 21. List the type and amount of the income on the dotted line next to line 21.

Repayments

If the taxpayer had to repay an amount that was included in income in an earlier year, the amount repaid from income may be deductible the year it is paid.

Or, if the amount repaid is more than $3,000, a credit may be taken against tax for the year it is paid. Generally, a deduction or credit can be claimed only if the repayment qualifies as an expense or loss incurred in a trade or business or in a for-profit transaction.

The type of deduction allowed in the year of repayment depends on the type of income it was included in the prior year. Generally, deduct the repayment on the same form or schedule on which it was previously reported as income.

If the amount repaid was $3,000 or less, deduct it from income in the year it's repaid.
If the amount repaid was more than $3,000, the repayment can be deducted. However, the taxpayer can choose instead to take a tax credit for the year of repayment if it was included in income under a claim of right on the prior year return.

When determining whether the amount repaid is more or less than $3,000, consider the total amount being repaid on the return. Each instance of repayment is not considered separately. Figure the tax for 2012 using one of the following methods:

Method 1 - Figure the tax for the current year claiming a deduction for the repaid amount. If the taxpayer must take it as a miscellaneous itemized deduction, enter it on Schedule A, line 28.

Method 2 - Figure the tax for the current year claiming a credit for the repaid amount. Follow these steps.

1. Figure the tax without deducting the repaid amount.

2. Refigure the tax from the earlier year without including in income the amount repaid.

3. Subtract the tax in (2) from the tax shown on the return for the earlier year. This is the credit.

4. Subtract the answer in (3) from the tax 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 the credit figured in (3) above on Form 1040, line 71, by adding the amount of the credit to any other credits on this line, and entering "I.R.C. 1341" in the column to the right of line 71.

Royalties

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income.

In most cases, royalties are reported in Part I of Schedule E. However, if the taxpayer holds an operating oil, gas, or mineral interest or is in business as a self-employed writer, inventor, artist, etc., report income and expenses on Schedule C or Schedule C-EZ.

Welfare and Other Public Assistance Benefits

Do not include in income governmental benefit payments from a public welfare fund based upon need, 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. Also, include in income any welfare payments that are compensation for services or that are obtained fraudulently.

Alternative Trade Adjustment Assistance (ATAA) Payments

Payments received from a state agency under the Demonstration Project for Alternative Trade Adjustment Assistance for Older Workers (ATAA) must be included in income. The amount to include in income is located on Form 1099-G and should be reported on Form 1040, line 21.

Persons with Disabilities

Include in income compensation received for services performed unless the compensation is otherwise excluded. However, do not include in income the value of goods, services, and cash received for training and rehabilitation because of 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 individuals with an intellectual disability do their work.

Disaster Relief Grants

Do not include post-disaster grants received under the Disaster Relief and Emergency Assistance Act in income if the grant payments are made to help the taxpayer meet necessary expenses or serious needs for medical, dental, housing, personal property, transportation, or funeral expenses.

Disaster Relief Payments

A qualified disaster is:

- A disaster which results from a terrorist or military action;
- A federally declared disaster; or
- A disaster which results from an accident involving a common carrier, or from any other event, which is determined to be catastrophic by the Secretary of the Treasury or his or her delegate.

Exclude from income all qualified disaster relief payments. Exclude payment amounts only to the extent any expense the payments pays for are not paid for by insurance or otherwise. Click to view a list of qualified disaster relief payments.

Disaster Mitigation Payments

Exclude from income any amounts received from a qualified disaster mitigation payment.

Home Affordable Modification Program (HAMP)

Benefits from Pay-for-Performance Success Payments under HAMP, the payments are not taxable.

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.

Medicare

Medicare benefits received under title XVIII of the Social Security Act are not includible in the gross income of the individuals for whom they are paid. This includes basic (part A (Hospital Insurance Benefits for the Aged)) and supplementary (part B (Supplementary Medical Insurance Benefits for the Aged)).

Old-age, Survivors, and Disability Insurance Benefits (OASDI)

OASDI payments under section 202 of title II of the Social Security Act are not includible in the gross income of the individuals to whom they are paid.

Nutrition Program for the Elderly

Food benefits received under the Nutrition Program for the Elderly are not taxable. If the taxpayer prepares and serves free meals for the program, include in income as wages the cash pay received, even if the taxpayer is also eligible for food benefits.

Activity Not For Profit

Include in income all payments received from an activity not expected to make a profit. For example, profit from a hobby or a farm operated mostly for recreation and pleasure.
Enter this income on Form 1040, line 21.

Alimony

Include in income on Form 1040, line 11, alimony payments. Amounts received for child support are not considered income.

Campaign Contributions

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 Form 1040, line 21, in the year transferred.

Child Support Payments

Child support payments are not reported as income on a return.

Court Awards and Damages

To determine if settlement amounts received must be included in income, 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.

Do not include in income compensatory damages for personal physical injury or physical sickness (whether received in a lump sum or installments).

Damages received for emotional distress due to a physical injury or sickness are not included in income. If the emotional distress is due to a personal injury that is not due to a physical injury or sickness (for example, employment discrimination or injury to reputation), include the damages in income, except for any damages received for medical care due to that emotional distress.

Fees for Services

Include all fees for services in income. Examples of these fees are amounts received for services performed as:

- A corporate director
    - Report these payments on Schedule C
- An executor, administrator, or personal representative of an estate,
    - Report fees on Form 1040, line 21. If the taxpayer is in the trade or business of being an executor, report as self-employment income on Schedule C
- A manager of a trade or business operated before declaring Chapter 11 bankruptcy,
    - Report this income on Form 1040, line 21
- A notary public, or
    - Report these payments on Schedule C
- An election precinct official.
    - Report these payments on line 7 of Form 1040

Foster Care Providers

Payments received from a state, political subdivision, or a qualified foster care placement agency for providing care to qualified foster individuals, are not included in income.

However, include in income payments received for the care of more than 5 individuals age 19 or older and certain difficulty-of-care payments.

Difficulty-of-care payments 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. Include in income difficulty-of-care payments received for more than10 qualified foster individuals under age 19, or 5 qualified foster individuals age 19 or older.

Gambling Winnings

Include gambling winnings in income on Form 1040, line 21. If itemizing deductions, deduct gambling losses for the year, but only up to the amount of the winnings.

NOTE: Winnings from lotteries and raffles are gambling winnings. In addition to cash winnings, include in income the fair market value of bonds, cars, houses, and other noncash prizes.

If the taxpayer received *Form W-2G, Certain Gambling Winnings*, showing the amount of gambling winnings and any tax taken out of them, include the amount from box 1 on Form 1040, line 21. Include the amount shown in box 2 on Form 1040, line 62, as federal income tax withheld.

Gifts and Inheritances

In most cases, property received as a gift, bequest, or inheritance is not included in income. However, if the property produces income such as interest, dividends, or rents, that income is taxable. If property is given to a trust and the income from it is paid, credited, or distributed to the taxpayer, that income is also taxable. If the gift, bequest, or inheritance is the income from the property, that income is also taxable.

Jury Duty

Jury duty pay must be included in income on Form 1040, line 21.

If the pay is turned over to the employer because the employer continues to pay the taxpayer's salary while serving duty, deduct the amount turned over to the employer as an adjustment to income. Enter the amount repaid to the employer on Form 1040, line 36. Enter "Jury Pay" and the amount on the dotted line next to line 36.

Medical Savings Accounts (MSAs)

In most cases, do not include in income amounts withdrawn from an Archer MSA or Medicare Advantage MSA if the money is used to pay for qualified medical expenses.

Generally, qualified medical expenses are those deductible on *Schedule A, Itemized Deductions*, which is covered in Domain 3.

Prizes and Awards

The fair market value of prizes and awards are reported as income on Form 1040, line 21. If the prize is refused, its value does not need to be included in income.

Cash awards or bonuses given by an employer for good work generally must be included in in income as wages. However, certain noncash employee achievement awards can be excluded from income, discussed in an earlier study guide.

There are exceptions for Pulitzer, Nobel, and similar prizes.

Qualified Tuition Programs (QTPs)

The part of a qualified tuition program distribution representing the amount paid or contributed to the program is not included in income. This is a return of the investment in the program.
In most cases, the beneficiary does not include in income any earnings distributed from a QTP if the total distribution is less than or equal to adjusted qualified higher education expenses.

Sale of Personal Items

If an item owned for personal use is sold, such as a car, refrigerator, furniture, stereo, jewelry, or silverware, the gain is taxable as a capital gain. Report it as explained in the instructions for the Schedule D. If an item is sold that is 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.

Union Benefits and Dues

Amounts deducted from a taxpayer’s pay for union dues, assessments, contributions, or other payments to a union cannot be excluded from income.

Some of these payments may be deductible as a miscellaneous deduction subject to the 2%-of-AGI limit if they are related to the taxpayer’s job and he or she itemizes.

Strike or lockout benefits paid, including both cash and the fair market value of other property, are usually included in income as compensation.

Skill Check Domain 2, Part 2

1. Lonnie works as an employee of Stork and Stork Law Firm as a paralegal. At the end of the year, what statement should she receive from her employer reporting her income for the entire year?

A. Schedule C

B. Form 1099-MISC

C. Form W-4

D. Form W-2

2. Luis received Social Security benefits of $10,000 in 2016. He also received a taxable pension of $25,000 and $1,000 in interest on his savings account, which is not tax-exempt. Luis files a Single tax return. Are any portion of his 2016 Social Security benefits taxable?

A. Yes

B. No

3. Distributions from an IRA are considered early if made before that taxpayer reaches what age?

A. Age 65

B. Age 60 ½

C. Age 59 ½

D. Age 65 ½

4. Which form is used to calculate self-employment tax?

A. Schedule C

B. Form W-2

C. Form 1099-MISC

D. Schedule SE

5. Nellie purchased a U.S. savings bond with her own money, but the bond was in both hers and her son Nat's name. After the bond matured, Nat redeemed the bond and kept all of the proceeds. Who should report the interest earned in the bond?

A. Nellie

B. Nat

C. Both Nellie and Nat

D. Neither Nellie nor Nat

6. The original cost of property or assets that has been increased or decreased by certain items is called the ________________.

A. Gain

B. Loss

C. Amount Realized

D. Adjusted Basis

7. Desse received interest income during the tax year. Assuming she would not otherwise be required to file Schedule B, what amount of interest income received would require her to file a Schedule B?

A. $1

B. $600

C. $1,600

D. $1,500

8. Which of the following types of income is non-taxable?

A. Alimony

B. Federal tax refunds

C. Military pay

D. Sick pay

9. Which taxpayer should report his or her tips to their employer?

A. Elsa, a server, received a total of $15 in cash tips during the month.

B. Sven, a hairdresser, received tickets to a local musical as a tip.

C. Kris, a valet, received a $25 gift card to his favorite bookstore.

D. Anna, who delivers pizza, received a $25 tip via credit card.

10. Sick pay is not considered to be wages and is not taxable. True or False.

A. True

B. False

11. Generally, amounts received from money market funds should be reported as _________.

A. Wages

B. Savings Bonds

C. Interest

D. Dividends

12. What form should the payer use to report interest paid to the taxpayer after a U.S. Savings Bond is redeemed?

A. Form 1099-MISC

B. Form 1099-INT

C. Form 1099-SSA

D. Form 1099-G

13. IRAs cannot be owned jointly. True or False?

A. True

B. False

14. Which of the following taxpayers can exclude the award received from income?

A. Violet received a new barbeque grill as an award for her outstanding performance.

B. Cora received a $50 bonus for completing the project before the deadline.

C. Alfred received a new watch on his 10-year anniversary with the company as a longevity award.

D. Isobel was awarded a weekend getaway to Lake Tahoe because she met her sales quota for the year.

15. Ivy spent two years in Paris learning the art of French cooking. While there, she opened both a checking and savings account at a local bank in Paris. In 2016, she earned $50 interest from the savings account and the total value of her accounts in France is $1,000. Which of the following is true?

A. Ivy doesn’t have to report foreign interest on her U.S. tax return.

B. Ivy should report the foreign interest she earned on Schedule B, Part I, and complete Schedule B, Part III.

C. Ivy is not required to report foreign interest if the total value of her foreign accounts is less than $10,000.

D. Ivy should complete Schedule C to report her foreign interest income.

Skill Check Domain 2, Part 2 – Answer Key

1. Lonnie works as an employee of Stork and Stork Law Firm as a paralegal. At the end of the year, what statement should she receive from her employer reporting her income for the entire year?

A. Schedule C

Incorrect. Schedule C is filed with a tax return to report self-employed and statutory employee's earnings.

B. Form 1099-MISC

Incorrect. Form 1099-MISC is used to report payments made to a person in a trade or business, usually for broker payments, rents, nonemployee compensation, prizes and awards, etc.

C. Form W-4

Incorrect. Form W-4 is used by an employer to determine the amount of taxes to withhold from salary.

D. Form W-2

Correct. Form W-2 shows total wages paid to an employee as well as any taxes or other amounts withheld during the year.

2. Luis received Social Security benefits of $10,000 in 2016. He also received a taxable pension of $25,000 and $1,000 in interest on his savings account, which is not tax-exempt. Luis files a Single tax return. Are any portion of his 2016 Social Security benefits taxable?

A. Yes

Correct. Some of Luis's Social Security benefits will be taxable. One-half ($10,000 ÷ 2 = $5,000) of his benefits plus total other income ($25,000 + $1,000 = $26,000) is $31,000 ($5,000 + $26,000). This amount is more than the base amount for his filing status ($25,000 for Single) so some portion will be taxable ($31,000 > $25,000)

B. No

Incorrect. Some of Luis's Social Security Benefits will be taxable. One-half ($10,000 ÷ 2 = $5,000) of his benefits plus total other income ($25,000 + $1,000 = $26,000) is $31,000 ($5,000 + $26,000). This amount is more than the base amount for his filing status ($25,000 for Single) so some portion will be taxable ($31,000 > $25,000).

3. Distributions from an IRA are considered early if made before that taxpayer reaches what age?

A. Age 65

Incorrect. Age 65 is not the age for which early distributions are determined.

B. Age 60 ½

Incorrect. Age 60 ½ is not the age for which early distributions are determined.

C. Age 59 ½

Correct. Distributions made before the taxpayer reaches age 59 ½ are considered early distributions and might be subject to a penalty.

D. Age 65 ½

Incorrect. Age 65 ½ is not the age for which early distributions are determined.

4. Which form is used to calculate self-employment tax?

A. Schedule C

Incorrect. Schedule C is used to calculate net profit or loss for business.

B. Form W-2

Incorrect. Form W-2 reports income, deductions, withholdings, etc for an employee.

C. Form 1099-MISC

Incorrect. Form 1099-MISC reports payments received by a non-employee.

D. Schedule SE

Correct. Schedule SE is used to calculate the amount of self-employment tax due.

5. Nellie purchased a U.S. savings bond with her own money, but the bond was in both hers and her son Nat's name. After the bond matured, Nat redeemed the bond and kept all of the proceeds. Who should report the interest earned in the bond?

A. Nellie

Correct. Even if a U.S. Savings Bond has co-owners, the taxpayer who provided the funds to purchase the bond should report the interest, even of the other owner redeemed the bond.

B. Nat

Incorrect. Elliot would not report the interest because he did not buy the bond.

C. Both Nellie and Nat

Incorrect. If a savings bond is issued in the names of co-owners, the interest is generally reported only by the owner who purchased the bond.

D. Neither Nellie nor Nat

Incorrect. Interest on a savings bond is usually reportable for the taxpayer who purchased the bond.

6. The original cost of property or assets that has been increased or decreased by certain items is called the ________________.

A. Gain

Incorrect. The gain is the amount realized from a sale or trade over the adjusted basis.

B. Loss

Incorrect. If the amount realized from a sale or trade is less than the adjusted basis, this is considered a loss.

C. Amount Realized

Incorrect. The amount realized is the sum of money plus the fair market value of any property received in a transaction less the expense of the sale.

D. Adjusted Basis

Correct. The adjusted basis is the net cost of an asset or property after adjusting the cost by various allowed items.

7. Desse received interest income during the tax year. Assuming she would not otherwise be required to file Schedule B, what amount of interest income received would require her to file a Schedule B?

A. $1

Incorrect. If Desse had only $1 of interest income, she would not be required to file Schedule B.

B. $600

Incorrect. If Desse had only $600 of interest income, she would not be required to file Schedule B.

C. $1,600

Correct. If Desse has more than $1,500 in interest, she must file Schedule B.

D. $1,500

Incorrect. Desse is not required to file Schedule B unless she receives more than $1,500 in interest income.

8. Which of the following types of income is non-taxable?

A. Alimony

Incorrect. Alimony should be included in income and is taxable.

B. Federal tax refunds

Correct. Federal tax refunds are not taxable.

C. Military pay

Incorrect. Military pay is generally taxed as wages.

D. Sick pay

Incorrect. Sick pay is considered to be part of salaries and wages.

9. Which taxpayer should report his or her tips to their employer?

A. Elsa, a server, received a total of $15 in cash tips during the month.

Incorrect. Total tips of any one month that are less than $20 do not need to be reported to the employer.

B. Sven, a hairdresser, received tickets to a local musical as a tip.

Incorrect. It is not necessary to report the value of tickets or passes received as a tip to the employer.

C. Kris, a valet, received a $25 gift card to his favorite bookstore.

Incorrect. Noncash tips (checks and debit/credit cards are considered cash) do not need to be reported to the employer.

D. Anna, who delivers pizza, received a $25 tip via credit card.

Correct. Total cash tips, including those made with checks and debit/credit cards, for the month that are more than $20, should be reported to the employer.

10. Sick pay is not considered to be wages and is not taxable. True or False.

A. True

Incorrect. Pay received from employers while sick or injured is considered salary or wages.

B. False

Correct. Sick pay is taxable and included in income as wages.

11. Generally, amounts received from money market funds should be reported as _________.

A. Wages

Incorrect. Wages are generally earned income received from an employer.

B. Savings Bonds

Incorrect. Savings bonds are issued to the general public by the government.

C. Interest

Incorrect. Money market accounts pay interest, not money market funds.

D. Dividends

Correct. Income received from money market funds should be reported as dividends.

12. What form should the payer use to report interest paid to the taxpayer after a U.S. Savings Bond is redeemed?

A. Form 1099-MISC

Incorrect. Form 1099-MISC reports payments received in the course of conducting a trade or business.

B. Form 1099-INT

Correct. When a savings bond is cashed, the payer should provide the taxpayer with Form 1099-INT if the interest on the bond is $10 or more.

C. Form 1099-SSA

Incorrect. The 1099-SSA reports Social Security benefits received.

D. Form 1099-G

Incorrect. Form 1099-G reports government payments, such as state refunds and offsets.

13. IRAs cannot be owned jointly. True or False?

A. True

Correct. IRAs cannot be owned jointly; however, the amount remaining in an IRA account at the time of death can be paid to beneficiaries.

B. False

Incorrect. IRAs cannot be owned jointly.

14. Which of the following taxpayers can exclude the award received from income?

A. Violet received a new barbeque grill as an award for her outstanding performance.

Incorrect. The fair market value of awards for outstanding work is included in income.

B. Cora received a $50 bonus for completing the project before the deadline.

Incorrect. Bonuses received for outstanding work is included in income.

C. Alfred received a new watch on his 10-year anniversary with the company as a longevity award.

Correct. Tangible personal property awarded for length of service can generally be excluded from income.

D. Isobel was awarded a weekend getaway to Lake Tahoe because she met her sales quota for the year.

Incorrect. The fair market value of prizes for outstanding performance is included in income.

15. Ivy spent two years in Paris learning the art of French cooking. While there, she opened both a checking and savings account at a local bank in Paris. In 2016, she earned $50 interest from the savings account and the total value of her accounts in France is $1,000. Which of the following is true?

A. Ivy doesn't have to report foreign interest on her U.S. tax return.

Incorrect. Taxpayers are required to report foreign interest income.

B. Ivy should report the foreign interest she earned on Schedule B, Part I, and complete Schedule B, Part III.

Correct! Taxpayers are required to complete Schedule B, Part III if interest income is from a foreign account or trust.

C. Ivy is not required to report foreign interest if the total value of her foreign accounts is less than $10,000.

Incorrect. Taxpayers are required to report foreign interest on their federal tax return regardless of the value of the foreign accounts.

D. Ivy should complete Schedule C to report her foreign interest income.

Incorrect. Profit or loss from business practiced as a sole proprietor is reported on Schedule C.

Domain 2, Part 3 – General Review of Subtractions from Income

Domain 2 of this course provides a general review of the individual tax return. Part 3 reviews information regarding different subtractions that can be made from income.

Sections in Part 3 of this domain include:

- Adjustments to Income
- Standard Deduction
- Itemized Deductions
- Skill Check

Domain 2, Part 3 Objectives

Domain 2 of the Annual Federal Tax Refresher (AFTR) Course reviews important concepts and guidelines in preparing individual tax returns.

After completing Domain 2 Part 3, participants should be able to:

- Recognize standard deduction amounts
- Identify eligible deductions from gross income
- Recall limits imposed on various itemized deductions
- Calculate the Pease Limitation

Adjustments to Income

Adjusted gross income (AGI) is gross income minus certain adjustments (subtractions) to income. A taxpayer's AGI has several implications and can determine deductions and credits a taxpayer might be eligible to take. Federal AGI can even impact a state tax return.

Educator Expenses

Eligible educators may deduct up to $250 of qualified expenses paid during the tax year. If a joint return is being filed and both the taxpayer and spouse are educators, each spouse may deduct up to $250 for a maximum deduction of $500.

The PATH Act of 2015 permanently extended this deduction.

Certain Business Expenses of Reservists, Performing Artists, and Fee-Based Government Officials

Deductions are allowed for:

- Certain business expenses of National Guard and reserve members who traveled more than 100 miles from home to perform services as a National Guard or reserve member
- Performing-arts-related expenses as a qualified performing artists
- Business expenses of a fee-based state or local government officials

Health Savings Account (HSA)

Taxpayers might be able to deduct some contributions (other than employer contributions, rollovers, and qualified HSA funding distributions from an IRA) made to an HSA for the tax year. Use Form 8889 to determine if a deduction can be taken.

Moving Expenses

Reasonable moving expenses incurred in connection with a job or business can be deducted if certain tests are met. The new workplace must be at least 50 miles farther from the old home than the old home was away from the old workplace. If there was no former workplace, the new workplace must be at least 50 miles from the old home.

The move must also be closely related in time to the start of work at the new location, generally expenses incurred within a year from the date the taxpayer first reported to work in the new location. Employees must work full-time 39 weeks during the first 12 months immediately following the arrival in the new location. Self-employed persons must also 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 immediately following their arrival.

Members of the military who move due to a military order or permanent change of station do not need to meet the distance or time “tests.”

Moving expenses are figured on Form 3903. Expenses reimbursed by an employer and expenses for meals are not deductible.

Self-Employment Tax

Self-employed taxpayers who owe self-employment tax may deduct one-half of the SE tax. The deductible amount is calculated on Schedule SE.

Self-Employed SEP, SIMPLE, and Qualified Plans

Taxpayers with self-employment income might be able to deduct contributions made to a SEP-IRA, SIMPLE IRA, and 401(k) retirement plan.

Self-Employed Health Insurance Deduction

Self-employed taxpayers might be able to deduct amounts paid for health insurance for themselves, spouse, and dependents (or a child under the age of 27 at the end of the year, even if the child is not the taxpayer's dependent).

Penalty of Early Withdrawal of Savings

Taxpayers can take a deduction on the penalty incurred on the early withdrawal of savings. The deduction is taken on line 30 of the 1040.

Form 1099-INT or Form 1099-OID shows the amount of any penalty the taxpayer was charged.

Alimony Paid

Taxpayers who make alimony payments to a spouse or former spouse under a divorce or separation instrument might be able to take a deduction. Amounts paid under divorce or separate maintenance decrees or written separation agreements are not always considered alimony. Table 18-1 in Publication 17 can help determine if payments are alimony.

Table 18-1. Alimony Requirements (Instruments Executed After 1984)

Payments ARE alimony if all of the following are true:	**Payments are NOT alimony if any 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.*

IRA Deduction

Taxpayers who made contributions during the tax year to a traditional IRA might be able to take an IRA deduction. The taxpayer (and spouse if filing a joint return) must have had earned income to take the IRA deduction.

For IRA purposes, earned income includes:

- Alimony and separate maintenance payments reported on line 11
- Nontaxable combat pay (if the taxpayer is a member of the U.S. Armed Forces)
- Net earnings from self-employment

The IRA Deduction Worksheet is used to figure the amount of the IRA deduction.

Student Loan Interest Deduction

Student loan interest is interest paid during the year on a qualified student loan. Generally, taxpayers can deduct the lesser of $2,500 or the amount of interest actually paid.

The student loan interest deduction is available to taxpayers who:

- Paid interest during the tax year on a qualified student loan
- Are legally obligated to pay interest on a qualified student loan
- Are not filing Married Filing Separately
- Have a modified adjusted gross income (MAGI) less than: $80,000 if Single, Head of Household, or Qualifying Widow(er), or less than $160,000 if Married Filing Jointly
- Cannot be claimed as dependents on someone else's return

A qualified student loan is taken solely to pay qualified higher education expenses. IRS publication 970 describes specifically which expenses qualify.

Tuition and Fees Deduction

Taxpayers might be able to deduct qualified education expenses paid during the year for themselves, their spouse, or their dependent(s). The tuition and fees deduction can reduce the amount of income subject to tax by up to $4,000. The total deduction is reported on line 34 of the 1040.

Taxpayers may deduct tuition and fees if all the following conditions are met:

- Qualified education expenses of higher education were paid in the tax year for academic periods beginning in the tax year and those beginning in the first three months of the next year
- Education expenses were paid for an eligible student
- The eligible student is taxpayer, spouse, or taxpayer's dependent(s)

The tuition and fees deduction cannot be claimed if:

- The filing status of the return is Married Filing Separately
- Taxpayer can be claimed as a dependent of another
- The taxpayer's modified adjusted gross income (MAGI) is more than $80,000 ($160,000 if Married Filing Jointly)
- The taxpayer (or spouse) was 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
- The taxpayer or anyone else claims an American Opportunity or Lifetime Learning credit in the tax year with respect to expenses to the student for whom the qualified education expenses were paid

Domestic Production Activities Deduction

Taxpayers might may be able to take up to 9% of qualified production activities income from the following activities:

- Construction of real property performed in the United States
- Engineering or architectural services performed in the United States for construction of real property in the United States
- Any lease, rental, license, sale, exchange, or other disposition of:
    - Tangible personal property, computer software, and sound recordings manufactured produced, grown, or extracted in whole or in significant part in the United States
    - Any qualified film the taxpayer produced
    - Electricity, natural gas, or potable water the taxpayer produced in the United States

In certain cases, the references above to the United States include Puerto Rico. The deduction can be reduced if the taxpayer had oil-related qualified production activities income.

For details, see Form 8903, Domestic Production Activities Deduction, and its instructions. The deduction is taken on line 35 of the 1040.

Write-In Deductions

Form 1040, line 36, provides space to “write-in” adjustments not included in lines 23-35.

Some items which can be included as write-in deductions include:

- Archer MSA deduction
- Jury duty pay surrendered to employer
- Deductible expenses related to income reported on line 21 from the rental of personal property engaged in for profit
- Reforestation amortization and expenses
- Repayment of supplemental unemployment benefits under the Trade Act of 1974
- Contributions to section 501(c) (18)(D) pension plans
- Attorney fees and court costs paid in connection with an award from the IRS for information the taxpayer provided that helped the IRS detect tax law violations

Figuring Adjusted Gross Income

Once all adjustments have been determined and reported on Form 1040, lines 23-35, total all the adjustments including any “write-in” adjustments included on line 36. Subtract the total adjustments from gross income (Form 1040, line 22) to arrive the adjusted gross income (AGI) on line 37.

If the adjusted gross income is less than zero, the taxpayer may have a net operating loss (NOL) that could be carried to another tax year. See instructions for Form 1045 for more information regarding net operating losses (NOLs).

Example: Walter files a Single return and works as a high school biology teacher. His 2016 income reported on Form W-2 was $40,000 and was his only source of income. During 2016, Walter paid $12,000 in alimony to his ex-wife Daisy.

Walter's gross income for 2016 was $40,000 and he may deduct up to $12,000 in alimony paid to his ex-wife; therefore, his adjusted gross income (AGI) is $28,000 ($40,000 - $12,000).

	20a	Social security benefits . . 20a | b Taxable amount			20b	
	21	Other income			21	
	22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** . . . ▶			22	40,000
Adjusted Gross Income	23	Educator expenses	23			
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ . . .	24			
	25	Health savings account deduction. Attach Form 8889	25			
	26	Moving expenses. Attach Form 3903	26			
	27	Deductible part of self-employment tax. Attach Schedule SE .	27			
	28	Self-employed SEP, SIMPLE, and qualified plans	28			
	29	Self-employed health insurance deduction	29			
	30	Penalty on early withdrawal of savings	30			
	31a	Alimony paid **b** Recipient's SSN ▶ 400-00-5115	31a	12,000		
	32	IRA deduction	32			
	33	Student loan interest deduction	33			
	34	Tuition and fees. Attach Form 8917	34			
	35	Domestic production activities deduction. Attach Form 8903 .	35			
	36	Add lines 23 through 35			36	12,000
	37	Subtract line 36 from line 22. This is your **adjusted gross income** . . . . ▶			37	28,000

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Form **1040** (2014)
EEA

Standard Deduction

Standard Deduction vs Itemized Deduction

After figuring the adjusted gross income (AGI), either the standard deduction or itemized deductions may reduce the AGI. In most cases, the taxpayer can choose which deduction to take and usually takes the largest deduction which results in the lowest tax.

The standard deduction is a fixed amount that is based upon the taxpayer's filing status and age, and whether or not the taxpayer is blind. It can also be reduced for taxpayers who can be claimed as an exemption by another taxpayer. The standard deduction is usually adjusted for inflation from year to year. It is advantageous to take the standard deduction if it is larger than the taxpayer's total allowable itemized deductions.

2016 Standard Deduction Amounts (for taxpayers under age 65 and who are NOT blind)

- Single $6,300
- Married Filing Jointly $12,600
- Head of Household $9,300
- Married Filing Separately $6,300
- Qualifying Widow(er) $12,600

Taxpayers who are at least 65 years or old or blind receive larger standard deduction amounts. The age and vision of a taxpayer (if filing jointly) is counted separately for each spouse.

There are additional standard deduction amounts for taxpayers age 65 or older or blind or both. After determining if the taxpayer is at least age 65 or blind, an additional amount can be added to the standard deduction amount for each occurrence (taxpayer and spouse). For unmarried taxpayers filing Single or Head of Household, the additional amount is $1,550. For taxpayers considered married and filing as Married Filing Jointly, Qualifying Widow(er), or Married Filing Separately, the additional amount added is $1,250 for each occurrence.

The additional amount for blindness will be allowed if the taxpayer or spouse are totally or partly blind on the last day of the tax year. If partly blind, a certified statement from an optometrist or eye doctor must be obtained declaring no more than 20/200 vision in one eye (even with eye glasses or contact lenses), or that the field of vision is not more than 20 degrees.

Example: Holden, age 67, and Phoebe, age 63, are married and plan to file as Married Filing Jointly. Phoebe is visually impaired, but Holden has perfect vision. They do not plan to take itemized deductions.

Since Holden is age 65 or older and Phoebe is blind, they can add $2,500 ($1,250 x 2) to their standard deduction. The standard deduction for a Married Filing Jointly couple is $12,600; therefore, Holden and Phoebe may use $15,100 ($12,600 + $2,500) as their standard deduction.

If someone else could claim the taxpayer (or spouse) as a dependent, the standard deduction amounts might be limited or reduced. If this is the case, the Standard Deduction Worksheet for Dependents should be used to calculate the standard deduction amount.

If the taxpayer is a dependent of another, not blind, and younger than age 65, he or she can generally deduct the greater of $1,050 or earned income plus $350. The standard deduction cannot exceed the basic standard deduction for taxpayer’s filing status. Earned income includes wages, salaries, tips, professional fees, and other compensation received for personal services performed.

Example: Archie, a high school student, worked at the local grocery store during the summer. He earned $1,750 in 2016. Archie's parents claim him as a dependent on their return, however he wants to file a return to claim a refund. Since Archie is the dependent of another, his standard deduction might be limited.

To arrive at the standard deduction amount, add $350 to the earned income of $1,750 which results in $2,100. Compare that calculation to the minimum standard deduction of $1,050. Since $2,100 is greater than the minimum of $1,050, Archie's standard deduction would be $2,100. This amount is allowed since it is not more than the basic standard deduction for his filing status of Single ($6,300).

Standard Deduction Restrictions

Sometimes taxpayers are not eligible to take the standard deduction and must itemize any allowable deductions.

The standard deduction may not be taken by:

- A married taxpayer whose filing status is Married Filing Separately and whose spouse is itemizing deductions
- Taxpayers filing a short year tax return in order to change their annual accounting period
- Taxpayers who were nonresident or dual-status aliens during the year

Itemized Deductions

Even though most taxpayers are eligible to take the standard deduction, it is more advantageous for some taxpayers to take the total allowable itemized deductions. The allowable itemized deductions are specific and can be sometimes be limited. If a taxpayer itemized, Schedule A and Form 1040 must be filed (cannot file 1040EZ or 1040A).

Once the amount of itemized deductions are determined, the amount is carried to Form 1040, line 40, and then subtracted from AGI.

Medical and Dental Expenses

A taxpayer may deduct certain medical and dental expenses paid that exceed 10% of AGI (7.5% if taxpayer or spouse is 65 or older) Form 1040, line 38. IRS Publication 502 explains medical and dental expenses that can be claimed on Schedule A, and expenses that cannot be deducted.

The deduction is allowed for expenses paid for the prevention and alleviation of a physical or mental defect or illness. Medical expenses include those related to diagnosis, cure, mitigation, treatment, or prevention of disease, or treatment affecting any function or structure of the body.

Deduction guidelines

- Expenses must be for taxpayer, spouse, or dependent, or for anyone who would qualify as a dependent except for having a gross income of more than $4,000
- Expenses must be paid during the current tax year, regardless of when incurred
- Expenses must not be compensated by insurance
- Expenses must not be paid out of a tax-free medical savings or health savings account
- The taxpayer subtracts from the deduction total any reimbursement of medical expenses, whether they were paid to the taxpayer or directly to the doctor or hospital

Qualifying expenses include but are not limited to:

- Professional services - doctors, dentists, surgeons, chiropractors, psychiatrists, psychologists, acupuncturists, Christian Science practitioners
- Care services - hospital, qualified long-term care, nursing, laboratory, inpatient drug or alcohol treatment
- Medications - insulin, prescription drugs
- Diseases - diagnosis, mitigation, cure, treatment or prevention
- Smoking cessation - program fees, prescription drugs to alleviate nicotine withdrawal (this does not include nicotine gum or patches)
- Weight loss - program fees to attend weight loss programs for specific diseases, including obesity, diagnosed by a physician
- Transportation - primarily for and essential to medical care
  Vehicle use - actual out-of-pocket expenses or the standard mileage rate for medical expenses (24 cents per mile); expenses for parking and tolls can be included for either method
- Conferences - admission and transportation for conferences relating to the chronic diseases of taxpayer, spouse, dependent
- Eye care - prescription eye glasses, contact lenses or laser eye surgery
- Supplementary items - false teeth, hearing aids, crutches, wheelchairs, guide dogs for the blind or deaf
- Insurance premiums - accident, health, long-term care insurance
  (Self-employed persons with a net profit might be able to deduct 100% of medical insurance premiums)

Non-qualifying expenses include:

- Non-prescription over-the-counter medicines or drugs
- Funeral / burial
- Most cosmetic surgery
- Attending a program for the improvement of general health
- Meals and lodging while attending a qualifying conference
- Diet food
- Insurance premiums for life insurance, loss of wages, or any policy that pays a guaranteed amount each week due to sickness
- Insurance premiums paid by employer, unless the premiums are included in box 1 of Form W-2

Deductible Taxes

Taxpayers who itemize might be able to deduct state, local, and foreign income taxes. State and local personal property taxes and state and local sales tax (in lieu of state income taxes) may also be deductible. Certain state, local and foreign real estate taxes are deductible as well.

State and local income taxes withheld from wages are deductible in the year withheld. State and local income tax estimates or prior-year payments are also deductible in the year paid. Foreign income taxes usually qualify as an itemized deduction or tax credit in the year paid.

Taxpayers have the option of deducting state and local income tax or local sales tax, not both. The taxpayer can claim the actual amount paid in sales tax or a standard amount based on the taxpayer's income level and the sales tax rate of the taxpayer's residence. The PATH Act of 2015 permanently extended this provision so there is no longer an annual expiration for this deduction.

Personal property taxes are deductible if the tax is imposed on an annual basis and is based on the assessed value of the property. Taxes not based on value of property are not deductible.

Deductible real estate taxes are generally local, state, and foreign taxes based upon the assessed value of real estate.

Example of taxes that are not deductible include federal income tax, Social Security tax, stamps, and inheritance or estate tax.

Example: Reed's state charges him a yearly vehicle registration tax of 1% of the car's value plus 40 cents per hundredweight. He paid a total registration of $65 based on the car's value ($5,000) and weight (3,750 pounds). Reed can deduct only the tax based upon value as an itemized deduction, which is $50 (1% of $5,000). The remaining $15 assessed on the car's weight is not deductible.

Deductible Interest

Some interest paid is deductible on Schedule A. In order for interest to be deductible the taxpayer must be liable for the debt and the interest must be paid in the current year. Home mortgage interest and investment interest (limited to net investment income) are both deductible. Personal interest cannot be deducted. Personal interest is interest paid on a loan to purchase personal property such as a car, credit card, or installment interest for personal expenses, and other nonbusiness-related properties.

Example: Max paid several types of interest during the year. He paid $5,000 in home mortgage interest, $1,000 in interest on his car loan, and $450 in credit card interest. Only the $5,000 in home mortgage interest would be deductible on Max's Schedule A.

Gifts to Charity

Charitable contributions are donations made to qualified charitable organizations. The contributions can be monetary or physical property. Qualified charitable contributions are deductible as itemized deductions. Taxpayers must also meet such record-keeping requirements as retaining receipts, bank statements, cancelled checks, etc. IRS Publication 526 outlines the requirements for each donation type.

Qualified organizations can be public or private foundations, including religious organizations, fraternal orders, non-profit hospitals and schools, foundations for the prevention of cruelty to children, and organizations of war veterans. Payments to individuals are never deductible.

Limits also apply on deductible amounts in addition to the general limits on itemized deductions. Specific record-keeping requirements must be met in order to deduct charitable contributions and vary depending on the value and type of contribution. For non-cash contributions of more than $500, Form 8283 may be required. For more information, see Publication 526, Charitable Contributions.

Deductible Contributions

Contributions can be in cash, property, or out-of-pocket expenses paid to do volunteer work for the kinds of organizations described earlier. If the taxpayer drove to and from the volunteer work, he or she can take the actual cost of gas and oil or 14 cents per mile. Add parking and tolls to the amount the taxpayer claims under either method, but do not deduct any amounts that were repaid to the taxpayer.

Example: Leroy volunteers for the local humane society. He has contributed $200 in cash and has driven 250 miles associated with driving to and from the animal shelter. Leroy can deduct his cash contribution and either his actual costs for gas and oil or 14 cents per mile. If Leroy chooses to deduct mileage, he can deduct $235.

$200 + (250 X $0.14) = $235

Nondeductible Contributions

Some examples of contributions that cannot be deducted are:

- Travel expenses (including meals and lodging) while away from home, unless there was no significant element of personal pleasure, recreation, or vacation in the travel
- Political contributions
- Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups
- Cost of raffle, bingo, or lottery tickets
- Value of the taxpayer's time or services
- Value of blood given to a blood bank
- Gifts to individuals and groups that are run for personal profit
- Gifts to foreign organizations
- Gifts to groups whose purpose is to lobby for changes in the laws
- Gifts to civic leagues, social and sports clubs, labor unions, and chambers of commerce

Casualty, Theft, and Losses

Casualty, theft, and losses are the unexpected loss of property and are deductible as an itemized deduction. A casualty occurs when property is damaged as the result of an identifiable event that is sudden, unexpected, and unusual. A theft occurs when property is taken or removed with the intent to deprive the owner of it. A theft is not mislaid or lost property. A loss on deposits occurs when a financial institution becomes insolvent or bankrupt.

The amount the taxpayer can deduct as casualty or theft is the amount not reimbursable by insurance.

Casualty and theft losses are reported on Form 4684 and are carried to Schedule A.

Job Expenses and Certain Miscellaneous Deductions

Certain expenses can be deducted as miscellaneous itemized deductions on Schedule A, but are allowed only to the extent they exceed 2% of AGI.

Deductions subject to the 2% limit fall into the three categories:

- Unreimbursed employee expenses
- Tax return preparation fees
- Other expenses

Unreimbursed Employee Expenses

Unreimbursed employee expenses can be deducted only if paid or incurred during the tax year for carrying on the trade or business of being an employee. The expenses must be ordinary and necessary. Some examples of unreimbursed employee expenses include:

- Dues to professional societies
- Legal fees related to job
- Occupational taxes
- Licenses and regulatory fees
- Passports for a business trip
- Union dues and expenses
- Work-related education
- Tools and supplies used in job
- Certain educational expenses

Form 2106

Form 2106 is filed to report unreimbursed employee expenses. The taxpayer must fill in and attach Form 2106 if either of the following applies:

- The taxpayer claims any travel, transportation, meal, or entertainment expenses for his or her job
- The taxpayer's employer paid the taxpayer for any job expenses that the taxpayer would otherwise report on line 21

If the taxpayer does not have to file Form 2106 or 2106-EZ, list the type and amount of each expense on the dotted line next to line 21 on Schedule A. If more space is needed, attach a statement showing the type and amount of each expense. Enter the total of all these expenses on line 21.

Example: Troy is required to wear protective clothing and provide his own safety equipment for his job as a welder. He is a member of a professional welding organization and pays yearly dues. He does not pay for any travel, transportation, meal, or entertainment expenses for his job. Troy's employer did not pay him for any of the job expenses that he incurred.

Because Troy paid for his job expenses, he can deduct them on line 21 of Schedule A. It is not necessary for him to complete Form 2106 because he did not pay any travel, transportation, meal, or entertainment expenses for his job and because Troy's employer did not pay him for any of job expenses that he incurred.

Certain Miscellaneous Deductions

Tax Preparation Fees

Taxpayers can usually deduct fees paid to have their tax return prepared in the year they were paid. Fees paid to a tax professional, cost of tax preparation software programs and tax publications, and fees paid for electronically filing a tax return can be deducted (subject to limits). Enter the expenses paid on Schedule A, line 22.

Other Expenses

Other expenses that are limited to the amounts that exceed 2% of AGI are reported on Schedule A, line 23, and include:

- Certain legal and accounting fees
- Clerical help and office rent
- Custodial (for example, trust account) fees
- The taxpayer's share of the investment expenses of a regulated investment company
- Certain losses on non-federally insured deposits in an insolvent or bankrupt financial institution
- Casualty and theft losses of property used in performing services as an employee from Form 4684, lines 32 and 38b, or Form 4797, line 18a
- Deduction for repayment of amounts under a claim of right if $3,000 or less
- Convenience fee charged by the card processor for paying the taxpayer's income tax (including estimated tax payments) by credit or debit card. The deduction is claimed for the year in which the fee was charged to the card.

Other Miscellaneous Deductions

Only the expenses listed next can be deducted on line 28 of Schedule A. List the type and amount of each expense on the dotted lines next to line 28. If more space is necessary, attach a statement showing the type and amount of each expense. Enter one total on line 28. These deductions are not limited.

- Gambling losses (gambling losses include, but are not limited to, the cost of non-winning bingo, lottery, and raffle tickets), but only to the extent of gambling winnings reported on Form 1040, line 21
- Casualty and theft losses of income-producing property from Form 4684, lines 32 and 38b, or Form 4797, line 18a
- Loss from other activities from Schedule K-1 (Form 1065-B), box 2
- Federal estate tax on income in respect of a decedent
- Amortizable bond premium on bonds acquired before October 23, 1986
- Deduction for repayment of amounts under a claim of right if more than $3,000
- Certain unrecovered investment in a pension
- Impairment-related work expenses of a disabled person

For more details, see IRS Publication 529.

<u>Pease Limitation</u>

Taxpayers who elect to itemize deductions rather than using the standard deduction might have a reduced deduction with the Pease limitation. This limitation reduces the total of itemized deductions for high-income taxpayers.

These phase-outs for limit on itemized deduction begins with an AGI of:

- $155,650 for taxpayers filing Married Filing Separately
- $259,400 for taxpayers filing Single
- $285,350 for taxpayers filing as Head of Household
- $311,300 for taxpayers filing either Married Filing Jointly or as Qualifying Widow(er)

If it is determined a taxpayer's itemized deductions are subject to the limit, the total of itemized deductions is reduced by the smaller of:

- 80% of itemized deductions that are affected by the limit (See Publication 17)
- 3% of the amount by which AGI exceeds threshold amount

The Pease limitation applies only to certain itemized deductions. It does not apply to the medical expense deduction, the investment interest deduction, or casualty, theft, or gambling loss deductions.

Skill Check Domain 2, Part 3

1. Cory, age 67, is divorced and lives alone. He doesn't provide support for any other individual. If Cory takes the standard deduction, how much can he deduct on his 2016 federal tax return?

A. $6,300

B. $9,300

C. $1,550

D. $7,850

2. Jada graduated college in 2013 and has since been paying off her student loans. Last year, she paid $3,300 in interest on her qualified student loan. Jada files a single return, cannot be claimed as a dependent on anyone else's return, and her gross income was $42,000. How much can Jada deduct as a student loan interest deduction on Form 1040, line 33?

A. $3,300

B. $0

C. $2,000

D. $2,500

3. Which of the following is deductible on Schedule A as an itemized deduction but is allowed only in the amount it exceeds 2% of AGI?

A. Charitable Contributions

B. Tax Return Preparation Fees

C. Gambling Losses

D. Casualty and Theft Losses

4. Which of the following taxpayers would receive the largest standard deduction for 2015?

A. Trevor, age 27, files a single return. He has no visual impairment.

B. Gary, age 54, and Patricia, age 49, file as Married Filing Jointly. Gary is considered legally blind, but Patricia's vision is perfect.

C. James, age 70, and Ginger, age 65, file a joint return and neither are visually impaired.

D. Roxanne, age 45, files as a Qualifying Widow and is legally blind.

5. Eli and Margot are married and file a joint return. Eli has $250,000 in wages as a Network Administrator in 2016. Margot earned $125,000 as a department director for a large corporation. They have no adjustments to income and have a total of $23,500 in itemized deductions (unprotected). What will be the allowable amount of itemized deductions on their tax return?

A. $21,589

B. $18,800

C. $1,911

D. $23,500

6. Rodney is employed by a court reporting firm. He is paid a weekly salary but pays for the dues to the National Court Reporters Association and his continuing education from his personal funds. What form should he file to deduct these expenses if Rodney chooses to itemize?

A. Form 4684

B. Form 8889

C. Form 3903

D. Form 2106

7. Janet, age 16 and unmarried, lives with her parents and is a full-time high school student. During the summer, she earned $1,250 working as a receptionist. Janet's parents provide all her support and claim her as a dependent on their return. Janet plans to file a return to claim a refund. What standard deduction should Janet take on her return?

A. $1,600

B. $1,050

C. $1,250

D. $350

8. Which of the following charitable contributions can be deducted on Schedule A?

A. Contributions to a political campaign

B. Gifts to qualified religious organizations

C. Value of blood donated to blood bank

D. Cost of raffle tickets at a charity event

Skill Check Domain 2, Part 3 Answer Key

1. Cory, age 67, is divorced and lives alone. He doesn't provide support for any other individual. If Cory takes the standard deduction, how much can he deduct on his 2016 federal tax return?

A. $6,300

Incorrect. Since Cory is over age 65, he can deduct more than $6,300.

B. $9,300

Incorrect. Cory is not filing as Head of Household; therefore he cannot deduct $9,300.

C. $1,550

Incorrect. This amount is the additional amount for unmarried taxpayers over age 65.

D. $7,850

Correct! Cory may deduct the standard deduction amount for single filers plus the additional amount for taxpayers over age 65, $7,850 ($6,300 + $1,550).

2. Jada graduated college in 2013 and has since been paying off her student loans. Last year, she paid $3,300 in interest on her qualified student loan. Jada files a single return, cannot be claimed as a dependent on anyone else's return, and her gross income was $42,000. How much can Jada deduct as a student loan interest deduction on Form 1040, line 33?

A. $3,300

Incorrect. The student loan interest deduction is limited.

B. $0

Incorrect. Jada qualifies to take a student loan interest deduction.

C. $2,000

Incorrect. The student loan interest deduction limit is more than $2,000.
D. $2,500

Correct. Because Jada paid interest on a qualified student loan, her filing status is Single, she cannot be claimed on anyone else's tax return, and her MAGI is less than $75,000, she may deduct her student loan interest paid up to the limit of $2,500.

3. Which of the following is deductible on Schedule A as an itemized deduction but is allowed only in the amount it exceeds 2% of AGI?

A. Charitable Contributions

Incorrect. Charitable contributions are deductible on Schedule A, but are not subject to the 2% limit.

B. Tax Return Preparation Fees

Correct. Tax return preparation fees are deductible as an itemized deduction but subject to the 2% limit.

C. Gambling Losses

Incorrect. Gambling losses are deductible on Schedule A, but are limited to the amount of income reported as gambling winnings.

D. Casualty and Theft Losses

Incorrect. Deductible casualty and theft losses are not subject to the 2% AGI limit.

4. Which of the following taxpayers would receive the largest standard deduction for 2015?

A. Trevor, age 27, files a single return. He has no visual impairment.

Incorrect. Trevor's standard deduction for 2016 would be $6,300.

B. Gary, age 54, and Patricia, age 49, file as Married Filing Jointly. Gary is considered legally blind, but Patricia's vision is perfect.

Incorrect. Gary and Patricia's standard deduction for 2016 would be $13,850.

C. James, age 70, and Ginger, age 65, file a joint return and neither are visually impaired.

Correct. James and Ginger's standard deduction would be $15,100 because they are both over 65.

D. Roxanne, age 45, files as a Qualifying Widow and is legally blind.

Incorrect. Roxanne could deduct $13,850 as her standard deduction.

5. Eli and Margot are married and file a joint return. Eli has $250,000 in wages as a Network Administrator in 2016. Margot earned $125,000 as a department director for a large corporation. They have no adjustments to income and have a total of $23,500 in itemized deductions (unprotected). What will be the allowable amount of itemized deductions on their tax return?

A. $21,589

Correct. Since Eli and Margot's income exceed the threshold amount for the Pease Limitation, their itemized deduction may be reduced by either (a) the smaller of 80% of the unprotected itemized deductions, or (b) 3% of the amount by which AGI exceeds the threshold amount for their filing status ($311,300). Reduce their itemized deduction to 80% for a total of $18,800 (80% x $23,500), and compare it to $1,911 [3% x ($375,000 AGI - $311,300 threshold amount)], which is 3% of their AGI that exceeds the threshold. The smaller is $1,911; therefore, their itemized deduction would be $21,589 ($23,500 - $1,911).

B. $18,800

Incorrect. $18,800 is 80% of unprotected itemized deductions that may or may not reduce the itemized deductions.

C. $1,911

Incorrect. The amount $1,911 is 3% of the amount Eli and Margot's income exceeds the threshold for Married Filing Jointly.

D. $23,500

Incorrect. $23,500 is the full amount of itemized deductions. These taxpayers are subject to the Pease limitation due to their AGI and their itemized deductions will be reduced.

6. Rodney is employed by a court reporting firm. He is paid a weekly salary but pays for the dues to the National Court Reporters Association and his continuing education from his personal funds. What form should he file to deduct these expenses if Rodney chooses to itemize?

A. Form 4684

Incorrect. Form 4684 is used to report losses from casualties and thefts.

B. Form 8889

Incorrect. Form 8889 relates to Health Savings Accounts.

C. Form 3903

Incorrect. Moving expenses are reported on Form 3903.

D. Form 2106

Correct. Use Form 2106 to deduct ordinary and necessary employee expenses.

7. Janet, age 16 and unmarried, lives with her parents and is a full-time high school student. During the summer, she earned $1,250 working as a receptionist. Janet's parents provide all her support and claim her as a dependent on their return. Janet plans to file a return to claim a refund. What standard deduction should Janet take on her return?

A. $1,600

Correct. Janet can deduct the greater of $1,050 or earned income plus $350 up to the basic standard deduction amount. Her earned income of $1,250 plus $350 is $1,600. Since $1,600 is greater than $1,050, Janet may deduct $1,600 as her standard deduction.

B. $1,050

Incorrect. Janet may deduct the larger of $1,050 or her earned income plus $350. Since her earned income plus $350 is greater, she should deduct the larger amount instead of $1,050.

C. $1,250

Incorrect. Janet's earned income is $1,250.

D. $350

Incorrect. $350 is not a standard deduction amount.

8. Which of the following charitable contributions can be deducted on Schedule A?

A. Contributions to a political campaign

Incorrect. Political contributions are not considered charitable contributions.

B. Gifts to qualified religious organizations

Correct. Contributions made to qualified religious organizations are deductible on Schedule A.

C. Value of blood donated to blood bank

Incorrect. Donations of blood cannot be deducted on a tax return.

D. Cost of raffle tickets at a charity event

Incorrect. The expense of raffle tickets or lottery tickets are not considered to be charitable contributions.

Domain 2, Part 4 – General Review of Credits, Payments, and Refunds

Domain 2 of this course provides a general review of the individual tax return. Part 4 provides a review of credits, payments, and refunds.

Sections in Part 4 of this domain include:

- Credits
- Affordable Care Act Provisions
- Tax Withholding and Estimated Tax Payments
- Payment and Refund Options
- Skill Check

Domain 2, Part 4 Objectives

Domain 2 of the Annual Federal Tax Refresher (AFTR) Course reviews important concepts and guidelines used in preparing individual tax returns.

After completing Domain 2 Part 4, participants should be able to:

- Identify taxpayer eligibility for credits
- Recall different types of tax payments
- Recognize the Affordable Care Act as it relates to the Health Insurance Premium Tax Credit and the Individual Shared Responsibility Payment
- Determine payment and refund options

Credits

Nonrefundable and Refundable Credits

Taxpayers might be eligible to take certain credits in order to reduce tax liability. Credits provide a dollar-for-dollar reduction in taxes owed. Most credits are limited to the tax liability and are not refundable, but some credits, such as the Earned Income Tax Credit, are refundable. Refundable credits are not limited to the tax liability and can create a tax refund.

Nonrefundable tax credits include:

- Child and Dependent Care Credit
- Education Credits (American Opportunity Credit is also partly refundable)
- Credit for Elderly or Disabled
- Child Tax Credit
- Foreign Income Tax Credit
- Retirement Savings Contribution Credit
- Adoption Credit

Refundable credits include:

- Earned Income Credit
- Excess Social Security Credit
- Additional Child Tax Credit
- Premium Tax Credit
- American Opportunity Credit (partially refundable)

Earned Income Tax Credit

The Earned Income Tax Credit (EITC) is a refundable credit that reduces or eliminates the taxes paid by low-income workers. To claim the credit, the taxpayers must have earned income of less than $51,567 during the year.

To claim the credit, the taxpayers must file a tax return even if they are not required to file or do not owe any tax and they meet all the rules for taking the credits.

There are four parts to the all the rules for EITC:

- Rules for Everyone
- Rules for Taxpayers with Qualifying Child(ren)
- Rules for Taxpayers with no Qualifying Child(ren)
- Figuring and Claiming EITC

If the taxpayers have a qualifying child, rules in parts 1, 2 and 4 apply. If the taxpayers do not have a qualifying child, rules in parts 1, 3, and 4 apply.

Earned Income Credit – Rules for Everyone

Part 1 - Rules for Everyone

There are seven rules that must be met by everyone who claims the Earned Income Tax Credit for 2016.

Rule 1 – Taxpayers AGI must be less than:

- $47,955 ($53,505 for Married Filing Jointly) with three or more qualifying children
- $44,648 ($50,198 for Married Filing Jointly) with two or more qualifying children
- $39,296 ($44,846 for Married Filing Jointly) with one qualifying child
- $14,880 ($20,430 for Married Filing Jointly) with no qualifying child

Rule 2 - Taxpayers must have valid Social Security Number (SSN)

Taxpayers (and spouse if filing a joint return) must have a valid SSN. Taxpayers with Individual Taxpayer Identification Numbers (ITINs) are not eligible for EITC. The Social Security card must not read "Not Valid for Employment." Any qualifying child on the return must have a valid SSN, unless the child was born and died during the tax year.

Rule 3 – Filing status cannot be Married Filing Separately.

Rule 4 – Taxpayers must be U.S. citizens or resident aliens all year.

Rule 5 – Taxpayers cannot file Form 2555 or Form 2555-EZ

Rule 6 – Investment income must be $3,400 or less

To claim EITC, taxpayers must have $3,400 or less in investment income. For most taxpayers, investment income is the sum of taxable and tax-exempt interest, dividend income, and capital gain net income. If taxpayers file Schedule E, Form 4797, Form 8814, or reports income on Form 1040, line 21, for rental of personal property, review IRS Publication 596.

Rule 7 – Taxpayer (or spouse if Married Filing Jointly) must have earned income.

Earned income includes:

- Wages, salaries, and tips
- Taxable employee compensation
- Net earnings from self-employment
- Certain disability pay reported as wages
- Union strike benefits
- Combat pay (if elected to include nontaxable combat pay in taxable income)

Examples of unearned income include:

- Alimony
- Unemployment benefits
- Worker's Compensation
- Social Security benefits
- Retirement income
- Interest income
- Payments from public assistance programs
- Gambling winnings

Earned Income Credit – Part 2: Rules for Taxpayers with Qualifying Children

Taxpayers with qualifying children not only must meet all the rules in Part 1 – Rules for Everyone, but must also meet all the rules in Part 2 – Rules for Taxpayers with Qualifying Children. Rules in Part 4 – Figuring and Claiming EITC also apply.

Rule 8 – Qualifying children must meet relationship, age, residency, and joint return tests.

Relationship Test

To be a qualifying child, the child must be the taxpayer's:

- Son, daughter, stepchild, foster child, or a descendent of any of them
- Brother, sister, half-brother, half-sister, stepbrother, stepsister, or descendent of any of them

Age Test

The child must be:

- Under age 19 at the end of 2016 and younger than the taxpayer (or spouse if filing a joint return)
- Under age 24 at the end of 2016, a student, and younger than the taxpayer (or spouse if filing a joint return)
- Permanently and totally disabled at any time during 2016, regardless of age

Residency Test

The child must have lived with the taxpayer in the United States for more than half the year. A child who was born or died during the year is considered to have lived with the taxpayer more than half the year if the taxpayer's home was the main home more than half the time he or she was alive in the year.

Joint Return Test

To meet this test, the child cannot file a joint tax return for the year unless the child and his or her spouse file a joint return only to claim a refund.

Rule 9 – The qualifying child cannot be used by more than one person to claim EITC.

Even if a child meets the tests to be a qualifying child of more than one taxpayer, the child can be used as the qualifying child for EITC on only one tax return. Tiebreaker rules apply if more than one taxpayer may use the child as a qualifying child for EITC. Special rules also apply for children of divorced or separated parents. See Publication 596 for an explanation of the tiebreaker and special rules.

Rule 10 – Taxpayer cannot be the qualifying child of another taxpayer.

If a taxpayer does not have any qualifying children, but meets all the requirements in Part 1 – Rules for Everyone, he or she must also meet the rules in Part 3 – Rules for Taxpayers without Qualifying Children. Rules 11-14 must be met for these taxpayers.

Earned Income Credit – Part 3: Rules for Taxpayers without Qualifying Children

Rule 11 – Taxpayer must be at least age 25 but under age 65.

Taxpayer (or spouse if filing a married filing joint return) must be at least 25 years old or under 65 at the end of 2016.

Rule 12 – Taxpayer cannot be the dependent of another person.

Rule 13 – Taxpayer cannot be the qualifying child of another taxpayer.

Rule 14 – Taxpayer must have lived in the U.S. more than half of the year.

The taxpayer (and spouse if filing a joint return) must have been in the United States more than half of the year. Military personnel stationed outside the US on active duty are considered to have lived in the U.S during the duty period for EITC purposes.

Earned Income Credit – Part 4: Figuring and Claiming the EITC

If a taxpayer has met all the requirements in Part 1 – Rules for Everyone and Part 2 – Rules for Taxpayers with Qualifying Children, or Part 3 – Rules for Taxpayers without Qualifying Children, proceed to Part 4 – Figuring and Claiming EITC. Rules in this part must be met by anyone claiming EITC.

Rule 15 – Earned income must be less than certain limits.

The earned income on the tax return must be less than:

- $47,955 ($53,505 for Married Filing Jointly) with three or more qualifying children
- $44,648 ($50,198 for Married Filing Jointly) with two or more qualifying children
- $39,296 ($44,846 for Married Filing Jointly) with one qualifying child
- $14,880 ($20,430 for Married Filing Jointly) with no qualifying child

Figure EITC using the EIC worksheet. Schedule EIC must also be completed and filed with the tax return to claim the EITC if the taxpayer has a qualifying child.

The maximum credit for tax year 2016 is:

- $6,269 with three or more qualifying children
- $5,572 with two qualifying children
- $3,373 with one qualifying child
- $506 with no qualifying child

Earned Income Tax Credit - Paid Preparer's Checklist

Paid tax return preparers must complete Form 8867 and it must also be submitted with the returns claiming EITC prepared by a paid tax preparer. Form 8867 ensures that paid preparers consider all EITC requirements and encourage proper EITC due diligence. Preparers should complete the Paid Preparer's Checklist using information provided by the taxpayers. Tax return preparers should be able to explain the meaning and reasoning for each question presented on the checklist.

Preparers are required to:

- Complete Form 8867 after obtaining information from taxpayer(s) and document additional questions asked to and the answers given by the taxpayer at the time of the interview
- Submit Form 8867 electronically for every electronic return with EITC
- Attach Form 8867 to any return claiming EITC prepared and presented to the taxpayer for filing
- Provide a copy of Form 8867 to the preparer submitting the tax return if the preparer is not the preparer submitting the return to the IRS

Child Tax Credit

The Child Tax Credit is a nonrefundable tax credit that could be worth up to $1,000 per qualifying child. The additional child tax credit is a refundable credit the taxpayer might be able to take if the taxpayer is unable to claim the full amount of the Child Tax Credit.

Qualifying Children

For the Child Tax Credit, a qualifying child is a child, descendant, foster child, stepchild, sibling, stepsibling, or a descendant of any of these, and all of the following must be true:

- The child is a U.S. citizen, U.S. national, or resident alien
- The child is under the age of 17 at the end of the tax year
- The child provided less than half of his or her own support in the current tax year
- The child lived with the taxpayer for more than half of the current tax year

A child is considered to have lived with the taxpayer if the child was born or died in the current tax year and lived in the home the entire time he or she was alive. Temporary absences, including school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived in the home.

Example: Tina's son, Alex, turned 17 on December 1, 2016. He is a citizen of the United States and Tina claimed him as a dependent on her return. Alex is not a qualifying child for the Child Tax Credit because he was not under age 17 at the end of 2016.

Credit Amount

The maximum amount that can be claimed for the credit is $1,000 for each qualifying child. Certain limits on the credit apply. Reduce the Child Tax Credit if either of the following applies:

- The amount of the total tax on Form 1040, is less than the credit. If this amount is 0 (zero), do not take this credit because there is no tax to reduce.
- Modified adjusted gross income (MAGI) is more than the following amounts for the taxpayer's filing status:
  - Married Filing Jointly - $110,000.
  - Single, Head of Household, or Qualifying Widow(er) - $75,000
  - Married Filing Separately - $55,000

For purposes of the Child Tax Credit, MAGI is the AGI plus the following amounts that may apply to the taxpayer:

- Any amount excluded from income because of the exclusion of income from Puerto Rico. On the dotted line next to Form 1040, line 38, enter the amount excluded and identify it as "EPRI." Also attach to the return a copy of any Form(s) 499R-2/ W-2PR
- 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 the taxpayer does not have any of the above, then modified AGI is the same as AGI.

Claiming the Child Tax Credit

To claim the Child Tax Credit, file Form 1040 or Form 1040A. The Child Tax Credit cannot be claimed on Form 1040EZ. Provide the name and identification number (usually a Social Security Number) on the tax return for each qualifying child.

If filing Form 1040, answer the questions in the form instructions for line 52, Form 1040, to find out which Child Tax Credit worksheet to use to figure the credit.

If the answer is "Yes" to questions 1 or 2 in the Form 1040 instructions, complete the Child Tax Credit worksheet in Publication 972; otherwise, use the Child Tax Credit Worksheet in the Form 1040 or Form 1040A instructions.

Additional Child Tax Credit

The Additional Child Tax Credit is for certain individuals who get less than the full amount of the Child Tax Credit. This credit could lead to a refund even if the taxpayer does not owe any tax.

To claim the Additional Child Tax Credit, follow these steps:

1. Make sure to figure the amount, if any, of the Child Tax Credit.
2. If the answer was "Yes" on line 9 or line 10 of the Child Tax Credit Worksheet in the Form 1040 or Form 1040A instructions, or on line 13 of the Child Tax Credit Worksheet in Publication 972, use Parts II through IV of Schedule 8812 to see if the Additional Child Tax Credit can be taken.
3. If there is an Additional Child Tax Credit on line 13 of Schedule 8812, carry it to Form 1040, line 67, or Form 1040A, line 43.

Child and Dependent Care Credit

The Child and Dependent Care Credit is a nonrefundable tax credit based on expenses incurred for the care of a qualifying person. This care must make it possible for the taxpayer to work or seek employment and is based on a percentage of the amount actually paid for care expenses.

A taxpayer may be able to take the credit for child and dependent care expenses if the taxpayer paid someone to care for:

- The taxpayer's qualifying child under age 13 whom the taxpayer claims as a dependent
- The taxpayer's disabled spouse or any other disabled person who could not care for themselves
- The taxpayer's child who was not claimed as a dependent due to the rules for children of divorced or separated parents

The credit can be up to 35% of the taxpayer's expenses. To qualify, the taxpayer must pay these expenses so he or she (and spouse if married) can work or look for work.

Child and Dependent Care Credit - Tests

In order to claim the credit for child and dependent care expenses, Form 1040 or 1040A must be filed and the following tests must be met:

- Qualifying Person Test
- Earned Income Test
- Work-Related Expense Test
- Joint Return Test
- Provider Identification Test

Child and Dependent Care Credit – Qualifying Persons

Child and dependent care expenses must be for the care of one or more qualifying persons.

A qualifying person is:

- A qualifying child who is a dependent of the taxpayer and was under age 13 when the care was provided
- The taxpayer's spouse who was not physically or mentally able to care for himself or herself and lived with the taxpayer for more than half the year
- A person who was not physically or mentally able to care for himself or herself, lived with the taxpayer for more than half the year, and either:
    - Was the taxpayer's dependent
    - Would have been the taxpayer's dependent except that:
        - He or she received gross income of $4,050 or more
        - He or she filed a joint return
        - The taxpayer, or spouse if filing jointly, could be claimed as a dependent on someone else's return

Child and Dependent Care Credit – Earned Income

To claim the credit, the taxpayer (and spouse if filing jointly) 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 reported as wages.

Generally, only taxable compensation is included, but nontaxable combat pay can be included in earned income if elected by the taxpayer. If filing a joint return and both the taxpayer and spouse received nontaxable combat pay, each may make his or her own election.

Earned income does not include:

- 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 the taxpayer for teaching or other services
- Nontaxable workfare payments
- Child support payments received
- Income of nonresident aliens which is not effectively connected with a U.S. trade or business
- Any amount received for work while an inmate in a penal institution

Child and Dependent Care Credit – Work-Related Expenses

Work-Related Expenses

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 the taxpayer (and spouse if filing jointly) to work or look for work
- They are for a qualifying person's care

Working or Looking for Work

To be work-related, the expenses must allow the taxpayer to work or look for work. If married, generally both the taxpayer and spouse must work or look for work. A spouse is treated as working during any month he or she is a full-time student or is not physically or mentally able to care for himself or herself.

Work can be for others or in in the taxpayer's own business or partnership. It can be either full-time or part-time. Work also includes actively looking for work. If, however, the taxpayer does not find a job and has no earned income for the year, this credit cannot be taken.

An expense is not considered work-related merely because it was incurred while working. The purpose of the expense must be to allow the taxpayer to work.

Child and Dependent Care Credit – Joint Return Test

Joint Return Test

Generally, married couples must file a joint return to take the credit. If, however, the taxpayer is legally separated or living apart from his or her spouse, the taxpayer might be able to file a separate return and still take the credit.

Child and Dependent Care Credit – Provider Identification Test

Provider Identification Test

Identify all persons or organizations that provided care for the child or dependent. Use Form 2441, Part I to show the information.

To identify the care provider, give the provider's:

- Name
- Address
- 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 (ITIN). If the care provider is an organization, then it is the Employer Identification Number (EIN).

It is not necessary to show the taxpayer identification number if the care provider is a tax-exempt organization (such as a church or school). In this case, enter "Tax-Exempt" in the space where the tax form calls for the number.

Child and Dependent Care Credit – Figuring the Credit

The credit is a percentage of work-related expenses. Expenses are subject to the earned income limit and the dollar limit. The percentage is based on adjusted gross income.

Work-related expenses include only payments made during the tax year.

Earned Income Limit

The amount of work-related expenses used to figure the credit cannot be more than either:

- The taxpayer's earned income for the year if single at the end of the year
- The smaller of the taxpayer's or spouse's earned income for the year if married at the end of the year

Dollar Limit

There is a dollar limit on the amount of work-related expenses that can be used to figure the credit. The dollar limit is a yearly limit. The amount of the dollar limit remains the same no matter how long, during the year, the taxpayer has a qualifying person in their household.

The dollar limits are:

- $3,000 if work-related expenses were paid for the care of one qualifying person at any time during the year
- $6,000 if work-related expenses were paid for the care of more than one qualifying person at any time during the year

If work-related expenses were paid for the care of two or more qualifying persons, the $6,000 limit does not need to be divided equally among them.

To determine the amount of the credit, multiply work-related expenses (after applying the earned income and dollar limits) by a percentage. This percentage depends on the taxpayer's adjusted gross income. The following table shows the percentage to use based on adjusted gross income.

IF your adjusted gross income is:		THEN the percentage is:
Over	But not over	
$ 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%

Education Credits

Types of Education Credits

There are two tax credits available to taxpayers who pay expenses for higher (postsecondary) education. They are:

- The American Opportunity Credit
- The Lifetime Learning Credit

One thing to remember: for each student, a taxpayer can claim either the American Opportunity Credit, or the Lifetime Learning Credit, or the tuition and fees deduction. This means that only one of the tax breaks can be taken for the same person on the same return.

Parents claiming two or more college-age students as dependents on their return can claim one of these tax breaks for one student and another for a different student.

Taxpayers can still take the student loan interest deduction even if they're claiming one of the other tax breaks.

American Opportunity Credit

This credit is for students who are earning their undergraduate degrees. The credit is specifically limited to those expenses incurred in the first four years of college.

The American Opportunity Credit is an amount equal to 100% of qualified tuition and related expenses up to $2,000 plus 25% of those expenses in excess of $2,000, but not in excess of $4,000. The maximum credit allowed for tax year 2016 is $2,500.

The full credit is available to taxpayers with a MAGI of $80,000 or less ($160,000 or less if filing jointly). The amount of the credit is gradually reduced if the taxpayer's MAGI is between $80,000 and $90,000 ($160,000 and $180,000 if filing jointly). If the MAGI is above $90,000 ($180,000 if filing jointly) the taxpayer cannot take the credit.

Lifetime Learning Credit

Where the American Opportunity Credit is limited to the first four years of college, the Lifetime Learning Credit has a wider availability. This credit can be used for graduate school, undergraduate expenses, even professional or vocational courses. Plus, there's no limit to how many years it can be claimed.

This credit is nonrefundable and the maximum credit is $2,000 per return.

Adoption Credit

Taxpayers may be able to take a credit for qualified expenses paid to adopt an eligible child. For 2016, the maximum adoption credit is $13,460 per child. The adoption credit is nonrefundable and most taxpayers can claim the credit in the year the adoption is final; however, there are some allowable exceptions and requirements.

The amount of the Adoption Credit begins to phase out when 2016 modified adjusted gross income (MAGI) reaches $201,920 and is eliminated at $241,920.

Qualifying adoption expenses include expenses that are reasonable and necessary in order to adopt the eligible child, including:

- Adoption fees
- Court costs
- Attorney fees
- Travel expenses while away from home
- Re-adoption expenses related to adoption of a foreign child

For the adoption of a special-needs child, the maximum credit is available regardless of actual qualifying expenses.

For the adoption credit, an eligible child is considered to be:

- Any child under age 18. If the child turned 18 during the year, the child is considered eligible for the part of year they were under age 18.
- Any physically or mentally disabled person unable to care for itself.

Retirement Contribution Credit

Taxpayers who make eligible contributions to an employer-sponsored retirement plan, or to an individual retirement arrangement (IRA), may be able to take a credit on his or her tax return. This credit is figured on Form 8880.

Taxpayers may be able to take the Retirement Savings Credit if the taxpayer or 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)
- Contributions to a 501(c)(18)(D) plan

Taxpayers cannot take the Retirement Contribution Credit if either of the following applies:

- The AGI shown on the 1040 tax return is more than $30,000 ($45,000 if head of household; $60,000 if married filing jointly)
- The person(s) who made the qualified contribution or elective deferral: (a) was born after January 1, 1998, (b) is claimed as a dependent on someone else's 2016 tax return, or (c) was a student

Credit for the Elderly or the Disabled

Elderly or disabled taxpayers who qualify may be able to reduce tax owed by taking a credit on Schedule R.

Individual are considered to be qualifying individuals for the Credit for the Elderly and the Disabled if they are U.S. citizens or resident aliens and either of the following apply:

- The taxpayer was age 65 or older at the end of the tax year
- The taxpayer was under age 65 at the end of the tax year and all three of the following statements are true:

    a. The taxpayer is retired on permanent and total disability
    b. The taxpayer received taxable disability income for the tax year
    c. On January 1st of the tax year, the taxpayer had not reached mandatory retirement age.

Permanent and total disability

Taxpayers are considered permanently and totally disable if they can’t engage in any substantial gainful activity because of a physical or mental condition. A qualified 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 expect to result in death.

Disability Income

Disability income must meet both of the following requirements:

- It must be paid under your employer’s accident or health plan or pension plan
- It must be included in your income as wages or payments for the time absent from work because of the permanent and total disability.

Generally, if a taxpayer is married, he or she must filed a joint return with his or her spouse in order to qualify for the Credit for the Elderly or the Disabled. If the taxpayer did not live with his or her spouse at any time during the tax year, taxpayers can file either a joint return or separate return and still take the credit.

Taxpayers can file as head of household and still take the credit even if their spouse lived with them during the first six months of the year, if certain test are met.

Income Limits

To be eligible for the Credit for the Elderly or the Disabled, two income limits must be considered.

- The first limit is the amount of the adjusted gross income (AGI).
- The second limit is the amount of the nontaxable social security and other taxable pensions, annuities, or disability income.

If the filing status is single, head of household, or qualifying widow(er), to qualify for the credit the AGI limit is $17,500 and the nontaxable social security and other nontaxable pensions is limited to $5,000.

If the filing status is married filing jointly and both spouses qualify for the credit the AGI limit is $25,000 and the nontaxable social security and other nontaxable pensions is limited to $7,500.

If the filing status is married filing jointly and only one spouse qualifies for the credit the AGI limit is $20,000 and the nontaxable social security and other nontaxable pensions is limited to $5,000.

If the filing status is married filing separately, to qualify for the credit the AGI limit is $12,500 and the nontaxable social security and other nontaxable pensions is limited to $3,750.

Claiming the Credit

The Credit for the Elderly or the Disabled calculated on Schedule R and the credit can be figured by the IRS or on the return before the return is filed.

The credit is generally limited to the amount of tax and is not refundable.

Foreign Tax Credit

Taxpayers who paid or accrued foreign taxed to a foreign county or U.S. possession and are subject to U. S. Tax on the same income, may be able to take either a credit or an itemized deduction for those taxes.

Qualifying Foreign Taxes

Taxpayers can claim a credit only for foreign taxes that are imposed by a foreign country or U.S. possession. Generally, only income, war profits and excess profits taxes qualify for the credit.

The credit or deduction cannot taken for foreign income taxes paid on income that has been excluded from U.S. tax under any of the following:

- Foreign earned income exclusion
- Foreign housing exclusion
- Income from Puerto Rico exempt from U.S. tax
- Possession exclusion

Choosing a Credit or a Deduction

Taxpayers can choose to take the amount of any qualified foreign taxes paid during the year as a foreign tax credit or as an itemized deduction.

To choose the deduction, taxpayers must itemize deductions on Schedule A. To choose the foreign tax credit, generally Form 1116 must be completed and filed with the return. A taxpayer must choose either the foreign tax credit or itemized deduction for all foreign taxes paid or accrued during the year annually.

Claiming the Credit

Taxpayers can claim the credit for qualified foreign taxes without filing Form 1116 if they meet all of the following requirements:

- All of foreign source income is passive income, such as interest and dividends
- All of foreign source income and the foreign income taxes are reported to you on a qualified payee statement, such as Form 1099-INT or Form 1099-Div or Schedule K-1 from a partnership, S corporation, estate or trust
- The total of qualified foreign taxes is not more than the limit for filing status

If the credit is claimed directly on Form 1040 or Form 1040-NR without filing Form 1116, taxpayers cannot carry back or carry forward any unused foreign tax to or from this year.

If Form 1116 is used to figure the credit, the foreign tax credit will be the smaller of the amount of foreign tax paid or accrued, or the amount of U.S. tax attributable to the foreign source income. Compute the limit separately for passive income, income resourced under a tax treaty, income derived from sanctioned countries, and all other income.

Carryback and Carryover of Unused Credit

If a taxpayer cannot claim a credit for the full amount of qualified foreign income taxes paid or accrued in the year, he or she is allowed a carryback and/or carryover of the unused foreign income tax. The amounts can be carried back for one year and then carried forward for 10 years the unused foreign tax. For more information on this topic see Publication 514, *Foreign Tax Credit for Individual*

<u>Excess Social Security Credit</u>

Most employers withhold social security tax from the wages of employees up to $7,347 for 2015. In taxpayers work for two or more employers, sometimes too much social security tax is withheld if the sum of the social security withholdings exceed $7,347 (for 2015). The excess amount of the withholdings refund to the taxpayer as a refundable tax credit which appears on Form 1040, line 71.

If a single employer mistakenly withholds more that the limit, the taxpayer is not eligible for a credit against his or her income tax. Instead the amount should be adjusted by the employer and any amount over the limit should be refunded to the taxpayer by his or her employer. If the employer does not adjust the over collection, taxpayers can file Form 843 for a claim for refund.

Notes: All wages are subject to Medicare tax withholding.

Example: Shauna worked for LMN Corporation from January 1, 2015 - May 1, 2015. During her employment at LMN Corporation, she earned $48, 387. The employer withheld 6.2% or $3,000 for social security withholdings. On May 2, 2015, Shauna began working for PQR Corporation where she earned $80,645 for the remainder of 2015. PQR withheld $5,000 for social security withholdings.

Since Shauna had more than $7,347 withheld for 2015, she is eligible for a credit of $653 ($8,000 - $7,347) on her tax return for excess social security paid.

Affordable Care Act Provisions

Affordable Care Act

Beginning in 2014, United States citizens, their dependents, and legal resident aliens were required to have Minimum Essential Health Care Coverage (MEC), have a health coverage exemption, or make a Shared Responsibility Payment (penalty or ISRP) with their tax return under the Affordable Care Act.

The Affordable Care Act (ACA) actually refers to two separate pieces of legislation - the Patient Protection and Affordable Care Act (P.L. 111-148) and the Health Care and Education Act of 2010 (P.L. 111-152). The ACA contains comprehensive health reform and includes tax provisions that affect individuals, families, insurers, employers, and government entities.

Health Care Marketplace

Health Insurance Marketplaces (also known as Exchanges) are websites available to consumers to purchase qualified health plans from different companies. In the Marketplace, plans are available in five categories and differ based on how the individual and the plan share the cost of medical costs, not on the coverage received. Each level has an actuarial value - a percentage of the total average cost for benefits the plan will cover.

The five categories and their actuarial values are:

- Bronze (60%)
- Silver (70%)
- Gold (80%)
- Platinum (90%)
- Catastrophic (only for people under age 30 or with hardship exemptions)

Individuals are not required to purchase health insurance plans in the Health Care Marketplace. Qualified plans can also be purchased through private exchanges and insurance providers.

Health Insurance Premium Tax Credit

Taxpayers who get their health insurance coverage through the Marketplace might be eligible for a premium tax credit. The premium tax credit is a refundable credit intended to help taxpayers with low or moderate income pay for health insurance premiums. The credit can be paid in advance to the taxpayer's insurance company to lower monthly premiums or can be claimed on the taxpayer's tax return. If the advance payment is selected, the amount paid in advance will be reconciled on the tax return.

To be eligible for the premium tax credit, the taxpayer must generally meet all of the following requirements:

- Health insurance must be purchased through the Health Insurance Marketplace.
- Taxpayer must not be eligible for coverage through an eligible employer or government plan.
- Income must be within certain limits.
- Taxpayer must not file as Married Filing Separately*.
- Taxpayer cannot be claimed as the dependent of another.

*Certain victims of domestic abuse may file as Married Filing Separately and still claim the premium tax credit. See Notice 2014-23 for criteria.

If an individual is eligible for the Premium Tax Credit, he or she can choose to either:

- Get the credit paid in advance directly to his or her insurance company
- Wait to get the credit when his or her tax return is filed

Getting the credit in advance can help lower the monthly premiums and out of pocket expenses. The amount of the credit determined during enrollment at the Marketplace is a projected amount. The actual amount and the credit will be calculated and reconciled on the tax return. If the amount paid in advance was too much, the difference will increase the amount the taxpayer owes and the tax refund might be reduced or result in a balance due.

If the credit is not paid in advance, it will still be calculated on the tax return and the credit will increase the tax refund or lower the balance due.

Any individual who receives the Premium Tax Credit must file a federal return, even if not otherwise required to do so.

Individuals and families whose household income for the year is between 100% and 400% of the Federal Poverty Line (FPL) for the family size will generally be eligible for the premium tax credit if the other requirements are met.

For 2016 returns, for residents of the 48 contiguous states or Washington D.C., the following table shows the household income that would be between 100% and 400% of the FPL:

- $11,770 (100%) up to $47,080 (400%) for an individual
- $15,930 (100%) up to $63,720 (400%) for a family of two
- $20,090 (100%) up to $80,360 (400%) for a family of three
- $24,250 (100%) up to $97,000 (400%) for a family of four
- $28,410 (100%) up to $113,640 (400%) for a family of five
- $32,570 (100%) up to $130,280 (400%) for a family of six

The Federal Poverty Line (FPL) is established annually by the U.S. Department of Health and Human Services. Three poverty lines are established: one for residents of the contiguous 48 states and Washington D.C., one for Alaska residents, and one for residents of Hawaii. For purposes of the Premium Tax Credit, eligibility is based on the most recently published set of poverty guidelines at the time of the first day of the annual open enrollment period.

For the purposes of the Premium Tax Credit, household income is the sum of the modified adjusted gross income (MAGI) of every member of the household for which the taxpayer may claim an exemption or any one that is required to file a federal tax return. Modified adjusted gross income is the adjusted gross income on the federal income tax return plus any excluded foreign income, nontaxable Social Security benefits (including tier 1 railroad retirement benefits), and tax-exempt interest received or accrued during the taxable year. It does not include Supplemental Security Income (SSI).

Example: Cory is employed by a local radio station and earns $45,000 annually. His wife, Ashley, manages a clothing store and earned $33,000 in 2016. They have one son, Levi, who is 17 years old. Levi works part-time on weekends and during the summer. In 2016, Levi earned $3,300 and will file a tax return as a dependent of another. Neither Cory nor Ashley are offered a health care plan at work. They plan to file as Married Filing Jointly and did not receive income from any other source.

Assuming that Cory and Ashley do not live in Alaska or Hawaii, they will not qualify for the Premium Tax Credit. Their household income of $81,300 ($45,000 + $33,000 + $3,300) exceeds 400% of the FPL for their household size.

Reconciling the Premium Tax Credit

If an individual was covered by a Marketplace plan at any time during the year, he or she will receive Form 1095-A after the end of the year of coverage reporting information about the coverage. The information on Form 1095-A should be used to reconcile the premium tax credit. In some cases, taxpayers may have received a portion of their premium tax credit in advance to help lower monthly premiums.

Since the premium tax credit is calculated on the tax return, many times the amount paid in advance, if any, is too low or too high. The difference between the premium tax credit calculated on the tax return and the amount paid in advance will affect the amount of the refund or balance due on the tax return.

The premium tax credit is reconciled on Form 8962.

If an individual does not reconcile his or her premium tax credit on the tax return, he or she may lose eligibility for the premium tax credit until it is properly reconciled.

Individual Shared Responsibility Payment

The ACA calls for each individual to have minimum essential health coverage, qualify for an exemption, or make a payment when filing his or her tax return. This provision went into effect January 1, 2014, and applies to individuals of all ages, including children.

Plans that qualify as minimum essential coverage include (but are not limited to):

- Any Marketplace plan, or any individual insurance plan already in place.
- Any employer plan (including COBRA), with or without “grandfathered” status. This includes retiree plans.
- Medicare.
- Medicaid.
- The Children's Health Insurance Program (CHIP).
- TRICARE (for current service members and military retirees, their families, and survivors).
- Veterans’ health care programs (including the Veterans Health Care Program, VA Civilian Health and Medical Program (CHAMPVA), and Spina Bifida Health Care Benefits Program).
- Peace Corps Volunteer plans.

Individual Shared Responsibility Payment Exemptions

Under some circumstances, individuals may not be required to make the individual responsibility payment if not covered by minimum essential coverage.

Individuals might qualify for an exemption if:

- Uninsured for less than three months of the year
- Income falls below the threshold required to file a federal tax return
- Incarcerated and not being held pending disposition of charges
- Coverage available is not affordable (annual premiums are more than 8% of household income)
- Member of recognized health care sharing ministry
- Member of a federally recognized tribe or eligible for services through an Indian Health Services provider
- Member of a recognized religious sect with religious objections to insurance including Social Security and Medicare
- Not lawfully present in the United States

Individual Shared Responsibility Payment Hardship Exemptions

If individuals have certain circumstances that affect their ability to purchase health insurance coverage, they may qualify for a hardship exemption. Some reasons a taxpayer could request a hardship exemption are:

- Homelessness
- Eviction in the past six months or faced eviction or foreclosure
- Received a shut-off notice from a utility company
- Death of a close family member
- Flood, fire, or other disaster that caused substantial damage to his or her property
- Bankruptcy filed in the past six months
- Substantial debt due to unpaid medical expenses in the last 24 months
- Unexpected increase in necessary expenses due to caring for an ill, disabled, or aging family member
- Dependent child was denied coverage in Medicaid and CHIP and another person is required by court order to provide medical support for the child
- Eligibility for enrollment in a qualified health plan through the marketplace only after an eligibility appeals decision that lowers costs on monthly premiums or cost-sharing reductions for a time period when not enrolled in a plan through the Marketplace
- Ineligibility for Medicaid because the taxpayer's state did not expand Medicaid under the ACA
- Insurance plan cancelled by the insurance company and no affordable plans are available in the Marketplace

Example: Mildred, a 72-year-old retired widow, lives alone. She has a limited income and does not have any health coverage. Her gross income for 2016 was $8,500. She is not required to make the individual responsibility payment because she is exempt due to the fact that she is not required to file a federal tax return. Mildred's gross income falls below the filing threshold.

Individual Shared Responsibility Payment

If individuals do not maintain minimum essential coverage and do not qualify for an exemption, he or she must pay the individual shared responsibility payment with their tax return.

For 2016, the individual shared responsibility payment is the greater of:

- 2.5% of household income that is above the tax return threshold for the filing status, or
- Flat dollar amount of $695 per adult and $347.50 per child limited to a maximum of $2,085

The payment is capped at the cost of the national average premium for a Bronze-level health plan available through the Marketplace in 2016.

For tax year 2017 and beyond, the percentage amount will remain at 2.5%, but the flat fee will be adjusted for inflation.

Example: Jim and Tami Baker (both under age 65) are married and have two small children under age 18. In 2016, they did not have minimum essential health coverage for any member of their family and did not qualify for an exemption. Their household income for 2016 was $80,700. (For this example, assume the payment amounts do not exceed the national average for Bronze-level coverage).

To calculate their shared responsibility payment, take the ***greater*** of:

- 2.5% of household income above the filing threshold
    - Their filing threshold for Married Filing Jointly taxpayers both under the age of 65 is $20,700, which is subtracted from the household income of $80,700. The result is $60,000 over the threshold amount. Two and a half percent of that amount is **$1,500** ($60,000 x 2.5%).
- Flat dollar amount of $695 per adult and $347.50 per child
    - $695 for each adult and $347.50 per child results in a flat amount of **$2,085** [($695 X 2) + ($347.50 X 2)].

Since using the flat dollar amount is greater, that amount will be used. Their shared responsibility payment on their 2016 return would be $2,085.

ACA Reporting

To monitor compliance with the individual and employer mandates, the ACA requires reporting by employers and insurers.

Form 1095-A Health Insurance Marketplace Statement

Form 1095-A is furnished by the Marketplace to individuals who enroll in a qualified health plan through the Marketplace. This form helps taxpayers reconcile the premium tax credit and file an accurate return.

Form 1095-B Health Coverage

Form 1095-B is used by insurers and certain employers to report information to the IRS and taxpayers who were covered by minimum essential coverage. The form reports the type of coverage, members of the tax household who were covered, and the period of coverage for the year.

Form 1095-C Employer-Provided Health Insurance Offer and Coverage Insurance

Form 1095-C is filed and furnished to any employee of an Applicable Large Employer (ALE) who is a full-time employee for one or more months. The form reports the coverage offered and coverage accepted from the employer.

An ALE is an employer with at least 50 full-time or full-time equivalent employees. Only ALE's are required to file Form 1095-C.

Tax Withholding and Estimated Tax Payments

Pay-As-You-Go Tax

The United States uses a pay-as-you-go tax system for federal income tax which means that tax must be paid as income is earned or received. Individuals should make installments of expected tax liability either through withholding or by making estimated tax payments.

When a tax return is filed after the end of the tax year, the amount paid in as withholding or estimated tax payments is reconciled against the actual tax owed calculated on Form 1040 (or 1040A or 1040EZ). If the amount of taxes paid in is more than the taxed owed, a tax refund will be due. If the amount paid in is not enough to cover the tax owed, a balance would be due and the taxpayer would be required to pay that amount by the return due date.

If a taxpayer did not pay enough tax throughout the tax year, either by withholding or by timely estimated tax payments, he or she may be subject to a penalty. Taxpayers can have the IRS figure the amount of the penalty for them or use Form 2210 to calculate the penalty.

Withholding

For most employees, the employer withholds income tax from pay and submits it to the IRS under the employee's name. Tax can also be withheld from other types of income including retirement income, commissions, gambling winnings, and unemployment compensation.

Employers' withholding are usually based upon the amount of pay received and the information included on Form W-4 by the employee. See Form W-4 below.

Income statements, such as Forms W-2, 1099MISC, W-2G, 1099R, should be provided to the taxpayer after the end of the tax year to not only report income received but also to report withholding submitted to the IRS on behalf of the taxpayer.

Estimated Tax Payments

For income not subject to withholding, estimated tax payments should be made throughout the tax year. This includes income from self-employment, alimony, rents, prizes, and gains from the sale of assets. Taxpayers can make estimated tax payments if their withholdings from salary or other income is not sufficient.

Estimated tax payments are used to pay both federal income tax and self-employment tax.

Generally, taxpayers should make estimated tax payments for 2016 if:

1. There is an expectation of at least a $1,000 balance due for 2016 (after subtracting refundable credits and withholdings)
2. The sum of withholdings and refundable credits are expected to be less than the smaller of:
    - 90% of the tax shown on the 2016 tax return
    - 100% of the tax shown of the 2015 return

Note: Special rules apply for farmers, fisherman, and higher income taxpayers. IRS Publication 505 has more information to these and other exceptions.

The estimated tax payments should be made quarterly during the tax year. Payment periods and due dates for calendar year taxpayers are:

Payment Period	**Due Date**
January 1 – March 31	April 15 (April 18 for 2016 returns)
April 1 – May 31	June 15
June 1 – August 31	September 15
September 1 – December 31	January 15, next year

If the due date falls on a Saturday, Sunday, or legal holiday, the payment will be due on the next day that is not a Saturday, Sunday, or legal holiday.

If the 2016 tax return is filed by February 1, 2017, and tax is paid in full, the payment due on January 15, 2017 is not needed.

Payment and Refund Options

At the end of the tax year, taxpayers usually have a balance due to the IRS or a refund due. If a balance is due and is more than $1, the payment should be made by the return due date, usually April 15 for calendar-year taxpayers. Even if an automatic extension is filed, the time to pay tax due is not extended. If a balance due is not paid by the return due date, interest and penalties can be assessed.

There are several different payment options available for taxpayers. Payments may be made electronically, by phone, or by mailing a check or money order. If the taxpayer's return is e-filed, the payment may also be made via electronic funds withdrawal, or by credit or debit cards. Information on payment options is available at www.irs.gov/e-pay. Payments can also be made through the Electronic Federal Tax Payment System (EFTPS), a free tax payment system for online and phone payments.

If the taxpayer cannot pay the full amount due, the taxpayer can request an installment agreement. If accepted, the taxpayer can make installments on the tax due. Penalties and interest might still be charged even if the installment agreement is granted. To request an installment agreement, file Form 9465 or apply online.

Taxpayers may also file Form 1127, Application for Extension of Time for Payment of Tax Due to Undue Hardship to request and extension of time to pay. This extension generally is not granted for more than six months. "Undue hardship" is more than an inconvenience; taxpayers must show they will have a substantial financial loss if taxes are paid on the date due and must attach supporting documentation.

Refund Options

If an overpayment is calculated when the return is complete, the taxpayer might be due a refund. If filing Form 1040 or Form 1040A, the taxpayer can choose to apply all or part of the overpayment to next year's estimated tax.

In some cases, it is possible the taxpayer's refund could offset amounts owed for past-due federal tax, state income tax, unemployment compensation debts, child or spousal support and other federal debts. Offsets are made by the Treasury Department's Financial Management Service (FMS), unless it is a federal tax debt which is offset by the IRS. Taxpayers will be notified if their refund has been offset.

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

- Direct deposit
- Purchase of U.S. Series I Savings Bonds
- Paper check

Direct Deposit of Refund

Taxpayer can have their refund deposited directly into a checking or savings account, including an Individual Retirement Arrangement (IRA). Taxpayers can also request to have refunds deposited in to a TreasuryDirect® online account to buy U.S. Treasury marketable securities and savings bonds.

If the taxpayers choose direct deposit, they may be able to split the refund and have it deposited among two or three accounts using Form 8888, Allocation of Refund.

For returns that are e-filed, direct deposits are usually sent in fewer than 21 days from the date of return acceptance by the IRS. If an accurate and complete tax return is paper-filed, the direct deposit could take more than six weeks. Taxpayers can use the online tool, Where's My Refund at www.IRS.gov, to check the status of their refund, or they can call the Refund Hotline at 1-800-829-1954.

Additional Direct Deposit Requirements

Preparers must never charge a separate fee for direct deposit and must accept any direct deposit election by a taxpayer to any eligible financial institution. The preparer must advise taxpayers they cannot rescind a direct deposit election and they cannot make changes to the routing transit numbers of financial institutions or account numbers after IRS has accepted the return. The preparer must not alter the direct deposit information in the electronic record after taxpayers have signed the tax return.

Example: Weston is expecting a refund of $400. He chooses to deposit $150 into his checking account, $150 into his savings account, and $100 into an IRA account. Taxpayers can choose the refund splitting option regardless of which Form 1040 series tax form they file.

In January 2015, the IRS imposed new limits on direct deposited refunds in an effort to combat fraud. The number of tax refunds electronically deposited into a single account will be limited to three. Additional refunds sent to the account will automatically be converted to a paper refund check and be mailed to the taxpayer. The IRS will notify taxpayers that the intended account has exceeded the direct deposit limits and a paper check will be issued.

This limit applies to financial accounts, such as bank savings or checking accounts, and to prepaid, reloadable cards and debit cards.

Purchasing U.S. Savings Bond with Tax Refund

Taxpayers can elect to use all or part of the tax refund to purchase U.S. Series I Savings Bonds using a TreasuryDirect® online account. Bonds must be purchased in increments of $50 up to a total of $5,000. Any unused amount can be refunded via paper check or direct deposit.

A bank account is not required in order to purchase the bonds, nor is it required to open an account in advance with the Treasury Department.

To purchase U.S. Bonds with a tax refund, file Form 8888, Allocation of Refund. Savings bonds are ordered after the IRS completes processing the tax return. Once the bonds are ordered, it may take up to three weeks for the taxpayer to receive the bonds in the mail.

Refund Checks

If a direct deposit is not indicated, a taxpayer will receive a paper check in the mail. Taxpayers should cash a tax refund check soon after it is received. Checks expire the last business day of the 12th month of issue. If the check has expired, the taxpayer can apply to the IRS to have it reissued.

Other notes regarding refund checks:

- If the taxpayers receive a check for a refund they are not entitled to, or for an overpayment that should have been credited to estimated tax payments, the check should not be cashed. Instead, call the IRS
- If the taxpayer receives a check for more than the refund claimed, he or she should not cash the check until the taxpayer receives a notice explaining the difference
- If the refund check is for less than what was claimed, it should be accompanied by a notice explaining the difference. Cashing the check does not stop the taxpayer from claiming an additional amount of refund

If the taxpayer did not receive a notice and he or she has any questions about the amount of the refund, wait two weeks. If the taxpayer still has not received a notice, call the IRS.

Skill Check Domain 2, Part 4

1. What is a refundable tax credit?

A. A tax credit that is limited to tax liability.

B. A tax credit that always creates a refund on the tax return.

C. A tax credit that is not limited but any excess must be applied to next year's estimated payments.

D. A tax credit that can reduce tax liability below zero (0).

2. A taxpayer cannot claim the Earned Income Tax Credit unless his or her investment income is:

A. $1,000 or less
B. $3,000 or less
C. $3,400 or less
D. $5,750 or less

3. Which taxpayer can claim the Earned Income Tax Credit if all other requirements are met?

A. A taxpayer who has only an ITIN (no SSN).

B. A U.S. citizen who lived in Honduras for the entire year with his child.

C. A taxpayer who files a Married Filing Separate return.

D. A taxpayer who has $7,000 in self-employment income.

4. Becky is single and has a modified adjusted gross income (MAGI) of $65,000. She has three qualifying children for the Child Tax Credit. Is Becky eligible for the Child Tax Credit on her tax return?

A. Yes

B. No

5. Which option is available for a taxpayer to receive a refund?

A. Gift Cards

B. Direct deposit into the taxpayer's bank account.

C. Money order

D. U.S. postage stamps

6. Under the Affordable Care Act (ACA), individuals must have minimum essential health coverage, qualify for an exemption, or do which of the following?

A. Make a payment when filing their tax return

B. File an extension of time to file

C. Join the military

D. Nothing

Skill Check Domain 2, Part 4 Answer Key

1. What is a refundable tax credit?

A. A tax credit that is limited to tax liability.

Incorrect. A refundable credit is not limited to tax liability.

B. A tax credit that always creates a refund on the tax return.

Incorrect. A refundable credit is not limited to tax liability, but will not always be greater than the tax liability nor will this credit always produce a tax refund.

C. A tax credit that is not limited but any excess must be applied to next year's estimated payments.

Incorrect. An excess created by a refundable credit can be refunded to the taxpayer and can be applied to next year's tax if the taxpayer elects to do so.

D. A tax credit that can reduce tax liability below zero (0).

Correct. Refundable credits can reduce tax liability below zero. It is possible to receive a refund of the excess credit.

2. A taxpayer cannot claim the Earned Income Tax Credit unless his or her investment income is:

A. $1,000 or less

Incorrect. Taxpayers can have more than $1,000 in investment income and still claim the EITC.

B. $3,000 or less

Incorrect. Taxpayers can have more than $3,000 in investment income and still claim the EITC.

C. $3,400 or less

Correct. Investment income must be $3,400 or less for the year for the taxpayer to be eligible for EITC.

E. $5,750 or less

Incorrect. Taxpayers must have less than $3,400 in investment income to claim the EITC.

3. Which taxpayer can claim the Earned Income Tax Credit if all other requirements are met?

A. A taxpayer who has only an ITIN (no SSN).

Incorrect. A taxpayer must have a valid Social Security Number (SSN) to claim the Earned Income Tax Credit.

B. A U.S. citizen who lived in Honduras for the entire year with his child.

Incorrect. Taxpayers with qualifying children must meet the residency test. The child must have lived with the taxpayer in the U.S. for more than half the year.

C. A taxpayer who files a Married Filing Separate return.

Incorrect. Taxpayers who file as Married Filing Separate are not allowed to claim the Earned Income Tax Credit.

D. A taxpayer who has $7,000 in self-employment income.

Correct. Self-employment income is considered earned income. Taxpayers with self-employment income are eligible to claim the Earned Income Tax Credit as long as their AGI does not exceed limits.

4. Becky is single and has a modified adjusted gross income (MAGI) of $65,000. She has three qualifying children for the Child Tax Credit. Is Becky eligible for the Child Tax Credit on her tax return?

A. Yes

Correct. The MAGI limit for taxpayer filing a Single return for Child Tax Credit is $75,000. Becky's MAGI is well below that limit so she would be eligible for the Child Tax Credit.

B. No

Incorrect. Becky is eligible for the Child Tax Credit because her MAGI is well below the limit of $75,000 for single filers.

5. Which option is available for a taxpayer to receive a refund?

A. Gift Cards

Incorrect. A taxpayer cannot receive a tax refund via gift card.

B. Direct deposit into the taxpayer's bank account.

Correct. Taxpayers may receive their tax refund via direct deposit.

C. Money order

Incorrect. Federal tax refunds are not issued via money order.

D. U.S. postage stamps

Incorrect. U.S. postage stamps are not a disbursement method for a federal tax refund.

6. Under the Affordable Care Act (ACA), individuals must have minimum essential health coverage, qualify for an exemption, or do which of the following?

A. Make a payment when filing their tax return.

Correct! The ACA calls for individuals to have minimum essential health coverage or make a payment with their tax return, unless qualified for an exemption.

B. File an extension of time to file.

Incorrect. If an individual does not have minimum essential health coverage and doesn't qualify for an exemption, he or she must make a payment with his or her tax return. Filing an extension of time to file will have no effect.

C. Join the military

Incorrect. Joining the military is not a requirement under the ACA.

D. Nothing

Incorrect. The ACA calls for individuals to have minimum essential health coverage or make a payment with his or her tax return, unless qualified for an exemption.