

2005 VOLUNTEER STUDENT GUIDE



FOR USE IN IRS VOLUNTEER
RETURN PREPARATION PROGRAMS

- **Volunteer Income Tax Assistance (VITA)**
- **Tax Counseling for the Elderly (TCE)**
- **Military Volunteer Income Tax Assistance (M-VITA)**
- **Volunteer Embassy and Consulate Tax Assistance (VECTA)**

For the most up-to-date tax products and information visit www.irs.gov.



IRS

Department of the Treasury
Internal Revenue Service
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Course Number 3004 M (Military/International)



IRS VOLUNTEERS

Pending Legislation

At the time this publication went to print, legislation providing relief for persons impacted by recent natural disasters was in the process of being passed and implemented. The training material includes draft tax forms that did not take the proposed legislation into account. Therefore, the legislation will cause various forms, tables, and worksheets to change. Additional guidance will be issued in the form of a supplement.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.



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Confidentiality Statement:

All tax information you receive from taxpayers in your VOLUNTEER capacity is strictly confidential and should not, under any circumstances, be disclosed to unauthorized individuals.

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WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

NOV 04 2005

Welcome Volunteers!

Thank you for being a critical part of the Volunteer Return Preparation Program (VRPP) of the Internal Revenue Service and its partners. Free programs such as Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) provide important services for over two million low-income and elderly people who need tax preparation assistance. I appreciate the time you have chosen to commit to help others with this complex task.

In this training and reference package, you will find tools that enhance your interaction with taxpayers. Of note are the updated Publication 4012, *Volunteer Resource Guide*, and the new Publication 678-W, *Comprehensive Problems and Exercises Workbook*. These tools combined with the lessons in the training material will help you provide high-quality tax preparation for the taxpayers who seek your assistance. Available separately this year is a new video offering interview tips and techniques to use as you engage taxpayers.

In addition to improving quality service, we continue to expand the training options available to you. This year, the material is available as four courses that stand on their own--Basic, Intermediate, Advanced and Military. **Link & Learn Taxes** is the web-based volunteer training program, which covers the same tax law theory and application as the paper-based training courses. This year a kit has been designed to aid students who use **Link & Learn Taxes**. Publication 4480, *Link and Learn Taxes Kit*, will consist of Publications 4012 and 678-W, as well as Form 6744, Test.

I urge you to electronically file (e-file) the returns you prepare. E-filing uses automation to quickly check for errors or missing information. Consequently, e-filed returns have a higher accuracy rate than paper-prepared returns.

I appreciate your efforts to protect the privacy of the taxpayers you assist by safeguarding the confidential information they share with you. Your site manager will discuss with you the steps you should take to guard the information provided to you. The protection of taxpayer information and quality service are the keys to the integrity of the program.

If you have any questions or recommendations about our training materials, please see your facilitator or site coordinator. They can take your suggestions, or you can write to us at the following address:

Internal Revenue Service
Stakeholder Partnerships, Education and Communication
SE:W:CAR:SPEC:PPD:E, Stop 45-WI
401 W. Peachtree St., NW
Atlanta, GA 30308

Thank you for being a part of this valuable public service for your neighbors and community.

Sincerely,

Ellie Cimaglia
Director, Stakeholder Partnerships,
Education and Communication

Tax Relief in Disaster Situations

Special tax law provisions may help taxpayers recover financially from the impact of a disaster, especially when the president declares their location to be a major disaster area. Depending on the circumstances, the IRS may grant additional time to file returns and pay taxes. Both individuals and businesses in a presidentially declared disaster area can get a faster refund by claiming losses related to the disaster on the tax return for the previous year, usually by filing an amended return.

Taxpayers may visit www.irs.gov for the following:

Tax Relief for Hurricane Rita Victims

Tax Relief for Hurricane Katrina Victims

Taxpayer Information Publications

Publication 547, Casualties, Disasters and Thefts

Publication 2194, Disaster Losses Kit for Individuals

Publication 2194B, Disaster Losses Kit for Businesses

Publication 3833, Disaster Relief: Providing Assistance through Charitable Organizations

IMPORTANT TAX LAW CHANGES FOR 2005

Uniform Definition of a Qualifying Child. Beginning in 2005, one definition of a “qualifying child” will apply for dependency exemption, head of household filing status, earned income credit (EIC), child tax credit, and credit for child and dependency care expenses.

In general, the relationship test, the residency test, the age test, and the support test must be met to claim someone as a qualifying child.

Each test will be discussed in detail in the appropriate lesson of this publication.

Standard deduction amount increased. The standard deduction (for taxpayers that do not itemize deductions on Schedule A (Form 1040)) has increased.

Married filing jointly or Qualifying Widow(er)	\$10,000
Head of household	7,300
Single or Married Filing separately	5,000

Exemption amount increased. The amount each taxpayer can deduct for each exemption has increased from \$3,100 to \$3,200.

Standard business-related mileage. The standard mileage rate for the cost of operating a car, van, pickup, or panel truck in 2005 increased from 37.5 cents a mile to 40.5 cents a mile for all business miles driven from 1/1/05 to 8/31/05 and to 48.5 cents from 9/1/05 to 12/31/05.

Medical and move-related mileage. The standard mileage rate for the cost of operating a vehicle for medical reasons or as part of a deductible move in 2005 increased from 14 cents a mile to 15 cents a mile from 1/1/05 to 8/31/05 and to 22 cents from 9/1/05 to 12/31/05.

Charitable Contributions of Cars, Boats, and Aircraft. If you donate a car to a qualified organization after December 31, 2004, your deduction is limited to the gross proceeds from its sale by the organization. This will be discussed further in the lesson on Itemized Deductions. Form 1098-C is used for auto donations in excess of \$500.

EIC INCOME AND INVESTMENT LIMITATIONS

For tax year 2005 the maximum credits are:

- Two or more qualifying children \$4,400
- One qualifying child 2,662
- No children 399

Earned Income. To be eligible for a full or partial credit, the taxpayer must have earned income of at least \$1 but less than:

- \$35,263 (\$37,263 married filing jointly) and two or more qualifying children;
- \$31,030 (\$33,030 married filing jointly) and one qualifying child;
- \$11,750 (\$13,750 married filing jointly) with no qualifying children.

Adjusted Gross Income. The taxpayer’s adjusted gross income (AGI) must also be less than the above dollar amounts.

Investment Income. Taxpayers whose investment income is more than \$2,700 cannot claim the EIC.



Social Security and Medicare Taxes. For 2005, the employer and employee will continue to pay:

1. 6.2% each for social security tax (old-age, survivors, and disability insurance), and
2. 1.45% each for Medicare tax (hospital insurance).

Wage limits. For social security tax, the maximum amount of 2005 wages subject to the tax increases to \$90,000. For Medicare tax, all covered 2005 wages are subject to the tax.

Self-Employment Tax. The self-employment tax rate on net earnings remains the same for 2005. This rate, 15.3%, is a total of 12.4% for social security and 2.9% for Medicare. The maximum amount subject to the social security part increased to \$90,000. All net earnings of at least \$400 are subject to the Medicare part.

Modified AGI Limit for Traditional IRAs Increases. For 2005, if you are covered by a retirement plan at work, your deduction for contributions to a traditional IRA will be reduced (phased out) if your modified adjusted gross income (AGI) is:

- More than \$70,000 but less than \$80,000 for a married couple filing a joint return or a qualifying widow(er),
- More than \$50,000 but less than \$60,000 for a single individual or head of household, or
- Less than \$10,000 for a married individual filing a separate return.

Traditional IRA Contribution and Deduction Limit. The contribution limit to your traditional IRA for 2005 will be increased to the smaller of \$4,000, or your taxable compensation for the year.

If you are age 50 or older in 2005, the most that can be contributed to your traditional IRA for 2005 will be the smaller of \$4,500 or your taxable compensation for the year.

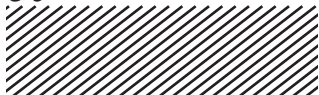
Roth IRA Contribution Limit. If contributions on your behalf are made only to Roth IRAs, your contribution limit for 2005 will generally be the lesser of \$4,000, or your taxable compensation for the year.

If you are age 50 or older in 2005 and contributions on your behalf are made only to Roth IRAs, your contribution limit for 2005 will generally be the lesser of \$4,500 or your taxable compensation for the year.

However, if your modified AGI is above a certain amount, your contribution limit may be reduced.

Education Credits. The maximum Modified Adjusted Gross Income (MAGI) increased to \$53,000 for single, head of household and qualified widower(er) taxpayers and \$107,000 for married filing jointly.

Child and Dependent Care Expenses. For 2005, the taxpayer no longer needs to meet the Keeping Up a Home test.



INTRODUCTION AND ADMINISTRATIVE GUIDELINES

Welcome to the Tax Year 2005 Volunteer Tax Preparation Program (VRPP). We're glad you decided to take advantage of this challenging, yet rewarding experience as an important player in the tax administration process.

Before "getting started" with the tax law and tax preparation aspect of the course, let's discuss the following administrative matters:

- How to uphold the IRS's privacy policy while serving as a volunteer.
- Your role in maintaining the integrity of the VRPP.
- Resources to assist you in preparing accurate and complete returns.
- Steps for conducting effective interviews with taxpayers.
- The importance of the screening and probing interviews.
- Frequent taxpayer inquiries.

The last topic "frequent taxpayer inquiries" provides insight into topics taxpayers frequently inquire about during the interview process. Your site reference materials contain additional information about these and other topics.

We encourage you to reinforce the tax law training in this course at your own pace using the on-line course (Link and Learn Taxes) at www.irs.gov keyword: volunteer training.

We welcome your comments and suggestions for improving our products and encourage you to respond to the course evaluation survey included in your kit. Your instructor will provide additional information about the evaluation process.

ALERT



This lesson covers personal and administrative matters that impact all volunteers. It is part of the basic, intermediate, advanced, and military/international courses.

ALERT



You are the key to the integrity of the VRPP.

Every year thousands of volunteers assist millions of people with their federal returns and have certain protections under the federal Volunteer Protection Act of 1997, Public Law 105-19 (42 U.S. Code sections 14501 et seq.). The Act applies to volunteers who perform services for nonprofit organizations or government entities, and receive no compensation other than reasonable reimbursement or allowance for expenses actually incurred (or any other things of value in lieu of compensation over \$500 per year), and to a volunteer serving as director, officer, trustee, or direct service volunteer. Consult your site coordinator for a copy of the Act.

Standards of Conduct and Program Integrity

As a VRPP volunteer, you have a responsibility to provide quality service and to uphold the ethical standards of the program. You must sign an agreement to adhere to these standards:

- Treat all taxpayers professionally, with courtesy and respect.
- Safeguard the confidentiality of taxpayer information.
- Apply the tax laws equitably and accurately to the best of your ability.
- Only prepare returns within the scope of your training and experience.
- Exercise reasonable care in the use and protection of equipment and supplies.
- Do not solicit business from taxpayers you assist or use knowledge you gained about them for any direct or indirect personal benefit for you or any other individual or organization.
- Do not accept payment for services provided. **Note:** You may receive compensation from your Site sponsor.

NOTE: Only paid preparers should accept payment for preparing a tax return. Paid preparers are legally liable under federal law for the returns they prepare; VRPP volunteers are not. This means you cannot accept payment of any kind for preparing a federal tax return or for providing any other tax-related assistance.

Taxpayers will trust that all information you receive from them is protected from disclosure. To maintain this trust:

- **Do not** disclose any personal tax information gained as a result of the service provided.
- **Do not** openly discuss taxpayers by name in the presence of other volunteers or taxpayers. You may discuss tax situations with other taxpayers and volunteers. For example, a volunteer may refer to a situation (not a taxpayer) and ask or give advice about the appropriate tax treatment for that specific situation.
- **Do not** retain taxpayer(s)' documents for a follow-up visit. Fully complete the taxpayer's return at the time of service.

ALERT



Do not solicit or accept payment for the services you provide. During an interview on a local television news program, a taxpayer complained that she had been improperly charged a fee by a VRPP participant to have her tax return prepared. She found out through the IRS that VRPP participants were suppose to prepare tax returns for free.

- **Do not** take the taxpayers' information for completion of the return outside the presence of the taxpayer.
- **Do not** prepare a tax return when you suspect an individual is not providing truthful information.

Some individuals may attempt to defraud the Government by filing false tax returns. If you have any question at all about the validity of information provided by a taxpayer, or are uncomfortable with a taxpayer situation, discuss your concern with your site coordinator or other individual in charge of the site.

Volunteer Site Credentials

The VRPP Wallet Card, Form 13645, was created to acknowledge the accomplishment of certified volunteers as well as to assist internal and external stakeholders with identifying certified volunteers. Your site coordinator or instructor may provide you a wallet card when you pass either an IRS test or an IRS-approved alternative partner test. If provided, you should bring your wallet card to the tax preparation site for identification purposes.

SITE IDENTIFICATION NUMBER (SIDN)

Each paper or electronically filed return should be identified with the appropriate site identification number (SIDN) to ensure that all volunteer-prepared returns are readily identifiable by the Internal Revenue Service.

Your SIDN is an 8-digit number preceded by the “letter S” that must be entered on all returns (Forms 1040, 1040A, and 1040EZ) you prepare—both paper and electronic. Your site coordinator provides this number along with other necessary guidelines for completing the return.

The SIDN should appear in the “Paid Preparer’s Use Only” section of the return and will be discussed in detail in Lesson 14, *Finishing the Return*.

SCOPE OF THE PROGRAM

It is vital for you to assist only with returns, supporting schedules and forms for which you have been trained and certified. Remember to refer taxpayers with tax situations outside your scope of training, experience and certification to your site coordinator and/or a paid preparer.

The training resources and tools discussed in this course support the completion of the following returns and attachments:

- Form 1040, U.S. Individual Income Tax Return & 1040 Schedules—A, B, C-EZ, EIC & R
- Form 1040A, U.S. Individual Income Tax Return & 1040A Schedules 1, 2, 3 & EIC

- Form 1040EZ, Income Tax Return for Single and Joint Filers w/ No Dependents
- Form-1040V, Payment Voucher
- Form 1040-ES, Estimated Tax For Individuals
- Form 2441, Child and Dependent Care Credit
- Form 8812, Additional Child Tax Credit
- Form 8863, Education Credits

The training does not address the more complex tax law associated with the following forms and schedules:

- Form 1040 Schedule C, Profit or Loss From Business
- Form 1040 Schedule D, Capital Gains and Losses
- Form 1040 Schedule E, Rents & Losses
- Form 1040X, Amended U.S. Individual Income Tax Return
- Form 2106, Employee Business Expenses (exception: Military/International Course)
- Form 3903, Moving Expenses (exception: Military/International Course)

HELP FROM THE IRS

The following tools and resources are available to assist you in filing an accurate and complete return.

e-file Software

A major initiative of the IRS is to encourage taxpayers to file their returns electronically—e-file. Those VRPP partners that electronically file customers' returns eliminate simple math errors and other omissions by using the edits in the software. Additionally, electronically filing certifies IRS receipt of the return and if a refund is due, customers will receive it sooner. The e-filing software is available FREE to qualifying VRPP sponsors. Consult your sponsor for additional information.

e-file Reference Materials

- **Volunteer e-file Administrator Guide** (Publication 3189) provides guidance on IRS standards for volunteer sites, administrative procedures in using return preparation software, and samples of the types of documents needed to successfully operate a volunteer e-file site.
- **Handbook for Authorized IRS e-file Providers** (Publication 1345) is another useful reference publication. It contains information of use to Electronic Return Originators already in the IRS e-file program.

Key Technical Reference Materials

When you arrive at the tax preparation site, your site coordinator will assist you with your resource needs. Throughout this course, your instructor will refer to various forms, publications, worksheets and instructions that will be useful during training and when assisting taxpayers. Although not required, it is suggested that each site maintain a technical research library—paper or electronic.

As a part of your training, you will receive two critical publications intended for use while in training and at your site when assisting taxpayers.

- **The Volunteer Resource Guide** (Publication 4012) is designed for use with Form 13614, Interview and Intake Sheet. The exhibit on page 7 depicts the correlation between the tabs in the publication and the questions on the Form. It is customized to the scope of the VRPP and is designed to assist you in preparing an accurate return by providing tips for “asking the right questions.”

Section one (white tabs) includes tax preparation reference materials and decisions charts for both paper and electronic filers and Section two (yellow tabs) contains step-by-step procedures for e-file software users.

Another useful component of Publication 4012 is a listing of contact numbers and web sites frequently used by volunteers.

- **Your Federal Income Tax For Individuals** (Publication 17) provides detailed explanations and examples of tax law topics typically seen at volunteer sites. It is a comprehensive tax resource guide for individual taxpayers.

Site and Technical Resources

- **The Interview and Intake Sheet (Form 13614)** is the starting point for further probing and interviewing to assess the taxpayer tax situations—filing status, number of exemptions, etc.

Your site coordinator can obtain Form 13614 (Exhibit 1) from the IRS or may develop a paper or electronic product to gather the information. Form 13614 can be downloaded from www.irs.gov and photocopied as needed.

- **Instruction Booklets – Forms 1040, 1040A and 1040EZ** provide line-by-line directions completing each of the tax return forms—Form 1040, 1040A and 1040EZ—and the applicable schedules associated with each product.
- **Taxpayer Information Publication (Publication 1194)** is a compilation of the most frequently requested taxpayer information publications. The publications referenced in this training material (i.e., Publication 596, Earned Income Credit

Publication 972, Child Tax Credit; Benefits Publication 501, Exemptions Standard Deduction and Filing Information) are normally included in Publication 1194. Publication 1194 is published as a two-volume set.

- **Volunteer Hotline Access 1-800-829-8482 (Volunteers Only)** is for telephonic VRPP tax assistance. This volunteer only hotline is operational during the filing season. When calling, identify yourself as a VRPP volunteer.
- **1040 Central at www.irs.gov** is your electronic source for tax forms, information and updates.
- **Volunteer Quality Alerts** are messages which provide tax law updates and other helpful tips to volunteers throughout the filing season. Monitor www.irs.gov – keyword: Volunteer Quality Alerts.
- **Volunteer Coordinator’s Handbook (Publication 1084)** contains an overview of how to establish and manage a Volunteer Site. It includes policies, procedures, roles and responsibilities, management tools and tips designed to insure consistency and quality in the delivery of VRPP services.
- **Equipment and Supplies** required at the tax preparation Site may be provided by the IRS. Consult your sponsor or site coordinator for specific information about available property, use restrictions, and security and maintenance requirements. A Property Loan Agreement (Form 13632) must be signed by individuals and/or organizations that receive Government property. All equipment remains the property of the Government and may not be used for commercial purposes.

Commercial and certain personal uses of the property may terminate the Property Loan Agreement. Recipients of Government property certifies that the equipment will be used for volunteer electronic tax return preparation and filing. It may also be used for related activities associated with supporting the volunteer program as listed in the Agreement.

Sites that file paper returns should use the VRPP overprinted returns forms (Form 1040, 1040A and 1040EZ) furnished by the IRS. These forms which are orderable in the fall of the year are modified to accommodate the site identification number in the Paid Preparer’s Only Use portion of the form.

This section is intended to serve as a reference. It does not constitute legal guidance. For additional guidance, contact your site coordinator or sponsor.

Form 13614 (Rev. 11-2005)	INTERVIEW AND INTAKE SHEET
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Instructions: This form will be used by screeners, preparers, or others involved in the return preparation process. Please complete all information. The partner or site may request additional information. The service statement and request for the taxpayer's signature(s) on page 2 must be included on partner in-take forms used in lieu of this IRS Form 13614.

You will need:

<input type="checkbox"/> Valid Picture I.D. <input checked="checked" type="checkbox"/> A Copies of ALL W-2, 1098, 1099 Forms and the amount of other income received by you and your spouse <input checked="checked" type="checkbox"/> A Tax Identification Number (TIN) for you, your spouse and any others shown on the tax return <input checked="checked" type="checkbox"/> E Provider's address and Tax Identification Number for Child/Dependent Care Credit	<input type="checkbox"/> Form 8332 or copy of divorce decree for non-custodial parent claiming child C <input type="checkbox"/> Proof of Account Number and Routing Transit Number of the financial institution for direct deposit into a savings or checking account <input type="checkbox"/> Copy of prior year's tax return, if available
--	--

Your First Name	M.I.	Last Name
Spouse's First Name	M.I.	Spouse's Last Name, if different
Address	City	State
		Zip Code
Telephone Number: Daytime	Evening	Cell
Your Date of Birth (mm/dd/yyyy) A D E H	Spouse's Date of Birth (mm/dd/yyyy) / /	

Critical Data

Check if U.S. Citizen or resident alien all year: <input type="checkbox"/> Taxpayer <input type="checkbox"/> Spouse A C D E F G H	Check if lived in U.S. for more than 6 months: <input type="checkbox"/> Taxpayer <input type="checkbox"/> Spouse B D E F G H
Check if Legally Blind: <input type="checkbox"/> Taxpayer <input type="checkbox"/> Spouse A D	Check if Permanently Disabled: <input type="checkbox"/> Taxpayer <input type="checkbox"/> Spouse D E
As of December 31st were you: <input type="checkbox"/> Single <input type="checkbox"/> Legally Married <input type="checkbox"/> Separated <input type="checkbox"/> Divorced A B D H	
If married, were you living with your spouse at anytime during the last 6 months of the year? <input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> N/A B	
Is your spouse deceased? <input type="checkbox"/> Yes <input type="checkbox"/> No	If yes, date spouse died (mm/dd/yyyy) / / A B D
Can your parents or someone else claim you or your spouse as a dependent on their tax return? <input type="checkbox"/> Yes <input type="checkbox"/> No A C D H	
Did you provide more than half the cost of keeping up a home for the year? <input type="checkbox"/> Yes <input type="checkbox"/> No B D H	
Has the Earned Income Credit been disallowed by IRS? <input type="checkbox"/> Yes <input type="checkbox"/> No H	

Family and Dependent Information

List everyone who lived in your home and anyone living outside your home that you or your spouse supported during the tax year. For example: Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them, also mother or father. **Do not include yourself or your spouse.** **C**

C First Name	Last Name	C E F H G Date of Birth (mm/dd/yyyy)	C H Relationship to you	H Months in home, *see Special Rules below	C US Citizen, Resident of US, Canada or Mexico	C Did person file joint return?	C E H Is child a full-time student or permanently and totally disabled?	Did child provide more than 50% of their own support?	Did you provide more than 50% of their support?	Did the person have Gross Income of \$3200 or more?	Is person qualifying child of another person?
								C	C	C	C H

***Special Rules** for Divorced, Legally Separated, or Never Married parents; if the child lived in your home for 6 months or less:

- Did one or both parents provide over half of the child's total support? Yes No **C**
- Is the child in custody of one or both parents for more than half of the year? Yes No **C B C F**
- Did the custodial parent sign the Form 8332 or similar statement releasing the exemption? Yes No **G**

During the tax year did you, your spouse, or anyone in your household:

Receive any investment Income (For example: interest or dividends)? A F <input type="checkbox"/> Yes <input type="checkbox"/> No	Pay student loan interest? F <input type="checkbox"/> Yes <input type="checkbox"/> No
Receive a distribution from an IRA or retirement plan? F <input type="checkbox"/> Yes <input type="checkbox"/> No	Attend college or vocational school? C D E F G H <input type="checkbox"/> Yes <input type="checkbox"/> No
Receive Social Security payments? A <input type="checkbox"/> Yes <input type="checkbox"/> No	Own a home? <input type="checkbox"/> Yes <input type="checkbox"/> No
Receive unemployment payments? A <input type="checkbox"/> Yes <input type="checkbox"/> No	Pay for child/dependent care that allowed you to work? E <input type="checkbox"/> Yes <input type="checkbox"/> No
Have income that was not reported on a W-2 or 1099? (For example: gambling winnings, jury duty, alimony or self employment income) A <input type="checkbox"/> Yes <input type="checkbox"/> No	Can someone other than you use your child to claim the EITC? H <input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> N/A
Make contributions to an IRA or a retirement plan? F <input type="checkbox"/> Yes <input type="checkbox"/> No	

Authorization

- Do you authorize the retention of Form 13614, Interview and Intake Sheet, to help with the processing of your tax return? Yes No
- Do you authorize the retention of your electronic tax return information for subsequent return preparation? Yes No
- Do you authorize the retention of your name, address, and telephone number for the purpose of mailing of product and/or services that may be of value to you? Yes No

Note: Answer all three questions, each one stands on its own merit.

Service Statement: You will not be denied service if you do not authorize any of these retention options. The information retained will not be shared with any unauthorized persons and will not be sold, given away, or used for commercial purposes. This information will be properly disposed of when no longer needed and retained no longer than 3 years from the due date of the return.

Signature

Date

Interview Notes:

- (Volunteer Use Only: Be sure to note anything that changed on this intake sheet because of your interview. Coordinator and IRS Site Reviewer will use this information to verify accuracy of return.)

COURSE INTRODUCTION AND OBJECTIVES

This course is designed to guide you through the basics of tax law and tax return preparation. You'll be able to answer frequently asked questions and assist taxpayers in filing an accurate and complete return.

After completing this course, you should be able to:

- Determine if the taxpayer need/should file a return
- Accurately fill out Forms 1040EZ, 1040A and 1040
- Accurately answer questions about filing a tax return
- Accurately and appropriately select and fill out additional forms and schedules that accompany each return.
- Find answers to any questions regarding filing a tax return
- Solicit “appropriate” information from the taxpayer to complete an accurate return.
- Test and become certified to be a volunteer return preparer

The Lessons and the Return Forms

Exhibits 2, 3 and 4 (pages 16–20) assist you in correlating the information presented in the course to the three tax return forms—Form 1040EZ, Form 1040A, and Form 1040.

The Four Courses

All volunteer assistors must take one of four courses—basic, intermediate, advanced or military/international and pass an IRS-approved test.

See Publication 6744, VRPP Test in your training kit for additional information about testing and certification. A complete listing of the courses and applicable lessons is in the table of contents of this publication.

Your training kit contains the materials you need to accomplish this requirement as follows:

- Student Text (Publication 678)
- Comprehensive Problems and Exercises (Publication 678-W)
- Test (Form 6744)
- Volunteer Resource Guide (Publication 4012—for use in the classroom and at the site)
- VRPP Plastic Bag, (Publication 1278)
- Evaluation Forms (Form 12466 and 12469)

It is very important that you assist only with returns, forms and supporting schedules for which you have been trained and certified to prepare. If you go beyond your training, you risk making errors

and causing difficulties for those you wish to help. Refer taxpayers with difficult returns, or with portions of returns that are beyond the scope of your training, to a paid professional tax preparer.

There are separate training supplements available for the following categories of taxpayers:

- Foreign Students and Scholars - Publication 678FS
- Tax Issues for Puerto Rico - Publication 678PR

LESSON FEATURES

Introduction and Objectives

Each lesson or segment contains a brief introductory statement and a list of objectives.

Summing Up This Section, Segment or Lesson

This feature provides a summary of the main points covered in the lesson. The summaries provide a comprehensive overview of the course content.

Sidebar Features

Sidebar features appear in the outer margins (left and right) of the text. These boxed features emphasize important points presented in the lesson, or provide additional, related information.

- **Potential Pitfalls** point out commonly made errors and indicate ways to avoid these errors.
- **Alert!** identifies pending legislation, tax law changes, or tax form changes that were expected, but not enacted or in final form when this publication went to print.

Interview Tips

To assist you in asking the right questions, interview tips are included in the lessons on filing status (Lesson 2), dependency and exemptions (Lesson 1), the earned income credit (Lesson 5) and the child tax credit (Lesson 6). These tips are repeated in your on-site reference guide—Volunteer Resource Guide, Publication 4012.

Proof Copies of Forms

Forms imprinted in this publication were current as of the “proof as of date” shown on each product. Final copies of the products can be found at www.irs.gov and may have supplemental changes. The charts and exhibits can be found in Publication 17 and the tax

return instruction booklets (in most cases). **Be sure to** compare the final forms with those in this publication and make sure you understand processing changes (if any) before helping taxpayers with their returns.

Exercises and Exhibits

The exercises and problems in the lessons and Publication 678-W (included in your Kit) allow you to apply the knowledge gained in each lesson. The information in this course can be reinforced using the web-based volunteer training—Link and Learn Taxes at www.irs.gov.

The exhibits are numbered starting at the beginning of each lesson. Many of the exercises contain exhibits of blank forms, or part of the form, that you must complete.

Testing and Certification

All volunteers must take the applicable test to show that they can complete returns accurately. Volunteers who do not pass the test may take the appropriate retest. Instructions on taking and grading the test are in the test booklet in your training kit. Your instructor will provide additional testing options.

SCREENING AND PROBING INTERVIEWS

To assist you in completing an accurate return, you must ask certain questions about the taxpayer and their families. Prior to completing the taxpayer's return, the taxpayer should provide answers to the critical intake questions shown on Form 13614 (*at a minimum*)—Exhibit 1 (page 7). The exhibit depicts the correlation between the critical intake questions and the information in your On-Site resource guide—Publication 4012.

All VRPP sites are required to ask the critical intake questions and conduct a probing interview to confirm the accuracy of the information provided by each taxpayer. You should not assume that prior year information or general information provided by the taxpayer is complete. Form 13614 (or an equivalent) serves as a starting point for interviewing the taxpayer to assess their tax situation—filing status, number of exemptions, tax credit eligibility, etc.

THE FOUR-STEP INTERVIEW PROCESS

As you become experienced with interviewing taxpayers, you will develop your own interview approach which should encompass the four steps in the following chart.

During the interview you should:

- Review each taxpayer’s response to the critical intake questions.
- Ask if they were uncertain about any responses.
- Explain the tax preparation process and encourage them to ask questions throughout the interview.
- Use the intake sheet along with the Interview Tips and charts in Publication 4012 to probe for accurate and complete information.



The four-step interview process

interview steps

Goal

Suggested Actions

step
1

Cultivate a comfortable environment and put the taxpayer at ease.

- Introduce yourself; engage in small talk (discuss the weather, difficulty in locating the site, apologize if long wait, etc.).
- Explain the tax return preparation process—the interview, how the information they provide will assist you in determining whether they must file a return, their eligibility for tax credits, how you will ensure the accuracy of the quality review process, etc.
- Allow the taxpayer to share any expectations, needs, and/or concerns by asking whether they have questions before beginning and encouraging them to ask questions throughout the process.

step
2

Use active listening skills.

- Watch for nonverbal listening cues (tone of voice, body language, eye contact, etc.)
- Listen, then respond by restating, paraphrasing and/or encouraging further dialogue

step
3

Assess the taxpayer’s responses to the critical intake questions (Form 13614 or equivalent)

- Scan the information for completeness
- Don’t assume—use the interview tips and decision trees in Publication 4012 to confirm:
 - Marital status (filing status)
 - Number of exemptions
 - Eligibility for Child Tax Credit
 - Eligibility for the Earned Income Credit

step
4

Advise taxpayer of the next steps

- Restate the return preparation process, quality review procedures, signature and record keeping requirements, etc.

As the interview continues, the taxpayer may become upset; even so, continue to ask the questions until you get enough information to complete the return. However, deal with the taxpayer’s emotional state:

- If silent (“Tell me more about . . .”)
- Upset (paraphrase or define any terms that may be unfamiliar to the taxpayer)
- Check your own comfort level
- Respond to any misunderstandings

- Continue with effective questioning and active listening
- Say “I hear you” or “I understand” and repeat the question
- Allow adequate response time
- Avoid making assumptions

CRITICAL INTAKE DOCUMENTS—PROOF OF IDENTITY, INCOME, ETC.

A critical component of the intake process is confirming that the taxpayer has the required documentation and that he/she is the individual being served. The three steps in this component include:

- **Confirm Taxpayer’s Identity.** The taxpayer should provide two forms of identification in order to receive tax preparation services. One must be valid picture identification—a U.S. driver’s license or state identification card, school photo, Military identification card, passport or VISA. Additional forms of identification are discussed later in Lesson 1, Getting Started.
- **Review Income/Reporting Documents.** The taxpayer must provide information depicting their income sources such as wage and earning statements (Form W-2), investment income (Forms 1099, etc.) as discussed in Lesson 3, Income.
- **Confirm Taxpayer Identification Number(s).** Each person listed on the taxpayer’s return must be identified by a number. This includes the taxpayer, the taxpayer’s spouse (if married) and any dependents claimed on the return. The taxpayer identification number (TIN) will be a social security number (SSN), an individual taxpayer identification number (ITIN) or an adoption individual taxpayer identification number (ATIN). All are discussed in detail in Lesson 1, Getting Started.

The taxpayer’s return cannot be prepared without the above information. If the taxpayer has the required proofs of identity, income reporting documents and taxpayer identification number(s) and their income is within the scope of the program a more intensive probing interview is required.

In those instances where the taxpayer appears to qualify for the VRPP assistance but does not have all the required documentation (W-2s, TINs, etc.) you may provide guidance as explained in Lessons 1 and 3 for acquiring the missing or incomplete documentation. If they have the required documentation but their tax situation is outside the scope of the VRPP and/or your VRPP certification you should courteously restate the scope of the program and encourage the taxpayer to seek services elsewhere or seek direction from the site coordinator.

Exercise—The Interview Process

Alice lost her husband Rodney to cancer during the tax year. The couple has two daughters—Julie (age 6) and Samantha (age 8). Alice has come to Justin’s VRPP site with some questions about completing her tax return.

Make your entries in “How Would You Respond” and be prepared to explain why.

The Volunteer says	Taxpayer’s Response	How would you respond (enter your reply)
Hello, I’m Justin. How may I help you today?	Hi, I’m Alice Moore. I need assistance with my tax return. My husband died and I’m trying to deal with my tax situation.	
Oh, I’m so sorry about your loss. It must be very difficult for you.	Thank you, I still miss him very much. I can hardly even write his name on the tax form, much less think about doing these taxes. He died last year.	
I understand. Well, we’ll take it slow today. Do you have any specific questions you’d like to address?	Well, yes, actually. A friend of mine told me about a widow filing status that might help me with my deductions. I was wondering if I should file that way on my tax return this year.	
Well actually, you may be able to file a joint return, and that should help too. I know this may be upsetting to you. I’ll have to ask you some questions that will help us determine your filing status.* First of all, did you remarry during the year?	No, of course not... What if I had remarried?	
It just means you wouldn’t qualify for the joint return filing status with your deceased husband. But you do qualify for married filing jointly, and I’d be happy to help you complete your return today.		

*See Publication 4012—Filing Status Tab

FREQUENT TAXPAYER INQUIRIES

Taxpayers normally ask questions during the interview process about the topics covered in this section. Visit [www.irs.gov-keyword: 1040 Central](http://www.irs.gov-keyword:1040) or see Publication 17 for additional topics and information.

Peel-Off Label

Taxpayers that e-file their return are normally removed from the IRS tax return package mailing list. If the taxpayer did not receive a tax return package and a paper return is filed, print or type their name and address in the space provided. Taxpayers that receive e-file assistance through the VRPP normally receive a tax return package each year even if their return is e-filed.

Installment Payment

Publication 594, The IRS Collection Process, explains taxpayers' rights and responsibilities regarding payment of federal taxes.

Copies of Prior-Years' Returns

Taxpayers should complete Form 4506, Request for Copy or Transcript of Tax Form, and mail it, with the required fee, to the IRS campus where the return was filed.

A transcript of a prior-year return may be obtained, also using Form 4506. There is no charge for the transcript which shows most line items from the original return, including accompanying forms and schedules.

Amended Returns

Form 1040X, Amended U.S. Individual Income Tax Return should be used by taxpayer to amend their return. Many mistakes are corrected in processing by the IRS and a letter of explanation is mailed at the time an error is identified or when a refund is issued.

Amended returns are not in the scope of this program.

Taxpayer Address Changes

Taxpayers should use Form 8822, Change of Address, to notify the IRS of any change of address. If taxpayers move after filing the return and before a refund is received, they should notify their old post office and the IRS of their new address.

Recordkeeping

Taxpayers should keep their tax documents until the statute of limitations runs out for the return. Usually, this is three years from the date the return was due or filed, or two years from the date the tax was paid, whichever is later. Refer taxpayers to Publication 552, Recordkeeping for Individuals or at www.irs.gov – keyword: Recordkeeping.

FREE Tax Preparation Locations

Consult your site coordinator for information about the location of other VRPP sites in your area. Taxpayer may call 1-800-829-1040 or visit AARP's

website at www.aarp.org/taxaide or call 1-888-227-7669 for this information.

Problems Navigating the IRS

Taxpayer may contact the Taxpayer Advocate if their attempts to deal with an IRS problem are unsuccessful.

Taxpayer can visit www.irs.gov/advocate or see Publication 1546, The Taxpayer Advocate Service the IRS provides. Also suggest Publication 910, Guide to Free Tax Services.

Refund Information

Taxpayer should be directed to www.irs.gov to obtain information about their refund. Specific information is available by clicking on "Where's My Refund?"

Innocent Spouse Relief

Taxpayers that file a joint tax return are jointly and individually responsible for the tax and any interest or penalty due on the joint return even if they later divorce. In some cases, a spouse (or former spouse) will be relieved of the tax, interest, and penalties on a joint tax return. Spousal relief is granted in certain situations when a taxpayer can prove he/she is not liable for amounts due in joint filing situations.

Taxpayer should see Publication 971, Innocent Spouse Relief which explains the types of relief, who may qualify for them, and how to get them. Married persons who did not file joint returns, but who live in community property states, may also qualify for relief.

Injured Spouse Relief

An injured spouse claim is different from an innocent spouse relief request. An injured spouse request the division of tax overpayment attributed to each spouse. The injured spouse must file Form 8379, Injured Spouse Claim and Allocation, to request his or her portion of the joint refund. The injured spouse must have made payments such as Federal income tax withheld from wages or estimated tax payments, unless EITC or another refundable credit was claimed on the joint return.

Married Filing Separately Advantages

Unless required to file separately, married taxpayers may want their tax figured on a joint return and on separate returns. To make sure they are receiving the most advantageous filing status. Generally, however married taxpayer pay more combined tax on separate returns than they would on a joint return. See Publication 17, Filing Status for Special Rules.

Label (See page 11.) Use the IRS label. Otherwise, please print or type.

Form header section with fields for name, address, and social security numbers. Includes a vertical 'LABEL HERE' stamp.

Introduction and Administrative Guidelines and Lesson 14 - Finishing the Return

Presidential Election Campaign (page 11)

Check here if you, or your spouse if a joint return, want \$3 to go to this fund? [] You [] Spouse

Income Attach Form(s) W-2 here. Enclose, but do not attach, any payment.

Income section with lines 1-6. Includes boxes for 'Lesson 3 - Income' and 'Lesson 2 - Filing Status and Filing Requirement'.

Note. You must check Yes or No.

Payments and tax

Payments and tax section with lines 7-10. Includes boxes for 'Lesson 4 - Deductions and Tax Computations', 'Lesson 5 - Earned Income Credit', and 'Lesson 14 - Finishing the Return'.

Refund

Have it directly deposited! See page 18 and fill in 11b, 11c, and 11d.

Refund section with line 11a and routing/account numbers. Includes a box for 'Lesson 14 - Finishing the Return'.

Amount you owe

Amount you owe section with line 12. Includes a box for 'Lesson 14 - Finishing the Return'.

Third party designee

Third party designee section with fields for name and phone number. Includes a box for 'Lesson 14 - Finishing the Return'.

Sign here

Joint return? See page 11. Keep a copy for your records.

Sign here section with declaration and signature lines for taxpayer and spouse. Includes a box for 'Lesson 14 - Finishing the Return'.

Paid preparer's use only

Paid preparer's use only section with fields for signature, date, and firm information. Includes a box for 'Enter your SIDN here'.

Label
(See page 18.)

Use the IRS label.
Otherwise, please print or type.

Introduction and Administrative Guidelines and Lesson 14 – Finishing the Return

Your first name and initial _____ Last name _____

If a joint return, spouse's first name and initial _____ Last name _____

Home address (number and street). If you have a P.O. box, see page 18. _____ Apt. no. _____

City, town or post office, state, and ZIP code. If you have a foreign address, see page 18. _____

OMB No. 1545-0085

Your social security number _____

Spouse's social security number _____

You **must** enter your SSN(s) above. ▲

Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 18) ▶ You Spouse

Filing status Check only one box.

1 Single

2 Married filing jointly

3 Married filing separately

4 Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶

5 Qualifying widow(er) with dependent child (see page 19)

Lesson 2 – Filing Status and Filing Requirement

Exemptions

6a Yourself. If someone can claim you as a dependent, do not check box 6a.

b Spouse

c **Dependents:**

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if qualifying child for child tax credit (see page 21)
				<input type="checkbox"/>
				<input type="checkbox"/>
				<input type="checkbox"/>
				<input type="checkbox"/>
				<input type="checkbox"/>

d Total number of exemptions claimed.

Lesson 1 – Getting Started

Boxes checked on 6a and 6b _____

No. of children on 6c who:

- lived with you _____
- did not live with you due to divorce or separation (see page 21) _____

Dependents on 6c not entered above _____

Add numbers on lines above ▶

Income

7 Wages, salaries, tips, etc. Attach Form(s) W-2. **Lesson 3 – Income** 7

8a Taxable interest. Attach Schedule 1 if required. 8a

b Tax-exempt interest. Do not include on line 8a. 8b

9a Ordinary dividends. Attach Schedule 1 if required. 9a

b Qualified dividends (see page 23). 9b

10 Capital gain distributions (see page 23). 10

11a IRA distributions. 11a

11b Taxable amount (see page 23). 11b

12a Pensions and annuities. 12a

12b Taxable amount (see page 24). 12b

13 Unemployment compensation and Alaska Permanent Fund dividends. 13

14a Social security benefits. 14a

14b Taxable amount (see page 26). 14b

15 Add lines 7 through 14b (far right column). This is your **total income**. ▶ 15

Adjusted gross income

16 Educator expenses (see page 26). 16

17 IRA deduction (see page 26). 17

18 Student loan interest deduction (see page 29). 18

19 Tuition and fees deduction (see page 29). 19

20 Add lines 16 through 19. These are your **total adjustments**. 20

21 Subtract line 20 from line 15. This is your **adjusted gross income**. ▶ 21

Lesson 10 – Adjustments

Tax, credits, and payments

Form 1040A (2005) lines 22-48. Includes sections for Tax (22), Standard Deduction (24-25), Credits (26-34), Total Credits (35), Total Tax (37-38), Total Payments (42-43), Refund (44), Amount you owe (47-48).

Standard Deduction for—
• People who checked any box on line 23a or 23b or who can be claimed as a dependent, see page 31.
• All others:
Single or Married filing separately, \$5,000
Married filing jointly or Qualifying widow(er), \$10,000
Head of household, \$7,300

If you have a qualifying child, attach Schedule EIC.

Direct deposit? See page 10 and fill in 45b, 45c, and 45d.

Amount you owe

Third party designee

Sign here

Joint return? See page 18. Keep a copy for your records.

Paid preparer's use only

Lesson 4 - Deductions and Tax Computation

Lesson 7 - Child and Dependent Care

Lesson 8 - Education Credit

Lesson 6 - Child Tax Credit

Lesson 9 - Miscellaneous Credits

Lesson 3 - Income
Lesson 5 - Earned Income Credit
Lesson 14 - Finishing the Return

Lesson 5 - Earned Income Credit

Lesson 6 - Child Tax Credit

Lesson 14 - Finishing the Return

Lesson 14 - Finishing the Return

Lesson 14 - Finishing the Return

Lesson 14 - Finishing the Return

Lesson 14 - Finishing the Return

Enter your SIDN here

Label

(See instructions on page 16.) Use the IRS label. Otherwise, please print or type.

Label Here

For the year Jan. 1–Dec. 31, 2005, or other tax year beginning , 2005, ending , 20 OMB No. 1545-0074 Your first name and initial Last name Your social security number If a joint return, spouse's first name and initial Last name Spouse's social security number Home address (number and street). If you have a P.O. box, give the P.O. box number and street. City, town or post office, state, and ZIP code. If you have a foreign address, see page 16. You must enter your SSN(s) above. Checking a box below will not change your tax or refund.

Introduction and Administrative Guidelines and Lesson 14 - Finishing the Return

Presidential Election Campaign

Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 16) You Spouse

Filing Status

1 Single 2 Married filing jointly 3 Married filing separately. Enter spouse's SSN above and full name here. 5 Qualifying widow(er) with dependent child (see page 17)

Lesson 2 - Filing Status and Filing Requirement

Exemptions

6a Yourself. If someone can claim you as a dependent, do not check box 6a 6b Spouse 6c Dependents: (1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) if qualifying child for child tax credit (see page 18) 6d Total number of exemptions claimed

Lesson 1 - Getting Started

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7 Wages, salaries, tips, etc. Attach Form(s) W-2 7 8a Taxable interest. Attach Schedule B if required 8b Lesson 3 - Income b Tax-exempt interest. Do not include on line 8a 8b 9a Ordinary dividends. Attach Schedule B if required 9a Lesson 12 - Sale of Home b Qualified dividends (see page 20) 9b Lesson 12 - Sale of Stock Lesson 13 - Sale of Home 10 Taxable refunds, credits, or offsets of state and local income taxes (see page 20) 11 Alimony received 11 12 Business income or (loss). Attach Schedule C or C-EZ 12 Lesson 12 - Sale of Stock Lesson 13 - Sale of Home 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here 13 14 Other gains or (losses). Attach Form 4797 14 15a IRA distributions 15a b Taxable amount (see page 22) 15 Lesson 11 - Pensions 16a Pensions and annuities 16a b Taxable amount (see page 22) 16 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 17 18 Farm income or (loss). Attach Schedule F 18 19 Unemployment compensation 19 20a Social security benefits 20a b Taxable amount (see page 24) 20 Lesson 11 - Pensions 21 Other income. List type and amount (see page 24) 21 22 Add the amounts in the far right column for lines 7 through 21. This is your total income 22

Adjusted Gross Income

23 Educator expenses (see page 26) 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 3902 26 27 Self-employed SEP, SIMPLE, and qualified plans 27 28 Self-employed health insurance deduction (see page XX) 28 29 Penalty on early withdrawal of savings 29 30 30 31a Alimony paid b Recipient's SSN 31a 32 IRA deduction (see page XX) 32 33 Student loan interest deduction (see page XX) 33 34 Tuition and fees deduction (see page XX) 34 35 Domestic production activities deduction. Attach Form 8903 35 36 Add lines 23 through 31a and 32 through 35 36 37 Subtract line 36 from line 22. This is your adjusted gross income 37

Lesson 10 - Adjustments to Income

Tax and Credits

38 Amount from line 37 (adjusted gross income)
39a Check if: You were born before January 2, 1941, Blind. Total boxes checked 39a
b If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here 31
40 Itemized deductions (from Schedule A) or your standard deduction (see left margin)
41 Subtract line 40 from line 38
42 If line 38 is \$109,475 or less, multiply \$3,200 by the total number of exemptions claimed on line 6d. If line 38 is over \$109,475, see the worksheet on page 33
43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-
44 Tax (see page 33). Check if any tax is from: a Form(s) 8814 b Form 4972
45 Alternative minimum tax (see page 35). Attach Form 6251
46 Add lines 44 and 45
47 Foreign tax credit. Attach Form 1116 if required
48 Credit for child and dependent care expenses. Attach Form 2441
49 Credit for the elderly or the disabled. Attach Schedule R
50 Education credits. Attach Form 8863
51 Retirement savings contributions credit. Attach Form 8880
52 Child tax credit (see page 37). Attach Form 8901 if required
53 Adoption credit. Attach Form 8839
54 Credits from: a Form 8396 b Form 8859
55 Other credits. Check applicable box(es): a Form 3800 b Form 8801 c Specify
56 Add lines 47 through 55. These are your total credits
57 Subtract line 56 from line 46. If line 56 is more than line 46, enter -0-

38
Lesson 9 - Miscellaneous Credit
40
41
Lesson 4 - Deductions and Tax Computation
42
43
44
45
46
47
Lesson 7 - Child and Dependent Care Credit
48
49
Lesson 8 - Education Credits
50
51
Lesson 6 - Child Tax Credit
52
53
Lesson 9 - Miscellaneous Credits
54
55
56
57

Other Taxes

58 Self-employment tax. Attach Schedule SE
59 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137
60 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required
61 Advance earned income credit payments from Form(s) W-2
62 Household employment taxes. Attach Schedule H
63 Add lines 57 through 62. This is your total tax

58
Lesson 3 - Income
Lesson 11 - Pensions
59
60
61
62
63

Payments

64 Federal income tax withheld from Forms W-2 and 1099
65 2005 estimated tax payments and amount applied from 2004 return
66a Earned income credit (EIC)
b Nontaxable combat pay election 66b
67 Excess social security and tier 1 RRTA tax withheld (see page 54)
68 Additional child tax credit. Attach Form 8812
69 Amount paid with request for extension to file (see page 54)
70 Payments from: a Form 2439 b Form 4136 c Form 8885
71 Add lines 64, 65, 66a, and 67 through 70. These are your total payments

64
Lesson 14 - Finishing the Return
65
Lesson 5 - Earned Income Credit
66a
66b
67
Lesson 6 - Child Tax Credit
68
69
70
71
72

Refund

72 If line 71 is more than line 63, subtract line 63 from line 71. This is the amount you overpaid
73a Amount of line 72 you want refunded to you
b Routing number
c Type: Checking Savings
d Account number
74 Amount of line 72 you want applied to your 2006 estimated tax 74

72
Lesson 14 - Finishing the Return
73a
73b
73c
73d
74

Amount You Owe

75 Amount you owe. Subtract line 71 from line 63. For details on how to pay, see page 55
76 Estimated tax penalty (see page 55) 76

75
76

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 56)? Yes. Complete the following. No
Designee's name Lesson 14 - Finishing the Return
Personal identification number (PIN)

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.
Your signature Date Your occupation Daytime phone number
Spouse's signature Date Spouse's occupation

Paid Preparer's Use Only

Preparer's signature Date Check if Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code Lesson 14 - Finishing the Return Enter your SIDN here

▶▶ SUMMING UP THIS LESSON ◀◀

The goal of the Volunteer Return Preparation Program (VRPP) is to assist taxpayers in filing a timely and accurate tax return while uphold the integrity of the VRPP program. Key points to remember:

- ▶ Know your rights and responsibilities.
- ▶ Uphold the quality and ethical standards of the VRPP.
- ▶ Prepare returns within the scope of the VRPP and for which you have been certified.
- ▶ Use the fact-gathering tools—interview and intake sheet (Form 13614), decision trees, etc.
- ▶ Avoid making assumptions, always interview the taxpayer.
- ▶ Use Government furnished equipment as stated in the property loan agreement.
- ▶ Refer to Publications 4012 and 17 when assisting taxpayers.
- ▶ Consult with other more experienced volunteers when necessary.
- ▶ Help is available from the IRS. Call the Volunteer Hotline during the filing season and use the IRS technical resources and tools.
- ▶ Always interview the taxpayer—don't assume that prior year information or information written on the Interview and Intake Sheet is correct.
- ▶ Do not misuse Government property or charge taxpayers for the services you provide as a VRPP Volunteer. A taxpayer filed a complaint with the IRS that a VRPP participant had charged her a fee for preparing her tax return. The Department of the Treasury's Office of Investigation was notified and subsequently identified another taxpayer that stated her tax return was prepared for a fee by the same person. The taxpayers' copies of the tax return confirmed that the tax returns had been prepared on a Government computer and had been electronically stamped as being prepared by the VRPP.
- ▶ Complete the Self-Assessment on page 1 of your Volunteer Resource Guide (Publication 4012) to determine if you have everything you need to provide top quality professional service before assisting volunteers.

STUDENT NOTES

INTRODUCTION AND OBJECTIVES

In this lesson you will learn the information required from the taxpayer in order to assist them in filing an accurate return. The lesson will build on the information in the Introduction and Administrative Guidelines regarding critical intake questions and probing interviews.

After completing this lesson you should be able to:

- Explain the importance of the taxpayer identification number (TIN).
- Identify the 3 types of taxpayer identification numbers.
- Define the terms personal and dependency exemption.
- Apply the tests to determine whether an individual can be claimed as a dependent on a taxpayer's tax return.

TAXPAYER IDENTIFICATION AND SUPPORTING DOCUMENTS

Based on information in the Introduction and Administrative Guidelines, regarding the intake process and the importance of confirming the taxpayer's identity and supporting documents, you should have the following information.

- Valid photo identification and taxpayer identification number(s)
- Birth dates of all individuals to appear on the return.
- Current year's tax package (if they received one)
- Wage and earning statement(s)
Form W-2, W-2G, etc.
- Interest and dividend statements (Forms 1099)
- A copy of last year's Federal and State returns (if available)
- Documentation supporting a claim to a dependency exemption (Forms 8332 or 2120, etc.)
- Day care provider's identifying number and receipts (if applicable)
- Bank routing numbers and an account number for direct deposit

ALERT



This lesson contains basic tax law and is required training for all volunteers.

POTENTIAL PITFALLS



The tax law and taxpayer's tax situation changes from year to year. Avoid filing an erroneous return or delaying the taxpayer's refund—validate verbal and written information provided by the taxpayer using interview tips and decision trees discussed in this training and included in your site quick reference guide (Publication 4012).

ALERT



Always validate the taxpayer's identity and confirm the accuracy of all TINs submitted on their return by viewing social security cards and/or ITIN and ATIN documentation.

At a minimum, you will need the above information to “Get Started.” Due to the extreme importance of the taxpayer identification number (TIN), a more detailed discussion follows.

TAXPAYER IDENTIFICATION NUMBERS

For tax purposes, all individuals appearing on a tax return must have a taxpayer identification number (TIN). The TIN can be a social security number (SSN), an individual taxpayer identification number (ITIN) or an adoption individual taxpayer identification number (ATIN).

Social Security Number (SSN)

Each year thousands of returns are delayed in processing or credit/deductions are disallowed because names and social security numbers listed on the returns do not match the Social Security Administration's (SSA) records. SSA issues SSNs on social security cards.

To minimize processing delays (and a potential refund delay) ask the taxpayer to see their social security card (either the original or a copy) for each individual listed on the return. Then, verify the accuracy of the social security number and the spelling of the individual's name by ensuring that the information on the tax return matches the social security card.

If the taxpayer, their spouse or dependent(s) are not eligible for an SSN, they will need either an adoption or individual taxpayer identification number (ATIN/ITIN) from the IRS. These numbers should be entered on the return wherever an SSN is required.

Adoption Taxpayer Identification Number (ATIN)

During the adoption process, the taxpayer may not have been able to obtain an existing or a new SSN for the child. If the taxpayer is eligible to claim the child as their dependent, and does not have the child's SSN, then they will need to provide an ATIN to claim the child as a dependent and (if eligible) to claim the child care credit.

Form W-7A, Application for Taxpayer Identification Number for Pending U.S. Adoptions, should be filed with the IRS if the following are true:

1. The child lives with the taxpayer and was placed with him/her by a legal adoption agency.
2. The taxpayer cannot get the child's existing SSN after attempting to by reasonable means; or SSA will not provide an SSN because the adoption is not final.
3. The taxpayer is eligible to claim the child as a dependent on his/her tax return.
4. The taxpayer cannot get an ITIN for the child.

POTENTIAL PITFALLS



Processing delays (and a refund delay (if applicable)) will result from submitting incorrect information on the return.

Individual Taxpayer Identification Number (ITIN)

The IRS issues an ITIN to nonresident or resident aliens who are required to have a U.S. taxpayer identification number but who do not have, and are not eligible to obtain, an SSN.

An ITIN is issued for federal tax purposes only. It **does not** entitle the individual to Social Security benefits or the earned income credit. The ITIN creates no inference concerning the taxpayer's immigration status or their right to work in the United States.

ALERT



ITINS are issued by the IRS for federal tax purposes only.

WHO NEEDS AN ITIN?

Federal law requires individuals with U.S. income, regardless of immigration status, to have to file a U.S. tax return. If a taxpayer must file a U.S. tax return or can be listed on a U.S. tax return as a spouse or dependent they must have a taxpayer identification number (TIN).

For most individuals their taxpayer identification number is a Social Security Number, or SSN. If the taxpayer is a foreign person who does not have and is not eligible to obtain an SSN, they use an ITIN.

The Instructions Form W-7, Application for IRS Individual Taxpayer Identification Number contain detailed information about individuals who need an ITIN and how to complete and submit Form W-7 to the IRS to obtain one. See page M-1-2 for information about resident and non-resident aliens. Examples of individuals who need an ITIN include:

- Non-resident aliens filing a U.S. tax return and not eligible for an SSN
- U.S. resident aliens (based on days present in the United States) filing a U.S. tax return and not eligible for an SSN
- Dependents or spouses of a U.S. citizen/resident alien
- Dependents or spouses of a non-resident alien visa holder

Proof of identity and foreign status for ITIN

An original, or a certified or notarized copy, of an **unexpired** passport is the only document that is accepted for both identity and foreign status. In lieu of a passport, the IRS will accept certified or notarized copies (two or more) of certain identifying documents such as:

- National identification card (must show photo, name, current address, date of birth, and expiration date)
- U.S. or Foreign driver's license
- U.S. state identification card
- U.S. or Foreign military identification card
- U.S. Citizenship and Immigration Services (USCIS) photo identification
- Medical records (dependents under 14 years old only)

ALERT



Do not make any annotation on earning statements (Form W-2s) that do not match the ITIN or SSN provided by the taxpayer.

ASSISTING TAXPAYERS WITH No ITIN

In general, ITIN eligible taxpayers should file Form W-7 and supply documentation that will establish foreign status and identity to receive an ITIN. You may complete their return using electronic filing software. **Do not** electronically transmit the return. The taxpayer must send the return along with Form W-7 and proof of identity documents to the address listed on the Form W-7.

The ITIN, a nine digit number begins with the number 9 and is formatted like an SSN (9NN-NN-NNNN). When using the TaxWise software, a temporary taxpayer identification number is required to complete a return for a taxpayer that does not have an ITIN. Instructions for establishing a temporary number are in Tab 1 – Publication 4012.

Upon completing the return package using TaxWise®, you must completely cross-out in INK the TIN on each form reflecting the temporary number and give the package to the taxpayer so that he/she can mail the package to the address shown in the Instructions for Form W-7.

To prevent processing delays due the separation of the forms/returns in a family package (multiple Form W-7s), stagger the forms and staple the package together to show the entire package as a family pack.

Volunteers should refer taxpayers that need assistance completing Form W-7 to the site coordinator unless they have been trained in the completion of the form or an authorized acceptance agent is present to provide assistance.

NOTE: An ITIN Acceptance Agent (AA) has entered into a contract with the IRS to act on behalf of an ITIN applicant. AA's complete Forms W-7/W-7SP and authenticate the supporting documentation. The AA completes a certificate of accuracy which is attached to the application and forwards the application and certificate to Philadelphia Submissions Processing Center (PSPC) for processing. Call 1-800-829-1040 or go to www.irs.gov and search Acceptance Agents for an AA referral listing.

ASSISTING TAXPAYERS WITH AN ITIN

You may assist taxpayers that visit your site in need of an ITIN. In those instances, you can only assist them by preparing their return and returning the completed return to them for submission to the IRS along with a properly completed Form W-7. Acceptance Agents are available throughout the country to assist taxpayers with the proper completion of Form W-7.

When a taxpayer seeks assistance with valid ITINs and no ITIN/SSN mismatch (described below), you may e-file or mail the taxpayer's return if their tax situation is within the scope of the VRPP. Their return will not require special processing.

POTENTIAL PITFALLS



Taxpayer may need assistance with returns with SSN/ITIN mismatches; you may prepare the return electronically, but it must be mailed to the IRS.

ASSISTING TAXPAYERS WITH MISMATCHED ITINs/SSNs

Taxpayers may seek your assistance with earning statements (W-2s) and/or reporting documents (1099s) reflecting an SSN and an ITIN as their taxpayer identification number—ITIN/SSN mismatch. You can assist the taxpayer with their return. You must not however, change the information on the W-2, nor should you electronically file their return with the IRS.

Prior to completing the return, you should confirm the taxpayer's identity as previously stated. For ITIN holders, an original or a copy of their ITIN Card or Letter issued by the IRS must be provided.

The taxpayer's ITIN number should be entered on the return and not the SSN appearing on the W-2.

ITIN ASSISTANCE FROM THE IRS—FOR VOLUNTEERS

Specific procedures for assisting taxpayers with the ITIN application process are published on www.irs.gov—keyword: volunteer ITIN procedures. Publication 1915, Understanding Your IRS ITIN and Form W-7 instructions are also available on the web.

▶▶ Summing Up This Subject ◀◀

- ▶ Without all the required supporting documentation (W-2, proof of identity, Forms 1099, child care information, etc.) you cannot prepare the taxpayer's return.
- ▶ Each person listed on the taxpayer's return must be identified by a valid taxpayer identification number (TIN)—the taxpayer, their spouse (if married) and any dependents.
- ▶ The TIN can be a social security number (SSN), an individual taxpayer identification number (ITIN) or an adoption individual taxpayer identification number (ATIN).
- ▶ Check the accuracy of each TIN (especially SSNs) as well as the spelling of the name associated with the number by reviewing the official document issued by the prescribing agency.
- ▶ If eligible, an ATIN may be used to identify a child being adopted by the taxpayer who does not have an SSN.
- ▶ Taxpayers that visit your site with a valid ITIN and no ITIN/SSN mismatch issues should submit the return to the appropriate IRS campus either by mail or electronically
- ▶ Specific procedures for assisting the taxpayer with the ITIN application process are published on www.irs.gov—keyword: volunteer ITIN procedures. Publication 1915, Understanding Your IRS ITIN and Form W-7 instructions are also available on the web.

PERSONAL AND DEPENDENCY EXEMPTIONS

Exemptions reduce the taxpayer's taxable income. Generally, the deduction for each exemption is \$3200 in 2005. There are two types of exemptions: personal exemptions and exemptions for dependents. While each is worth the same amount, different rules apply to each type.

POTENTIAL PITFALLS



Avoid claiming exemptions for nonqualifying individuals, thus, incorrectly reducing the taxpayer's taxable income. Use tools in the dependency/exemptions tab in Publication 4012 to avoid this common error.

PERSONAL EXEMPTIONS

Generally, a taxpayer may claim a personal exemption for himself/herself. If filing a joint return or in certain other circumstances, a taxpayer may claim an exemption for a spouse.

The Taxpayer's Personal Exemption

A personal exemption (a \$3200 reduction in their taxable income) can be claimed by the taxpayer unless the taxpayer is eligible to be claimed as a dependent on another person's return. If this is true, the taxpayer cannot claim an exemption, even if the other taxpayer does not actually claim the person as a dependent on their return.

Exemption for a Spouse

The taxpayer's spouse can be claimed as a personal exemption on the return if these conditions are met:

- The taxpayers must be married on December 31, 2005. State or local laws determine the validity of a marriage.
- The taxpayer's spouse cannot be claimed as a dependent on another person's tax return (even if the other taxpayer does not claim the taxpayer's spouse as a dependent).
- The taxpayer files a joint return with the spouse OR the taxpayer files a separate return, the spouse has no gross income.

Personal Exemptions—Divorced, Deceased or Separated Taxpayers

If a taxpayer's spouse died during the year and the taxpayer did not remarry by December 31st, he/she can generally claim the personal exemption for the deceased spouse. This exemption can be claimed only if the taxpayer was not divorced or legally separated from their spouse on the date of death and would have been able to claim the exemption if the spouse had not died.

ALERT



Interview each taxpayer to confirm their marital status on December 31st of each year using the tools in Publication 4012.

INTERVIEW TIPS – PERSONAL EXEMPTIONS

The following is a set of interview questions designed to assist you in applying the rules for personal exemptions. In some cases, the question may reference topics that will be discussed later.

TIP		Personal Exemptions	
interview tips	Probe/Action: Ask the taxpayer:		
step 1	Were you married during any part of the tax year? (answer yes if state common law rules met)	If YES , go to Step 2. If NO , go to Step 7.	
step 2	Were you still married on December 31st of the tax year?	If YES , go to Step 5. If NO , go to Step 3. NOTE: Abandonment does not change marital status—answer yes if the taxpayer’s response to Steps 3 and 4 are No.	
step 3	Did you obtain a final decree of divorce or separate maintenance by December 31st of the tax year?	If YES , you cannot claim a personal exemption for your former spouse. Go to Step 7. If NO , go to Step 4.	
step 4	Did your spouse die during the tax year?	If YES , go to Step 5. If NO , go back through steps 1–3 and clarify answers.	
step 5	Are you filing a joint tax return? Answer “yes” if you are filing a joint return to claim a refund and there would be no tax liability for either spouse if separate returns were filed.	If YES , go to Step 7. If NO , go to Step 6.	
step 6	Did your spouse have income or can anyone else claim your spouse as a dependent?	If YES to either, you cannot claim a personal exemption for your spouse. Go to Step 7 to see about your own personal exemption. If NO to both, you can claim a personal exemption for your spouse.	
step 7	Can anyone claim you or your spouse (if married) as a dependent on their return	If YES , you cannot claim a personal exemption for yourself or your spouse. If NO , you can claim a personal exemption for yourself and your spouse.	

DEPENDENCY EXEMPTIONS

ALERT



The tax law changed this year for this portion of the return.

Make sure you use the correct tax law.

The incorrect application of the dependency tests can delay processing of the taxpayer's return by the IRS.

Beginning in 2005, the term “dependent” means—a qualifying child or a qualifying relative. Each dependency exemption for a qualifying relative and/or qualifying child reduces the taxpayer's taxable income by \$3200.

A taxpayer cannot claim a dependency exemption for **married individuals** that **file a joint return**, unless the joint return is being filed to claim a refund and there would be no tax liability for either spouse if separate returns were filed.

QUALIFYING CHILD DEPENDENCY TESTS

To be a “qualifying child” the person must meet the following tests:

1. **Relationship**
2. **Age**

NOTE: A qualifying child can be under age 19 on December 31, 2005; or age 19 or older, but under age 24 and a full time student; or any age and at anytime during the year permanently and totally disabled.

- A full time student (age 19 or older; but under age 24) is a child who during any 5 months of 2005, was enrolled as a full-time student at a school, or took a full-time, on-farm training course given by a school or a state, country or local government agency. A school includes a technical, trade, or mechanical school. It does not include an on-the-job training course, correspondence course or night school.
- Permanently and totally disabled individuals cannot engage in any substantial gainful activity because of a physical or mental condition and a doctor determines the condition has lasted or can be expected to last continuously for at least a year or can lead to death.

3. **Citizen or Resident**
4. **Support** (See page 13 – Support Test)
5. **Residency**

Qualifying Child or More than One Person

If more than one person files a return claiming the same qualifying child for the tax benefits listed below, the IRS will determine which taxpayer will be eligible to claim the benefit using the tie-breaker rule.

- Dependency Exemption
- Child Tax Credit
- Head of Household
- Earned Income Credit
- Credit for the Child and Dependent Care Expenses

Tie-Breaker Rule

IF . . .	THEN the child will be treated as the qualifying child of the . . .
only one of the persons is the child's parent	parent
both persons are the child's parent	parent with whom the child lived for the longer period of time. If the child lived with each parent for the same amount of time, then the child will be treated as the qualifying child of the parent with the highest adjusted gross income (AGI)
none of the persons are the child's parent	parent with the highest AGI

QUALIFYING RELATIVE DEPENDENCY TEST

To be a “qualifying relative” the person must meet the following tests:

1. Relationship OR Member of Household.

To pass the relationship test, a “qualifying relative” does not have to live with the taxpayer. A qualifying relative must be related to the taxpayer as shown in Step 1 of Exhibit 1-1.

or

If the “qualifying relative” does not pass the Relationship Test, they may pass the **Member of Household Test**, if they lived with the taxpayer for the entire year as a member of the taxpayer's household and the relationship did not violate local law.

2. Gross income.

Generally, a person cannot a qualifying relative if the person had gross income of \$3200 or more. There is an exception if the person is disabled and has income from a sheltered workshop.

3. Support (See page 13 – Support Test)

4. Citizen or Resident

5. Not a Qualifying Child.

A qualifying relative cannot be the taxpayer's qualifying child or the qualifying child of anyone else.

DEPENDENTS – NEW TAX LAW

The Dependents Worksheet (Exhibit 1-1) from Draft 1040 Instructions will be used to teach this portion of the course. All volunteers are encouraged to use the worksheet in the 1040 or 1040A instructions or the interview tips included in this lesson and Publication 4012 when applying the new dependency rules. The information in Step 3—Child Tax Credit—will be discussed in Lesson 6.

Form 1040—Line 6c

Line 6c—Dependents

Dependents and Qualifying Child for Child Tax Credit

You can take an exemption for each of your dependents. In general, a person must be either a qualifying child or a qualifying relative to be your dependent. Certain qualifying children may allow you to take the child tax credit on line 52, and the additional child tax credit on line 68. Follow the steps below to find out if a person qualifies as your dependent, qualifies you to take the child tax credit, or both. If you have more than four dependents, attach a statement to your return with the required information.

Step 1 Qualifying Child

Relationship Test

A qualifying child is a child who is your...

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

Age Test

AND

was ...

Under age 19 at the end of 2005

or

Under age 24 at the end of 2005 and a student (see page 21)

or

Any age and permanently and totally disabled (see page 21)

Support Test

AND

who...

Did not provide over half of his or her own support for 2005 (see Pub. 501)

Residency Test

AND

who...

Lived with you for more than half of 2005. If the child did not live with you for the required time, see *Exception to "time lived with you" condition* on page 21.



CAUTION If the child meets the conditions to be a qualifying child of any other person (other than your spouse if filing jointly) for 2005 see *Qualifying child of more than one person* on page 21.

Need more information or forms? See page 7.

- Do you have a child who meets the conditions to be your qualifying child?
 - Yes.** Go to Step 2.
 - No.** Go to Step 4 on page 20 to see if you can claim a qualifying relative as a dependent.

Step 2 Qualifying Child Dependent

Citizen or Resident Test

- Was the child a U.S. citizen, U.S. national, or a resident of the United States, Canada, or Mexico? If the child was adopted, see *Exception to citizen test* on page 21.
 - Yes.** Continue → Go to Form 1040, line 7.
 - No.** STOP
- Was the child married?
 - Yes.** See *Married person* on page 21.
 - No.** Continue →

See page 1-8

- Look at the qualifying child and qualifying relative conditions in Steps 1, 2, and 4. Could you, or your spouse if filing jointly, be claimed as a dependent on someone else's 2005 tax return?
 - Yes.** You cannot claim any dependents. Go to Step 3 to see if you can claim the child as a qualifying child for the child tax credit.
 - No.** You can claim this child as a dependent. Complete Form 1040, line 6c, columns (1) through (3) for this child. Then, go to Step 3 to see if you can check the box on line 6c, column (4).

Step 3 Child Tax Credit

See Lesson 6

- Was your qualifying child under age 17 at the end of 2005?
 - Yes.** Continue → Go to Form 1040, line 7.
 - No.** STOP
- Was the child a U.S. citizen, U.S. national, or a resident of the United States? If the child was adopted, see *Exception to citizen test* on page 21.
 - Yes.** This child is a qualifying child for the child tax credit. If this child is your dependent, check the box on Form 1040, line 6c, column (4). Otherwise, you must complete and attach Form 8901.
 - No.** STOP Go to Form 1040, line 7.

Step 4 Qualifying Relative Dependent

Relationship Test

A qualifying relative is a person who is your...

Son, daughter, stepchild, foster child, or a descendant of any of them (for example, your grandchild)

or

Brother, sister, or a son or daughter of either of them (for example, your niece or nephew)

or

Father, mother, or an ancestor or sibling of either of them (for example, your grandmother, grandfather, aunt, or uncle)

or

Stepbrother, stepsister, stepfather, stepmother, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law

Member of Household

or

Any other person (other than your spouse) who lived with you all year as a member of your household if your relationship does not violate local law

Not a Qualifying Child

AND

who was not...

A qualifying child (see Step 1) of any other person for 2005

Gross Income

AND

who...

Had gross income of less than \$3,200 in 2005. If the person was permanently and totally disabled, see *Exception to gross income test* on page 21

Support

AND

For whom you provided...

Over half of his or her support in 2005. But see the exceptions for *Children of divorced or separated parents* on this page, *Multiple support agreements* on page 21, and *Kidnapped child* on page 21.

1. Does any person meet the conditions to be your qualifying relative?

Yes. Continue  **No.** 

Go to Form 1040, line 7.


2. Was your qualifying relative a U.S. citizen, U.S. national, or a resident of the United States, Canada, or Mexico? If your qualifying relative was adopted, see *Exception to the citizen test* on page 21.

Yes. Continue  **No.** 

Go to Form 1040, line 7.


Citizen or Resident

3. Was your qualifying relative married?

Yes. See *Married person* on page 21. **No.** Continue 

See page 1-8

4. Look at the qualifying child and qualifying relative conditions in Steps 1, 2, and 4. Could you, or your spouse if filing jointly, be claimed as a dependent on someone else's 2005 tax return?

Yes.  **No.** You can claim this person as a dependent. Complete Form 1040, line 6c, columns (1) through (3) for this qualifying relative. Do not check the box on Form 1040, line 6c, column (4).

Definitions and Special Rules

(listed in alphabetical order)

Adopted brother or sister. An adopted brother or sister is always treated as your own brother or sister. An adopted brother or sister includes a person placed with your parents for legal adoption even if the adoption is not final.

Adopted child. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption even if the adoption is not final.

Brother. A brother includes a brother by half blood.

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

- The parents are divorced or legally separated or lived apart at all times during the last 6 months of 2005.
- The child received over half of his or her support for 2005 from the parents (without regard to the rules on *Multiple support agreements* on page 21).
- The child is in custody of 1 or both of the parents for more than half of 2005.
- A decree of divorce or separate maintenance or written separation agreement that applies to 2005 provides that (a) the noncustodial parent can claim the child as a dependent, or (b) the custodial parent will sign a written declaration that he or she will not claim the child as a dependent for 2005. If the divorce or separation agreement went into effect before 1985, this requirement is met if the noncustodial parent provides at least \$600 for the support of the child for 2005.

The noncustodial parent is the parent with whom the child lived for the lesser portion of 2005.

Form 1040—Line 6c



This rule does not apply for head of household filing status, the credit for child and dependent care expenses, or the earned income credit.

See Pub. 501 for more details.

Exception to citizen test. If you are a U.S. citizen or U.S. national and your adopted child lived with you as a member of your household in 2005, that child meets the citizen test.

Exception to gross income test. If your relative is permanently and totally disabled (defined on this page), do not include any income for services performed at a sheltered workshop if the main reason for the relative's presence at the workshop is medical care and the income is only from activities at the workshop that are incident to such medical care. A sheltered workshop is an eligible institution that provides special instruction or training designed to alleviate the disability. For details on eligible institutions, see Pub. 501.

Exception to "time lived with you" condition. A child is considered to have lived with you for all of 2005 if the child was born or died in 2005 and your home was this child's home for the entire time he or she was alive. Temporary absences for special circumstances, such as for school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home. Also see *Children of divorced or separated parents* on page 20, or *Kidnapped child* below.

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

Kidnapped child. Your child is considered to have lived with you for more than half of 2005 if all of the following apply.

1. The child is presumed by law enforcement authorities to have been kidnapped by someone who is not a family member.
2. In the year the kidnapping occurred, the child lived with you for more than half of the portion of the year before the date of the kidnapping.
3. The child was under age 18 at the end of 2004.
4. The child was not determined to be dead at the end of 2004.

Your child is considered to be your qualifying relative (see Step 4 on page 20) if items (1), (3), and (4) above are met and the child was your qualifying relative for the portion of the year before the date of the kidnapping.



This rule does not apply for the credit for child and dependent care expenses.

Married person. If the person is married, you cannot claim that person as your dependent if he or she files a joint return. But the person can file a joint return if the return is filed only as a claim for refund and no tax liability would exist for either spouse if they had filed separate returns. If the person meets this exception, go to Step 2, question 3, on page 19 (for a qualifying child) or Step 4, question 4, on page 20 (for a qualifying relative). If the person does not meet this exception, go to Step 3 on page 19 (for a qualifying child) or Form 1040, line 7 (for a qualifying relative).

Multiple support agreements. You will be treated as having provided over half the support of your relative if all of the following apply.

- No one person contributed over half of the support of your relative.
- You and another person(s) provided more than half of your relative's support.

- You and that other person(s) would otherwise be able to claim your relative as a dependent in 2005.
- You contributed over 10% of your relative's support.
- All other persons described above who contributed over 10% of the support sign a statement agreeing not to claim your relative as a dependent for 2005.

You must keep any signed statements for your records. You must also attach to your return a multiple support declaration identifying each of the other persons who agreed not to claim the exemption. You can use Form 2120 for this purpose.



A child claimed as a dependent under these rules does not qualify you for head of household filing status.

Permanently and totally disabled. A person who, at any time in 2005, cannot engage in any substantial gainful activity because of a physical or mental condition and a doctor has determined that this condition (a) has lasted or can be expected to last continuously for at least a year, or (b) can lead to death.

Qualifying child of more than one person. If the rules for *Children of divorced or separated parents* on page 20 do not apply and the child is the qualifying child of more than one person, only one person can claim the child as a qualifying child for all of the following tax benefits.

1. Dependency exemption (line 6c).
2. Child tax credits (lines 52 and 68).
3. Head of household filing status (line 4).
4. Credit for child and dependent care expenses (line 48).
5. Earned income credit (lines 66a and 66b).

If you and the other person(s) cannot agree who will claim the child as a qualifying child, the IRS will apply the following rules.

- If only one of the persons is the child's parent, the child will be treated as the qualifying child of the parent.
- If both persons are the child's parents, the child will be treated as the qualifying child of the parent with whom the child lived for the longer period of time in 2005. If the child lived with each parent for the same amount of time, the child will be treated as the qualifying child of the parent who had the higher adjusted gross income (AGI) for 2005.
- If none of the persons is the child's parent, the child will be treated as the qualifying child of the person who had the highest AGI for 2005.

Example. You and your 5-year-old daughter moved in with your mother in April 2005. Your daughter meets the conditions to be a qualifying child for both you and your mother. If you and your mother both claim the child as a qualifying child, the rules above apply. Under these rules, you are entitled to treat your daughter as a qualifying child because you are the child's parent.

If you can claim the child as a qualifying child, go to Step 2 on page 19. Otherwise, stop; you cannot claim any benefits based on this child. Go to Form 1040, line 7.

Sister. A sister includes a sister by half blood.

Student. A child who during any 5 months of 2005:

- Was enrolled as a full-time student at a school, or
- Took a full-time, on-farm training course given by a school or a state, county, or local government agency.

A school includes a technical, trade, or mechanical school. It does not include an on-the-job training course, correspondence school, or night school.

Need more information or forms? See page 7.

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SUMMARY OF THE RULES FOR CLAIMING AN EXEMPTION FOR A DEPENDENT

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

Tests To Be a Qualifying Child	Tests To Be a Qualifying Relative
<ol style="list-style-type: none">1. The child must be your son, daughter, stepchild, eligible foster child, brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them.2. The child must be (a) under age 19 at the end of the year, (b) under age 24 at the end of the year and a full-time student, or (c) any age if permanently and totally disabled.3. The child must have lived with you for more than half of the year.²4. The child must not have provided more than half of his or her own support for the year.5. If the child meets the rules to be a qualifying child of more than one person, you must be the person entitled to claim the child as a qualifying child.	<ol style="list-style-type: none">1. The person cannot be your qualifying child or the qualifying child of anyone else.2. The person either (a) must be related to you in one of the ways listed under <i>Relatives who do not have to live with you</i>, or (b) must live with you all year as a member of your household.²3. The person's gross income for the year must be less than \$3,200.³4. You must provide more than half of the person's total support for the year.⁴

¹There is an exception for certain adopted children.

²There are exceptions for temporary absences, children who were born or died during the year, children of divorced or separated parents, and kidnapped children.

³There is an exception if the person is disabled and has income from a sheltered workshop.

⁴There is an exception for multiple support agreements.

GROSS INCOME

Generally, a person cannot be a qualifying relative if the person had gross income of \$3200 or more. There is no gross income test in determining whether a person is a qualifying child.

Gross income is all taxable income in the form of money, goods, property, and services. It includes all unemployment compensation and certain scholarships. It does not include welfare benefits or nontaxable social security benefits.

SUPPORT TEST

The support test that applies to determine if an individual is a “qualifying child” is different from the support test required for an individual to be a “qualifying relative.” For an individual to be considered a “qualifying relative” the taxpayer must have provided more than half the individual’s total support for the entire year. An individual can be a “qualifying child” however, as long as the individual did not provide more than half of his or her own support for the entire year. There is no requirement that the taxpayer provide more than half of a qualifying child’s support.

The worksheet for Determining Support (Exhibit 1-2) is available in Publication 17 to assist you in determining whether the taxpayer provided more than 50 percent of an individual’s support.

Similarly, to determine if an individual provided over half of his or her own support (“qualifying child” test), compare the individual’s contributions to his or her own support to the entire amount of support the individual received from all sources.

Some support items, like food and rent, benefit more than one member of a household. Divide the value of these support items among the number of household member, that benefit.

Capital items (furniture, appliances, automobiles) should be included if they are solely for the dependent’s own use or benefit.

EXCEPTIONS TO THE SUPPORT TEST

The following two exceptions to the support test will be discussed later.

1. Children of divorced or separated parents or parents who lived apart during the last 6 months of the year; and
2. Persons supported under a multiple support agreement.

Sources of support information

You will be asking the taxpayer some very personal questions when conducting this test. If the taxpayer becomes uncomfortable, explain that the information is necessary to help determine whether an individual is a dependent.

You may need to ask the taxpayer about the individual’s own sources of support, for example:

- Income received (taxable and nontaxable)
- Savings accounts (amounts both spent and saved)
- Borrowed amounts, such as student loans and car loans
- Tax-exempt income, including social security benefits, life insurance proceeds
- Nontaxable pensions, gifts, and tax-exempt interest

Do not include in support any amounts that are:

- paid from the individual’s own funds for income taxes and social security taxes,
- paid as life insurance premiums, or
- not spent, such as amounts put in savings or invested.
- scholarships received by full time students.

The taxpayer should be prepared to discuss how much “total support” he or she provided toward the following for the individual(s) they wish to claim as a dependent:

- Food, clothing and shelter (at fair rental value)
- Education and recreation expenses
- Medical and dental care
- Transportation and other items solely for the individual’s benefit—furniture, appliances, automobiles, etc.

State benefit payments like Temporary Assistance for Needy Families (TANF), food stamps, and housing are considered support provided by the state and not a parent or guardian.

Exercise 1–Determining Support

Traci needs help to determine whether her mother meets the support test. Each individual’s contributions are shown in the table below.

Traci’s contributions to her mother’s support	Expenses paid for by her mother
Food-\$1,500	Rent-\$2,400
Medical Bills-\$500	Recreation-\$300
	Clothes-\$150
	Transportation-\$100
	Life Insurance-\$400
	Television Set-\$200

1. What is the total support for Traci’s mother?
2. How much financial support did Traci provide?
3. How much did Traci’s mother contribute toward her support?
4. Did Traci provide more than 50% of her mother’s support?

Show your work here:

Exhibit 1-2, Draft Worksheet for Determining Support from Publication 17

Funds Belonging to the Person You Supported

- 1. Enter the total funds belonging to the person you supported, including income received (taxable and nontaxable) and amounts borrowed during the year, plus the amount in savings and other accounts at the beginning of the year **1.** _____
- 2. Enter the amount on line 1 that was used for the person's support **2.** _____
- 3. Enter the amount on line 1 that was used for other purposes **3.** _____
- 4. Enter the total amount in the person's savings and other accounts at the end of the year **4.** _____
- 5. Add lines 2 through 4. (This amount should equal line 1.) **5.** _____

Expenses for Entire Household (where the person you supported lived)

- 6. Lodging (complete line 6a or 6b):
 - 6a. Enter the total rent paid **6a.** _____
 - 6b. 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 or the support test for children of divorced or separated parents. See *Multiple Support Agreement* or *Support Test for Children of Divorced or Separated Parents*.

NOTE: This worksheet is from an August 2005 draft of the Personal Exemptions and Dependents Chapter in Publication 17.

Exercise 2—Critical Definitions

Match each term with its definition by typing in the number of the term in the blank next to the corresponding definition. Click the Glossary button to review the definitions of these terms.

Terms:	Definitions:
1. Gross Income	<input type="checkbox"/> Exemptions allowed to taxpayers for a qualifying child and/or qualifying relative.
2. Dependency Exemptions	<input type="checkbox"/> Dollar amount that can be deducted from an individual's total income, thereby reducing the taxable income
3. Gross Income Test	<input type="checkbox"/> To claim a person as a qualifying relative, the person's gross income must be less than \$3200.
4. Exemption Amount	<input type="checkbox"/> All taxable income in the form of money, goods, property and services.

EXCEPTIONS TO THE SUPPORT TEST

As stated earlier, there are two exceptions to the support test, which include persons supported by two or more individuals (multiple support) and children of divorced or separated parents—custodial and noncustodial parents.

SUPPORT EXCEPTION 1 OF 2—MULTIPLE SUPPORT

In a situation where no person contributes over one-half of the support of an individual, the individual still may be a “qualifying relative” of a taxpayer if—

- over one-half of such individual's support was received by 2 or more persons each of whom would have been able to claim the individual as a dependent but for the over 50 percent support test;
- the taxpayer contributed over 10 percent of such individual's support;
- each person who contributed over 10 percent of the individual's support (other than the taxpayer) signs a statement waiving his/her rights to claim the individual as a dependent; and
- the taxpayer attaches a Multiple Support Declaration Form 2120 to his or her tax return for the year the dependency exemption is taken.

Example 1—Completing a Multiple Support Declaration (Form 2120)

Henry E. and Harold S. Loras each provided more than 10% of the total support of their mother Angela S. Loras. Neither one of the brothers individually provided more than 50% of their mother's support. Together, however, Henry and Harold provided more than 50% of their mother's support so they decided Henry will claim the dependency exemption for their mother. Henry must complete and attach Form 2120 (Exhibit 1-3) to his return.

Exhibit 1-3

Henry's Form 2120

Form 2120 (Rev. December 2005) Department of the Treasury Internal Revenue Service	Multiple Support Declaration ▶ Attach to Form 1040 or Form 1040A.	OMB No. 1545-0071 Attachment Sequence No. 114
Name(s) shown on return Henry E. Loras		Your social security number xxx xx xxxx
During the calendar year 2005, the eligible persons listed below each paid over 10% of the support of: Angela S. Loras (my mother) <small style="margin-left: 300px;">Name of qualifying relative supported</small>		
I have a signed statement from each eligible person waiving his or her right to claim this qualifying relative as a dependent for any tax year that began in the above calendar year.		
Harold S. Loras Eligible person's name		xxx xx xxxx Social security number
123 Main Street Anytown, USA 00000 Address (number, street, apt. no., city, state, and ZIP code)		

SUPPORT EXCEPTION 2 OF 2—CUSTODIAL AND NON-CUSTODIAL

A child of divorced or separated parents or parents who lived apart during the last 6 months of the year will generally be considered the “qualifying child” of the parent with whom the child shared the same principal abode for the greater part of the year (the custodial parent). However, the child will be considered the qualifying child or qualifying relative of the noncustodial parent (i.e., the parent who is not the custodial parent) if the following requirements are met—

- the child receives over half of his or her support during the calendar year from his or her parents who are either divorced or legally separated under a decree of divorce or separate maintenance; who are separated under a written separation agreement; or who lived apart at all times during the last 6 months of the calendar year; and
- the decree of divorce or separate maintenance or written separation agreement applicable to the taxable year provides that the noncustodial parent shall be entitled to the dependency exemption (and if the decree or agreement was executed before January 1, 1985, the noncustodial parent provided at least \$600 of support for the child during the calendar year), or the custodial parent has signed a

Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents (Exhibit 1-4), allowing the noncustodial parent to claim the exemption.

The noncustodial parent will not be entitled to the dependency exemption, however, if a multiple support agreement has been executed that gives the exemption to someone other than the non-custodial parent.

Example 2

Ellen M. and Richard A. Stonehill are divorced. Together, they provided over half of the support of their two children in 2005. The children were in the custody of one or both parents for more than half of the year. Richard was the custodial parent because the children shared the same principal abode with their father for the greater part of the year. The divorce decree specifies that Ellen can claim the dependency exemptions. Ellen provided \$1,500 of support for each child. Assuming all other tests are met, Ellen may claim both children as dependents.

If Ellen had provided only \$500 of support for each child, she could not claim dependency exemptions for the two children. To claim the exemptions, she must provide at least \$600 of support for each child.

If the divorce occurred after 1984 and Richard and Ellen had agreed that Ellen would claim the dependency exemptions for the children, Richard should execute and sign Form 8332 and Ellen would be allowed to claim the dependency exemption regardless of how much support she provided. Exhibit 1-4 shows a completed Form 8332 for Ellen.

Exhibit 1-4

Ellen's Form 8332

Form 8332 (Rev. December 2003) Department of the Treasury Internal Revenue Service	Release of Claim to Exemption for Child of Divorced or Separated Parents ► Attach to noncustodial parent's return each year exemption is claimed.	OMB No. 1545-0915 Attachment Sequence No. 115
Name of noncustodial parent claiming exemption		Noncustodial parent's social security number (SSN) ►
Part I Release of Claim to Exemption for Current Year		
I agree not to claim an exemption for <u>Ellen M. Stonehill</u>		
		Name(s) of child (or children)
for the tax year 20 <u>05</u> .		
<u>/s/ Richard A. Stonehill</u> Signature of custodial parent releasing claim to exemption	<u>XXX : XX : XXXX</u> Custodial parent's SSN	<u>1/6/2006</u> Date
Note: If you choose not to claim an exemption for this child (or children) for future tax years, also complete Part II.		

INTERVIEW TIPS FOR EXEMPTIONS FOR DEPENDENTS

Exhibit 1-5



Table 1: Dependency Exemption for Qualifying Child

interview tips

Probe/Action: Ask the taxpayer:

step 1	Was the person your son, daughter, stepchild, eligible foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (i.e., your grandchild, niece or nephew).	If No , go to Table 2 – Qualifying Relative Interview Tips If Yes , go to Step 2 Note: An adopted child is treated as your child.
step 2	Was the person under age 19 at the end of the year? OR Was the person under age 24 at the end of the year and a full-time student for some part of each of five months during the year? OR Was the person any age and permanently and totally disabled?	If No , go to Table 2 If Yes , Go to Step 3 Note: A permanently and totally disabled person cannot engage in any substantial gainful activity due to a physical or mental condition and a doctor has determined their condition may last for 12 months or more or can lead to death.
step 3	Did the person provide over half of his or her own support for the year?	If No , go to Step 4 If Yes , may not claim an exemption for this person. Note: A worksheet for determining support is included in Publication 17.
step 4	Did the person live with you as a member of your household for more than half of the year?	If No , go to Qualifying Relative Interview Tips If Yes , go to Step 5 Note: There are exceptions for kidnapped children, a child that born or died in 2005; certain temporary absences – school, vacation, medical care, etc., etc.
step 5	Was the person a U.S. citizen, U.S. national, or a resident of the U.S, Canada or Mexico?	If No , you may not claim this person as a dependent. If Yes , go to Step 6 Answer yes if you are a U.S. citizen or U.S. national and your adopted child lived with you as a member of your household in 2005.
step 6	Was this person married on December 31, 2005?	If No , go to Step 8 If Yes , go to Step 7
step 7	Is the person filing a joint return for this tax year?	If No , go to Step 8 If Yes , you cannot claim this person as a dependent. Answer no, if the person is filing a joint return to claim a refund and no tax liability would exist for either spouse if they had filed separate returns.
step 8	Is the person a qualifying child of any other person?	If No , go to Step 9 If Yes , you cannot claim this person as a dependent. (See Exceptions in Footnote – Step 8)
step 9	Can you or your spouse (if filing jointly) be claimed as a dependent on someone else's tax return this year?	If No , you can claim an exemption for this person. If Yes , you cannot claim this person as a dependent. (See footnote – Step 9)


Footnotes:

Step 8: A Multiple Support Declaration (Form 2120 may be used) must be filed with the return if except for the support test, two or more persons may claim the exemption for the person. See Steps 9 – through 13 of Table 2 – Qualifying Relative Interview Tips.

Custodial and Non-Custodial Parents. Form 8332 or a statement containing information on the form is required when the custodial parent releases the exemption to the non-custodial parent. See Table 3 – Support – Custodial and Non-Custodial Parents

Qualifying Child of More Than One Person. The taxpayers must decide who can claim the exemption if the qualifying child can be claimed by more than one person. If the taxpayers cannot decide who will claim the exemption, the IRS will decide using the tie-breaker rule discussed earlier.

Step 9: If you can be claimed as a dependent by another person, you may not claim anyone else as your dependent. Even if you have a qualifying child or qualifying relative, you may not claim that person as a dependent.

 Table 2: Dependency Exemption for Qualifying Relative (Start with Table 1)	
interview tips	Probe/Action: Ask the taxpayer:
step 1 Was the person your son, daughter, foster child or a descendant of any of them (i.e., your grandchild) OR Was the person your brother, sister, or a son or daughter or either of them (i.e., your niece or nephew) OR Was the person your father, mother, or an ancestor or sibling of either of them (i.e., your grandmother, grandfather, aunt or uncle) OR Was the person your stepbrother, stepsister, stepfather, stepmother, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law?	If No , go to Step 2 If Yes , go to Step 3 Caution: The relatives listed in Step 1 do not have to live with you.
step 2 Was the person any other person (other than your spouse) who lived with you all year as a member of your household?	If No , you cannot claim this person as a dependent. If Yes , go to Step 3 Note: There are exceptions for kidnapped children, a child that born or died in 2005; certain temporary absences — school, vacation, medical care, etc., etc.
step 3 Is the person your qualifying child or the qualifying child of anyone else?	If Yes , the person is not a qualifying relative (See Qualifying Child Interview Tips) If No , go to Step 4
step 4 Was the person a U.S. citizen, U.S. national, or a resident of the U.S, Canada or Mexico for any part of the year?	If No , you cannot claim this person as a dependent. If Yes , go to Step 5 Answer yes if you are a U.S. citizen or U.S. national and you adopted a child lived with you as a member of your household in 2005.
step 5 Did the person have gross taxable income of less than \$3,200 in 2005?	If No , you cannot claim this person as a dependent. If Yes , to go Step 6
step 6 Did you provide more than half the person's total support for the year?	If Yes , go to Step 11 If No , go to Step 7 Note: A worksheet for determining support is included in Publication 17.
step 7 Did another person provide more than half the person's total support?	If Yes , you cannot claim an exemption for this person. If No , go to Step 8
step 8 Did 2 or more people together provide more than half the person's total support?	If Yes , go to Step 9 If No , you cannot to claim this person as a dependent.

**Table 2: Dependency Exemption for Qualifying Relative**

Continued

interview
tips

Probe/Action: Ask the taxpayer:

step 9	Did you provide more than 10% of the person's total support for the year?	If Yes , go to Step 10 If No , You cannot claim this person as a dependent.
step 10	Did the other person(s) providing over 10% of the person's total support for the year provide you with a signed statement (Form 2120) agreeing not to claim the exemption?	If Yes , go to Step 11. If No , you cannot claim this person as a dependent.
step 11	Was this person married on December 31, 2005?	If Yes , go to Step 12 If No , go to Step 13
step 12	Is the person filing a joint return for this year?	If Yes , you cannot claim this person as a dependent. If No , go to Step 13 Answer no, if the person is filing a joint return to claim a refund and no tax liability would exist for either spouse if they had filed separate returns.
step 13	Can you (or your spouse (if filing jointly)) be claimed as a dependent on someone else's tax return this year?	If Yes , you cannot claim this person as a dependent. If No , you can claim an exemption for this person.



Table 3: Support Test Only - Custodial/Non-Custodial Parents
(Start with Table 1)

interview tips

Probe/Action: Ask the taxpayer:

<p>step 1</p>	<p>Did the qualifying child receive over half of his or her support from their parents who are: Divorced OR Legally separated under a decree of divorce OR Separated under a maintenance agree OR Separated under a written maintenance agreement</p>	<p>If Yes, go to Step 3 If No, go to Step 2</p>
<p>step 2</p>	<p>Did the qualifying child receive over half of his or her support from parents who lived apart at all times during the last 6 months of the year?</p>	<p>If Yes, go to Step 4 If No, you cannot claim an exemption for this person</p>
<p>step 3</p>	<p>Does the decree of divorce OR Separate maintenance OR written separation agreement entitle the noncustodial parent to the dependency exemption for the qualifying child? Note: If the decree or agreement was executed before January 1, 1985, the noncustodial parent must provided at least \$600 of support for the child during 2005)</p>	<p>If Yes, go to Step 5. If No, go to Step 4</p>
<p>step 4</p>	<p>Did the custodial parent provide the taxpayer a signed written declaration (Form 8332 or similar document) releasing their claim to the exemption for the qualifying child?</p>	<p>If Yes, go to Step 5. If No, you cannot claim an exemption for this person.</p>
<p>step 5</p>	<p>Can you (or your spouse (if filing jointly)) be claimed as a dependent on someone else's tax return this year?</p>	<p>If Yes, you cannot claim this person as a dependent. If No, you can claim an exemption for this person.</p>

Caution: The noncustodial parent cannot claim the exemption if a multiple support agreement has been executed that gives the exemption to someone else.

COMPLETING THE EXEMPTIONS SECTION OF THE TAX RETURN

A tax identification number, generally, a social security number, is required for all dependents listed on a return. Otherwise, the return may be processed without the benefit of the dependency exemption, which may result in an increased tax or decreased refund for the taxpayer.

The Exemptions section of Forms 1040A and 1040 are the same (as shown below). The exemption amount is included in the standard deduction on Form 1040EZ.

Exhibit 1-5

Form 1040/1040A, page 1

Exemptions		6a <input checked="" type="checkbox"/> Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a.				No. of boxes checked on 6a and 6b
		b <input checked="" type="checkbox"/> Spouse				2
		c Dependents:				No. of children on 6c who:
(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> If qualifying child for child tax credit (see page 25)	• lived with you	
James	Nicholson	000:00:3333	son	<input checked="" type="checkbox"/>	1	
				<input type="checkbox"/>	• did not live with you due to divorce or separation (see page 26)	
				<input type="checkbox"/>	Dependents on 6c not entered above	
				<input type="checkbox"/>	Add numbers on lines above	
d Total number of exemptions claimed.					3	

If more than six dependents, see page 24.

Exemptions are claimed on Lines 6a through 6d of Forms 1040 and 1040A. First, enter the taxpayer's personal exemption on Line **6a**. Then, if applicable, enter the exemption for the taxpayer's spouse on Line **6b**. Enter the total of Lines 6a and 6b in the line in the right-hand margin.

Enter any dependency exemptions on Line **6c**. In column 3, enter the specific relationship for each dependent, such as son, daughter, grandson, or granddaughter. If you use the word "child," there may be a delay in the processing of the return.

Check column 4 if the taxpayer's dependent is also a qualifying child for the child tax credit. The child tax credit is discussed in detail in a later lesson.

Total the Line 6c exemptions on the three right-hand-margin lines, which include:

- Children who lived with the taxpayer
- Children who did not live with the taxpayer as a result of divorce or separation, and
- Other dependents not entered on the lines above.

Indicate the total number of exemptions (personal and dependency) in Line 6d.

Exercises

1. Janice is 18 years old and a full-time student. She can be claimed as a dependent on her parents' tax return. Janice will file Form 1040EZ to report income from her summer job. Can Janice claim a personal exemption for herself on her return?

2. Tom Brown supports his wife's uncle, Jim (her mother's brother), who lives in another city. Jim has no gross income for the calendar year. The Browns file a joint return. Can the Browns claim Jim as a dependent if all other tests are met?

3. Ruth filed a joint return with her husband whom she married in November. They claimed two personal exemptions on their return. Ruth had no income; her husband had \$10,600 income. Can Ruth's father, who supported her and paid for the wedding, claim her as a dependent on his return? _____
4. Joe is 65 years old and lives with his son and daughter-in-law. In 2005, Joe's taxable pension income was \$4,700. Can Joe's son and daughter-in-law claim a dependency exemption for Joe if all other tests are met? _____
5. Randy's son, Paul, earned \$4,300 last year. Paul is 18 years old and started college in September 2005. He is a full-time student. Does Paul's earned income of \$4,300 preclude Randy from claiming Paul as a dependent? _____
6. Mrs. Wiley has three children, Mark, Tim, and Mary. Each child contributes toward Mrs. Wiley's support. Mark provides 45 percent, Tim, 35 percent, and Mary, 10 percent.
 - A. Which, if any, of her children can claim a dependency exemption for Mrs. Wiley under a multiple-support agreement?

 - B. If Mark is to claim the dependency exemption, who must sign a statement waiving his/her right to claim Mrs. Wiley as a dependent? _____
7. Under the terms of Peter's pre-1985 divorce decree, Peter can claim the exemption for his child. He provided \$700 toward the child's support. Can Peter claim the child's exemption even if the child's mother is the custodial parent for the tax year? _____

Exercise 1

- A. \$5,150 ($\$1,500 + \$500 + \$2,400 + \$300 + \$150 + \$100 + \200)
Note that life insurance premiums are not considered support.
- B. \$2,000 ($\$1,500 + \500)
- C. \$3,150 ($\$2,400 + \$300 + \$150 + \$100 + \200) Note that life insurance premiums are not considered support.
- D. No, because the total support for Traci's mother is \$5,150 and Traci provided only \$2,000.

Exercise 2—Critical Definitions

Order of the answers in the Definition Boxes: 2, 4, 3, 1

Exercise 3—Exemptions

1. No. Janice's parents are claiming her as a dependent.
2. Yes; Mrs. Brown's uncle passes the relationship test for a qualifying relative.
3. No, because Ruth filed a joint return with her spouse.
4. No, because Joe's income exceeded \$3,200 (the exemption amount for tax year 2005).
5. No. As long as Paul does not provide over half of his own support for the year, the amount of Paul's gross income is not taken into account in determining whether Paul is a qualifying child. Paul cannot be a qualifying relative because his gross income exceeds the exemption amount (\$3,200 for 2005).
- 6a. Mark & Tim must decide who will claim the exemption. Mary is not eligible since she did not provide more than 10% of the support.
- 6b. Tim must sign. Mary's signature is not required on the waiver since she is not eligible to take the exemption. Mark must maintain Tim's signed statement and documentation of the support provided by all parties with his tax records.
7. Yes. Peter provided at least \$600 in support and the terms of his pre-1985 divorce decree grant him the exemption.

▶▶ Summing Up This Section ◀◀

- ▶ Exemptions reduce the taxpayer's taxable income. Generally, the deduction for each exemption is \$3200 in 2005.
- ▶ There are two types of exemptions: personal exemptions and exemptions for dependents. While each is worth the same amount, different rules apply to each type.
- ▶ Generally, personal exemptions are claimed by the taxpayer and, if they are married, one exemption for their spouse.
- ▶ A personal exemption (a \$3200 reduction in their taxable income) can be claimed by the taxpayer unless the taxpayer is eligible to be claimed as a dependent on another person's return.
- ▶ If a taxpayer is divorced or legally separated on December 31, 2005, he or she cannot claim an exemption for his or her (former) spouse.
- ▶ Apply new 2005 tax law changes for dependency exemptions. Use the worksheet in the 1040 instructions and tools in your Volunteer Quick Reference Guide (Pub. 4012) to avoid filing errors and processing delays.
- ▶ Different tests apply to determine if an individual is a qualifying child or a qualifying relative.
- ▶ If the taxpayer wants to take a dependency exemption, review each dependency test to make sure the dependent qualifies.



Military/International students continue.

All others go to Lesson 2, page 2-1.

STUDENT NOTES

In this segment we will address the unique exemption situations you may encounter when assisting members of the U.S. Armed Forces with their tax returns. At the end of this lesson you will be able to:

- Explain how to obtain an SSN for children born abroad.
- Determine whether a service member's spouse is a nonresident alien or resident alien.
- Determine whether a U.S. service member is entitled to claim the personal exemption for a spouse who is a nonresident alien.
- Apply the dependency tests to determine whether a service member can be claimed as a dependent.
- Apply the dependency tests to determine whether an individual can be claimed as a dependent by a service member.

CHILDREN BORN ABROAD OBTAINING A SSN

Military families who wish to apply for a social security number for a child born overseas should begin the process by first contacting their base legal office or U.S. embassy officials to obtain a Report of Birth Abroad. This document serves as proof of U.S. citizenship and can be used in the future.

To register the birth of a child born abroad, the parents should bring the child to the Embassy/Consulate office along with the applicable fee(s):

- The child's original birth certificate
- The parents' marriage certificate
- Any divorce decree or death certificate (original documents required) from any previous marriage

While applying for the Report of Birth Abroad, parents should also apply for a social security number and passport for their child. The SSN will be mailed directly to the taxpayer. The process takes several months. Without a social security number the parents will NOT be able to claim the child as a dependent or take advantage of credits such as the Earned Income Tax Credit or the Child Tax Credit, even if all of the other prerequisites are met.

DETERMINING RESIDENCY STATUS

Most members of the Armed Forces are U.S. citizens or resident aliens. However, occasionally you may have questions about the residency status of a service member or a service member's spouse and dependents.

For U.S. tax purposes, a nonresident alien is an individual who is not a citizen or resident of the United States. A nonresident alien generally must pay tax only on income received from sources within the United States. Filing status, eligibility for tax credits and other matters are affected by an individual's residency status.

Once you've determined that a taxpayer is an alien (not a U.S. citizen), you must then determine his or her alien status for tax purposes. An alien has one of the following statuses:

1. **Resident:** Qualifies as a U.S. resident for tax purposes by meeting either the green card test or the substantial presence test
2. **Nonresident:** Is not a resident of the United States
3. **Dual status:** Is both a nonresident alien and a resident alien for the tax year

Placement in the correct category is crucial in determining what income to report and which tax return to file. Nonresident aliens must file a Form 1040NR, U.S. Nonresident Income Tax Return.

Resident aliens generally are taxed on their worldwide income, the same as U.S. citizens. Therefore, resident aliens should use the same tax forms (Forms 1040, 1040A and 1040EZ) as U.S. citizens.

RESIDENCY STATUS TESTS

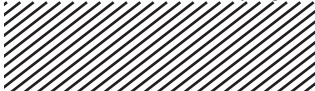
An individual is considered to be a U.S. resident alien if he or she meets either of these two tests:

- The Green Card Test
- The Substantial Presence Test

An individual who does not meet one of these two tests is considered to be a nonresident alien.

Green Card Test

When individuals are issued green cards by the United States Citizenship and Immigration Services (USCIS), they generally become lawful, permanent residents of the United States and are considered to have met the green card test. The green card is an alien registration card that indicates that the individual has been granted the privilege, according to immigration laws, of residing permanently in the United States as an immigrant.



This resident status continues indefinitely unless it is taken away from the individual or is administratively or judicially determined to have been abandoned.

Substantial Presence Test

Individuals who do not have green cards may still qualify as resident aliens if they meet the requirements of the substantial presence test for the calendar year. To meet this test, an individual must be physically present in the United States on at least:

1. 31 days during the current year, and
2. 183 days during the 3-year period that includes the current year and the two years immediately before that, counting:
 - All the days he or she was present in the current year (2005) and
 - 1/3 of the days he or she was present in the first year before the current year (2004) and
 - 1/6 of the days he or she was present in the second year before the current year (2003)

To correctly apply the substantial presence test, it is necessary to define the term “United States.” For tax purposes, the United States includes the following:

- All 50 states and the District of Columbia
- The territorial waters of the United States
- The seabed and subsoil of those submarine areas that are adjacent to the U.S. territorial waters and over which the United States has exclusive rights under international law to explore and exploit natural resources

The term does not include U.S. possessions and territories or U.S. air space.

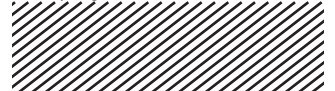
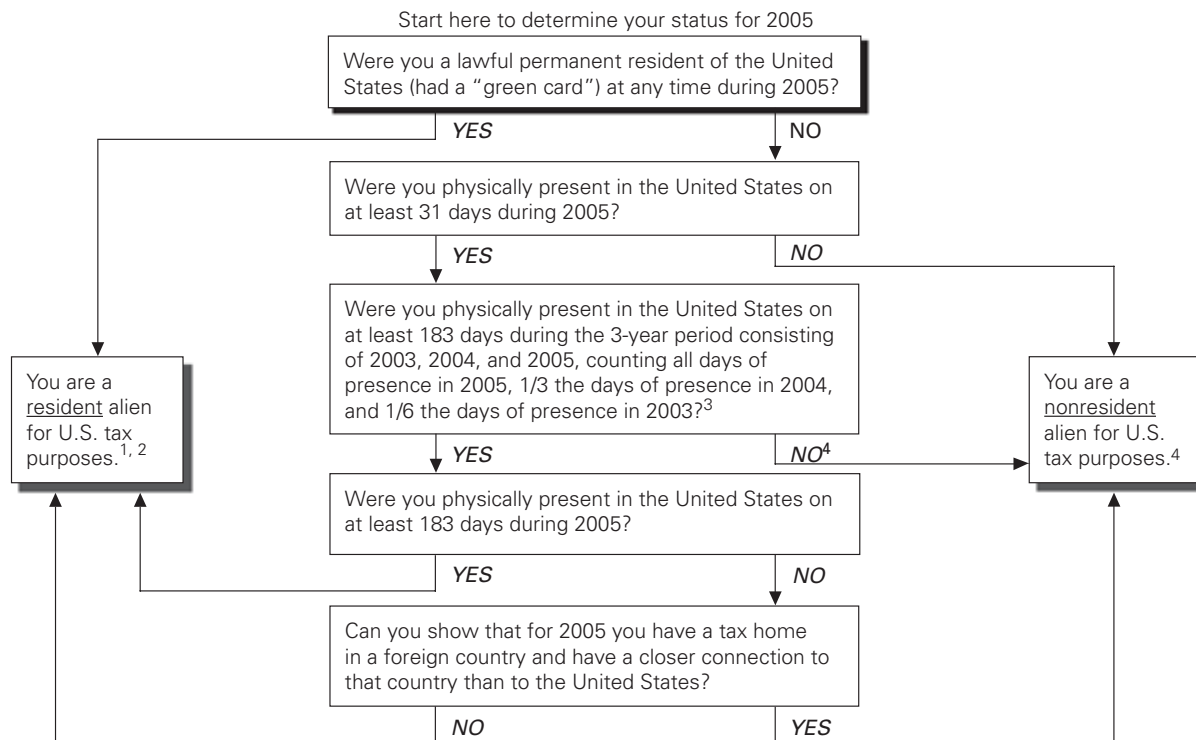


Exhibit M-1-1. Nonresident Alien or Resident Alien?



¹ If this is your first or last year of residency, you may have a dual status for the year. See Dual Status Aliens in Pub. 519.

² In some circumstances you may still be considered a nonresident alien under an income tax treaty between the U.S. and your country. Check the provisions of the treaty carefully.

³ Do not count the days you were unable to leave the United States because of a medical condition that arose while you were in the United States.

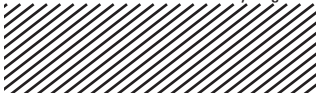
⁴ If you meet the substantial presence test for 2006, you may be able to choose treatment as a U.S. resident alien for part of 2006. For details, see Substantial Presence Test under Resident Aliens and First-Year Choice under Dual-Status Aliens in Pub 519.

Example 1

Sgt. Paul Kingman and his wife Gabriella were married at the end of 2005. She lived in the United States for 120 days in 2005 (from September to December) as a nonresident alien. She was in the United States on 120 days in each of the years 2003 and 2004. To determine if she meets the substantial presence test for 2005, total the following:

- The full 120 days of presence in 2005
- 40 days in 2004 (1/3 of 120), and
- 20 days in 2003 (1/6 of 120)

Since the total for the 3-year period is 180 days, Gabriella is not considered to be a resident under the substantial presence test for 2005.



EXCEPTIONS TO THE SUBSTANTIAL PRESENCE TEST

There are exceptions to the substantial presence test that may affect the resident or nonresident alien spouse of a service member. An individual is treated as present in the United States on the day the individual is physically present in the country. However, you should not count the days an individual:

- Regularly commutes to work in the United States from a residence in Canada or Mexico
- Is in the United States for less than 24 hours when in transit between two places outside the United States
- Is unable to leave the United States because of a medical condition that developed while he or she was in the United States
- Was an exempt individual

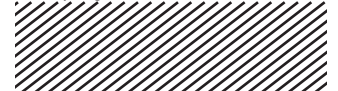
Regular Commuters from Canada or Mexico

For the purposes of the substantial presence test, the term “commute” means to travel to work and return home within a 24-hour period. An individual is considered to commute “regularly” if they commute to work in the United States on more than 75 percent of the workdays during their working period.

Workdays are the days on which they work in the United States or Canada or Mexico. Working period is the period beginning with the first day in 2005 in which an individual is physically present in the United States to work.

The working period for an individual whose work requires them to be present in the United States on a seasonal or cyclical basis begins on the first day of the season or cycle on which they are present in the United States to work.

The period ends on the last day of the season or cycle on which they are in the United States to work. Thus, an individual may have more than one working period in 2005, and their working periods may begin in one calendar year and end in the following calendar year.



Exempt Individual

For the substantial presence test, do not count days for which an individual is “exempt.” The term “exempt individual” does not refer to someone exempt from U.S. tax, but to anyone in the following categories:

- An individual temporarily present in the United States as a foreign-government-related individual
- A teacher or trainee, temporarily present in the United States under a “J” or a “Q” visa, who substantially complies with the requirements of the visa
- A student, temporarily present in the United States under an “F,” a “J,” an “M,” or a “Q” visa, who substantially complies with the requirements of the visa
- A professional athlete temporarily in the United States to compete in a charitable sports event

CHOOSING RESIDENCY STATUS

Aliens who do not meet the green card test or the substantial presence test for 2004 or 2005, and did not choose to be treated as residents for part of 2003, but will meet the substantial presence test for 2006, can choose to be treated as U.S. resident for part of 2005. To make this choice, the individual must have been:

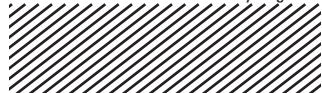
- Present in the U.S. for at least 31 consecutive days in 2005 and
- Present in the U.S. for at least 75% of the days beginning with the first day of the 31-day period in 2005 and ending with the last day of 2005

As a general rule, most alien enlistees in the Armed Forces are resident aliens. In peacetime, all enlistees in the Armed Services must be U.S. citizens or permanent residents of the U.S.

Alien enlistees will generally be classified as resident aliens if they are:

- Enlisting voluntarily and
- Have been granted permanent residency in the U.S.

The United States has treaty agreements with certain nations that allow a very limited number of their citizens to retain their non-resident alien status. Alien enlistees in this category should seek



advice from their base legal officer. Other aliens who are present in the United States merely because of military assignments and who have residences outside the United States are nonresident aliens.

Choice to Treat Nonresident Spouse as a Resident

Remember, a nonresident alien spouse may choose to be treated as a resident alien if all the following conditions are met:

- The nonresident alien spouse must be married to a U.S. citizen or resident alien at the end of the tax year
- Both spouses must choose to treat the alien spouse as a resident alien
- One of the spouses must be a U.S. citizen or resident alien on the last day of the tax year

A statement signed by both spouses must be attached to the joint return for the first tax year for which the choice applies. The statement should contain:

1. A declaration that one spouse was a nonresident alien and the other spouse was a U.S. citizen or resident alien on the last day of the tax year and that the nonresident alien spouse chooses to be treated as a U.S. resident for the entire tax year, and
2. The name, address, and taxpayer identification number of each spouse

Once a nonresident alien chooses to be treated as a resident, “the choice” applies to all later tax years unless one of the following situations occurs:

- Revocation by either spouse
- Death of either spouse
- Legal separation
- Inadequate records

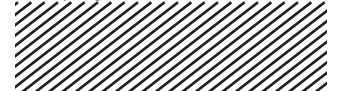
If the choice is ended for any of these reasons, neither spouse can make a choice for any future year.

Choice to Treat Nonresident Spouse as a Nonresident

If the choice is made to treat the nonresident spouse as a nonresident for tax purposes, the following rules apply:

- The nonresident alien spouse cannot file a joint return
- The nonresident alien spouse is generally not eligible for certain credits, such as the earned income credit or the education credits

Continuing with rules that apply when the choice is made to treat the nonresident spouse as a nonresident:



The spouse who is a U.S. citizen or resident may claim an exemption for the nonresident alien spouse if the nonresident alien has no gross income for U.S. tax purposes and is not another taxpayer's dependent. Check the box on line 6b of Form 1040 or Form 1040A and write "NRA" to the right of the word "spouse."

ALERT



Generally, dual-status aliens should be referred to a military legal assistance officer or paid tax professional.

The nonresident alien spouse does not have to file a federal income tax return if he or she had no U. S. source income. Nonresident alien spouses do not have to report any income from sources outside the United States so long as they remain nonresident aliens.

DUAL-STATUS ALIENS

An alien may be both a nonresident and resident alien during the same tax year. The most common dual-status tax years are the years of arrival and departure. Dual-status aliens are taxed on income from all sources for the part of the year they are resident aliens. They are taxed on income from U.S. sources only for the time they are nonresident aliens.

Dual-status aliens must file Form 1040 and mark it "Dual-Status Return" if they are resident aliens on the last day of the tax year. If they are *nonresident* aliens at the end of the year, they must file Form 1040NR and mark it "Dual-Status Return."

In either case, they must attach a separate statement to explain their income and compute the tax for the other part of their dual-status year. Dual-status aliens must either itemize their allowable deductions or claim zero deductions because dual status aliens cannot use the standard deduction.

POTENTIAL PITFALLS



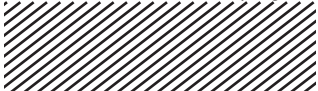
Do not electronically file returns with the ITIN/SSN that do not match.

UNDOCUMENTED ALIENS

In addition to dual-status aliens, you may encounter undocumented aliens who wish to file tax returns. Typically, undocumented aliens who meet the substantial presence test are considered resident aliens for tax purposes. Although undocumented aliens are not eligible for a social security number because they do not have legal work authorization, they are eligible for an ITIN, which enables them to file a tax return.

As a volunteer preparer, you may encounter the following common scenario that often causes processing problems for the IRS:

An undocumented alien "acquires" (buys, trades etc.) a social security number to provide to their employer. The employer hires the alien and gives the alien a W-2 at the end of the year with the invalid SSN. The alien then files a tax return with their ITIN listed as their identification number. This causes a processing problem for the IRS. The refund will most likely be held until the issue can be resolved.



PERSONAL EXEMPTIONS—FOREIGN SPOUSE

Taxpayers who file a joint return may claim their spouses as personal exemptions. On a Married Filing Separate return, taxpayers may claim their spouse as personal exemptions only if the spouse had no gross income.

The same rules apply to military personnel who reside in the United States or who live abroad.

However, special filing rules apply to taxpayers who wish to claim personal exemptions for spouses who are nonresident aliens. These rules apply to service members whether they live in the United States or overseas.

There are no special rules for service members who are married to U.S. resident aliens; they can claim the standard personal exemption for their spouses.

There are two ways service members who are married to nonresident aliens can claim the personal exemption for their spouses:

- If the spouse chooses to be treated as a nonresident alien for tax purposes, the exemption can be claimed on a Married Filing Separate return
- If the spouse chooses to be treated as a U.S. resident alien for tax purposes, the exemption can be claimed on a joint return (the spouse does not have to be from Canada or Mexico to make this choice)

Married Filing Separate Return

In order for a nonresident alien spouse to be claimed as a personal exemption on a service member's Married Filing Separate return, the spouse:

- Must not have any gross income for U.S. tax purposes
- Cannot be the dependent of another U.S. taxpayer
- Must have an Individual Taxpayer Identification Number (ITIN)

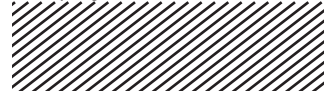
DEPENDENCY TESTS—MILITARY PERSONNEL

The dependency test changed in Tax Year 2005 (this program year) based on new guidelines for the definition of a dependent.

Review the information in the base lesson closely before proceeding.

A taxpayer can take one exemption for each dependent who meets all qualifying child and/or qualifying relative dependency tests.

The dependency tests apply in the same way to U.S. service members who wish to claim dependency exemptions or who may be claimed as a dependent on someone else's return. However, you may encounter unique issues regarding the application of



the support test and the citizen/resident tests to members of the military, specifically those overseas. The rest of the topic discusses these two tests.

Armed Forces Member as a Dependent

If you recall for an individual to be a qualifying relative, the taxpayer must have provided more than 50 percent of the individual's support for the entire year including food, lodging, clothing, education, recreation, transportation, medical and dental care. To be a qualifying child, the individual need only have NOT provided more than half of his or her own support for the year.

Individuals who have been in the Armed Forces for the entire year generally cannot be claimed as dependents on another taxpayer's return because the support test will not have been met.

However, individuals in the Armed Forces for part of the year can often be claimed as dependents if they meet all dependency tests. When determining whether the support test has been met, remember to take into account all amounts that service members receive from the Armed Forces.

Similarly, individuals who are appointed to one of the Armed Forces academies and reside at the academy all year cannot be claimed as dependents. However, an appointee at the academy for only part of the year may qualify as a dependent if all the tests are met.

Armed Forces Member Claiming a Dependent

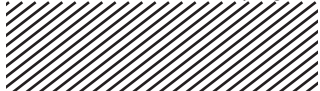
Members of the military can claim an exemption for their dependents if the dependency tests are met. Further, a member of the military can authorize an allotment from his or her pay for the support of dependents. The amount is considered as provided by the military member in figuring who provides more than half of the dependent's support.

If an allotment is used to support persons other than those the military member names, the military member can claim exemptions for them if they otherwise qualify as the military member's dependent.

Example:

Army Sergeant Jeff Banks authorizes an allotment for his widowed mother.

She uses the money to support herself and Jeff's 10-year old sister. If that amount provides more than half of each individual's support, Jeff can claim an exemption for each of them, if they otherwise qualify, even though he only authorized the allotment for his mother.



CITIZEN OR RESIDENT TEST

Earlier, you learned about the citizen/resident test. The requirements are exactly the same for dependents of members of the military. To meet the citizen/resident test, the dependent must generally be a U.S. citizen, a U.S. national, a U.S. resident, or a resident of Canada or Mexico for some part of the tax year.

Children

Children are usually citizens or residents of the country of their parents. This often holds true even if both parents are not citizens of the same country.

For example, if a service member is married to a nonresident alien in a foreign country, and their child is born in that country, the child may be entitled to U.S. citizenship. In most instances, the U.S. parent will register the child with the U.S. Embassy or Consulate closest to where they live.

Adopted Children

Service members who legally adopt a child who is not a U.S. citizen or resident can claim the child as a dependent if the other dependency tests are met. The following must be true for the tax year:

- The child is a member of the taxpayer's household
- The service person's home is the child's main home, and
- The service person is a citizen or national of the United States.

▶▶ Summing Up This Section ◀◀

- ▶ Armed forces personnel should contact their base legal office or U.S. Embassy for assistance with tax matters and other matters including obtaining SSNs, filing their tax return, etc.
- ▶ An individual's tax situation is impacted by their alien status.
- ▶ Aliens can choose to be a part-year resident alien.
- ▶ Special rules apply to military personnel who wish to claim a personal exemption for a nonresident alien spouse.
- ▶ Nonresident aliens must have an ITIN.
- ▶ The support test and citizen/resident test for military personnel require some special considerations.
- ▶ Children born abroad may be entitled to U.S. citizenship even if one of the parents is a nonresident alien.



STUDENT NOTES



INTRODUCTION AND OBJECTIVES

In this lesson you will learn how to determine the correct filing status to use when completing a tax return. You will also learn how to establish whether there is a filing requirement and which tax form to use. You must choose the correct filing status before you can determine if there is a filing requirement. The filing status is also used to determine whether the taxpayer is eligible to claim certain deductions and credits.

After completing this lesson you should be able to:

- Apply the requirements for each of the five filing statuses.
- Determine who must file.
- Determine who should file.
- Select the appropriate tax form to use.

FILING STATUS

There are five filing statuses:

1. Single
2. Married filing jointly
3. Married filing separately
4. Head of household, and
5. Qualifying widow(er) with dependent child

In general, a taxpayer's filing status depends on whether he or she is considered unmarried or married. Determining the appropriate filing status is critical to the accuracy of the taxpayer's return.

SINGLE

A taxpayer is considered **single** if, on the last day of the year, any of the following is true.

- The taxpayer was never married.
- The taxpayer was legally separated, according to state law, under a decree of divorce or separate maintenance.
- The taxpayer was widowed before January 1, 2005, and did not remarry in 2005. However, the taxpayer may be able to use another filing status that will give a lower tax.

See *Head of Household* and *Qualifying Widow(er) with Dependent Child*, later.

POTENTIAL PITFALLS



A common-law marriage is recognized for federal tax purposes if the marriage is recognized by the state where the taxpayers now live or in the state in which the common-law marriage was entered. Legal advice may be required to determine if a common-law marriage exists.

ALERT



If a taxpayer files a joint return they cannot amend it to file separately after the due date for filing the tax return.

MARRIED FILING A JOINT RETURN

Taxpayers may use the **married filing jointly** status if they are married. A marriage means only a legal union between a man and a woman as husband and wife. They are considered married if, on the last day of the year, one of the following applies:

- They are married and live together as husband and wife.
- They live together in a common-law marriage recognized in the state where they now live or in the state where the common-law marriage began.
- They are married and live apart but are not legally separated under a decree of divorce or separate maintenance.
- They are separated under an interlocutory (not final) divorce decree.
- The taxpayer's spouse died during the year and the taxpayer has not remarried.

If taxpayers file a joint return, combine the husband's and wife's tax items (for example, income) on the same return. Both the husband and wife must sign the return and both are responsible for any tax owed on that return. Taxpayers can choose the married filing joint status even if only one spouse has income.

Taxpayers filing a joint return generally have a lower tax than their combined tax for any other filing status.

MARRIED FILING A SEPARATE RETURN

Taxpayers who are married may choose to file separately. The husband and wife report their own incomes and deductions on separate returns. Taxpayers may choose the **married filing separately** status even if one spouse had no income.

If the taxpayers live in a community property state, they must follow state law to determine their separate income. For more information, see Publication 555, *Community Property*.

If a married couple files separately and one spouse itemizes deductions, the other spouse must also itemize deductions because he or she cannot take the standard deduction. See Lesson 5 for more information on itemized deductions.

Taxpayers filing separate returns generally have a higher tax than when filing jointly. Occasionally, however, separate returns may result in a lower tax. If you think this might be the case, compute the tax liability for (a) married filing jointly and (b) married filing separately. Choose the filing status that results in the lower tax.

When a married taxpayer files separately, the taxpayer must show his or her social security number in the label section. Also, the spouse's full name must be entered on line 3 in the space provided opposite the married filing separately check box.

ALERT



A taxpayer who would normally file married filing separately may qualify for the Head of Household filing status. See rules for Head of Household. Married Persons Living Apart With Dependent Children.

HEAD OF HOUSEHOLD

The working Families Tax Relief ACT of 2004 set up a uniform definition of a Qualifying Child. Beginning in tax year 2005 this definition must be observed to determine whether a taxpayer can claim Head of Household filing status.

- A taxpayer is eligible for Head of the household filing status only with respect to a qualifying child or a qualifying relative.
- A Qualifying Child is determined without regard to the exception for children of divorced or separated parents.
- A Qualifying Child who is married must not have filed a joint return for the tax year unless the return is filed only as a claim for refund and no tax liability would exist for either spouse if they had filed separate returns.

Generally, taxpayers who file under the **head of household** filing status have a lower tax than if they file as single. If they qualify, taxpayers should use the head of household status instead of the single status.

Head of Household Qualifications

ALERT



A qualifying child who is married at the end of the year must meet the marital and nationality tests under the new rules for the "Uniform Definition of a Qualifying Child."

1. The taxpayer must be unmarried (single, widowed, divorced, or legally separated) on the last day of the year

OR

The taxpayer must meet the tests for married persons living apart with dependent children (explained later in this lesson)

AND

2. The taxpayer must have paid more than half the cost of keeping up a home that was the main home for more than half the year (except for temporary absences) of any of the following:
 - A. The taxpayer's **Qualifying Child** who must have lived with the taxpayer but does not have to be claimed by the taxpayer,
 - B. The taxpayer's child who lived with the taxpayer but is not a Qualifying Child must be the taxpayer's dependent.
 - C. Only the relatives listed at the end of this discussion that lived with the taxpayer and who were the taxpayer's dependents.

EXCEPTION: The taxpayer may claim head of household filing status if the taxpayer's parent can be claimed as a dependent, even if the parent does not live with the taxpayer. However, the taxpayer must pay more than half the cost of maintaining the parent's home for the entire year.

"Child" includes:

- The taxpayer's child or stepchild (whether by blood or adoption), foster child, sibling or stepsibling, or a descendant of one of these.

"Relative" includes:

- Child who is not a Qualifying Child
- Parent, grandparent
- Brother, sister, stepbrother, stepsister
- Half brother, half sister
- Stepmother, stepfather
- Mother-in-law, father-in-law
- Brother-in-law, sister-in-law
- Son-in-law, daughter-in-law

AND

- Uncle, or aunt, nephew, or niece
- An individual (other than the taxpayer's spouse) who lives in the taxpayer's home for the entire year and who is a member of the taxpayer's household (but not a servant or an employee) is also viewed as being a relative.

"Relative" does not include cousins and more distant relatives.

ALERT



The taxpayer cannot file as head of household for a person who is a dependent only because he or she lived with with the taxpayer for the whole year or because the taxpayer may claim him or her as a dependent under a multiple support agreement.

Keeping Up the Home

The taxpayer must pay more than half the cost of keeping up the home. The cost of keeping up a home includes payments for: rent, mortgage principal and interest, real estate taxes, insurance on the home, repairs, utilities, domestic help, and food eaten in the home. Welfare payments are not considered amounts that the taxpayer furnishes to keep up a home.

The home must have been the main home for more than half the year except for temporary absences. Temporary absences include those for school, vacation, illness, business, or military service.

The following chart may help you decide who is eligible to claim head of household filing status.

Exhibit 1

Who Is a Qualifying Person for Filing as Head of Household?¹

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 can not 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	a qualifying person. ⁵
	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) ⁶	he or she lived with you more than half the year, and you can claim an exemption for him or her ⁷	a qualifying person.
	he or she did not live with you more than half the year	not a qualifying person.
	you cannot claim an exemption for him or her	not a qualifying person.

¹A person cannot qualify more than one taxpayer to use the head of household filing status for the year.

²The term “qualifying child” is defined under *Exemptions for Dependents*, in Lesson 1. **Note:** A child may be your qualifying child for head of household filing status even if the child is not a qualifying child for whom you claim as an exemption. This applies if the child is the qualifying child of the noncustodial parent under the rules described under *Children of divorced or separated parents* under *Qualifying Child*, in Lesson 1.

³ This person is a qualifying person if the requirements described under *Married child* are met.

⁴The term “qualifying relative” is defined under *Exemptions for Dependents*, in Lesson 1.

⁵See *Special rule for parent* for an additional requirement.

⁶A person who is your qualifying relative only because he or she lived with you all year as a member of your household is not a qualifying person.

⁷If you can claim an exemption for a person only because of multiple support agreement, that person is not a qualifying person. See *Multiple Support Agreement*, in Lesson 1.

Married Persons Living Apart With Dependent Children

Some married taxpayers who live apart from their spouses may be considered unmarried for tax purposes. If so, these taxpayers are permitted to file as head of household and receive the benefit of lower tax amounts.

A married taxpayer can file as head of household if:

1. The taxpayer files a separate return,
2. The taxpayer paid more than half the cost of keeping up his or her home for the year,
3. The taxpayer's spouse did not live in the home during the last six months of the year,
4. The taxpayer's home was the main home of the taxpayer's child, stepchild, adopted, or foster child for more than half of the year, and
5. The taxpayer is entitled to claim the child, stepchild, adopted child, or foster child as a dependent, unless one of the following exceptions for divorced or separated parents applies:
 - the taxpayer signed a statement allowing the noncustodial parent to claim the child as a dependent, or
 - the noncustodial parent provided at least \$600 for the child's support and can claim the dependent under a pre-1985 agreement.

Reporting Head of Household Filing Status

Taxpayers must enter the name of the person who qualifies them for the head of household status. If the person is a dependent, enter the dependent's name on line 6c of the exemption section of the tax return. If the qualifying child is not claimed as a dependent, enter the name of the nondependent person on line 4 in the filing status section of the tax return.

Example 1

Darlisa is divorced and provided over half the cost of keeping up a home. Her five-year-old daughter, Jayla, lived with her for seven months last year. Darlisa does not claim Jayla as a dependent; her ex-husband does.

Darlisa may use head of household status. Darlisa must write Jayla's name in the space on Form 1040 or 1040A, on line 4.

Exhibit 2

Darlisa's Form 1040A, page 1

Filing status Check only one box.	1 <input type="checkbox"/> Single	4 <input checked="" type="checkbox"/> Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here. ► <u>Jayla</u>
	2 <input type="checkbox"/> Married filing jointly (even if only one had income)	5 <input type="checkbox"/> Qualifying widow(er) with dependent child (see page 19)
	3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ►	

QUALIFYING WIDOW(ER) WITH DEPENDENT CHILD

A widow or widower, with one or more dependent children, may be able to use the **qualifying widow(er)** with dependent child filing status. This filing status yields the lowest tax rate (the same tax for married filing jointly).

If the taxpayer's spouse died during 2003 or 2004 and the taxpayer did not remarry before the end of 2005, the taxpayer may be able to file as a qualifying widow(er) with dependent child. To qualify, the taxpayer must:

- Have been entitled to file a joint return for the year the spouse died (it does not matter whether or not a joint return was actually filed),

AND

- Have a child, foster child, adopted child, or stepchild who qualifies as the taxpayer's dependent for the year,

AND

- Have furnished over half the cost of keeping up a home that was the main home of the child for the entire year.

An "adopted child" includes a child lawfully placed with the taxpayer by an authorized placement agency for legal adoption.

Social Security survivor benefits received on behalf of the child are considered to be amounts furnished by the child, not by the parent.

In the year a taxpayer's spouse dies, if the taxpayer does not remarry, he or she can use the married filing jointly filing status or married filing separately filing status and can claim an exemption for the deceased spouse. For two years after the year of death, the taxpayer may file as a qualifying widow(er) with dependent child, but may not claim an exemption for the deceased spouse. After the second year following the year of death, the taxpayer can no longer use the qualifying widow(er) filing status. The taxpayer may use either the head of household or single filing status depending on his or her situation then.

The following chart may help you decide which filing status to use for a taxpayer with a qualifying dependent if the spouse is deceased and the taxpayer has not remarried.

Exhibit 3

Filing Status After Death of Spouse		
Tax Year	Filing Status	Exemption for Deceased Spouse?
1. Year of Death	Married (joint)	Yes
	OR	
2. First Year after death	Married (separate)	Yes
	Qualifying widow(er)*	No
3. Second year after death	Qualifying widow(er)*	No
4. After the second year after death	Head of household**	No
	OR	
	Single	No
* With a qualifying dependent who is a son, daughter, stepson, or stepdaughter.		
** With a qualifying relative.		

You may find the flowchart shown in Exhibit 4 helpful in determining the correct filing status. It has some of the same questions as shown in the Interview Tips on the following page.



Filing Status

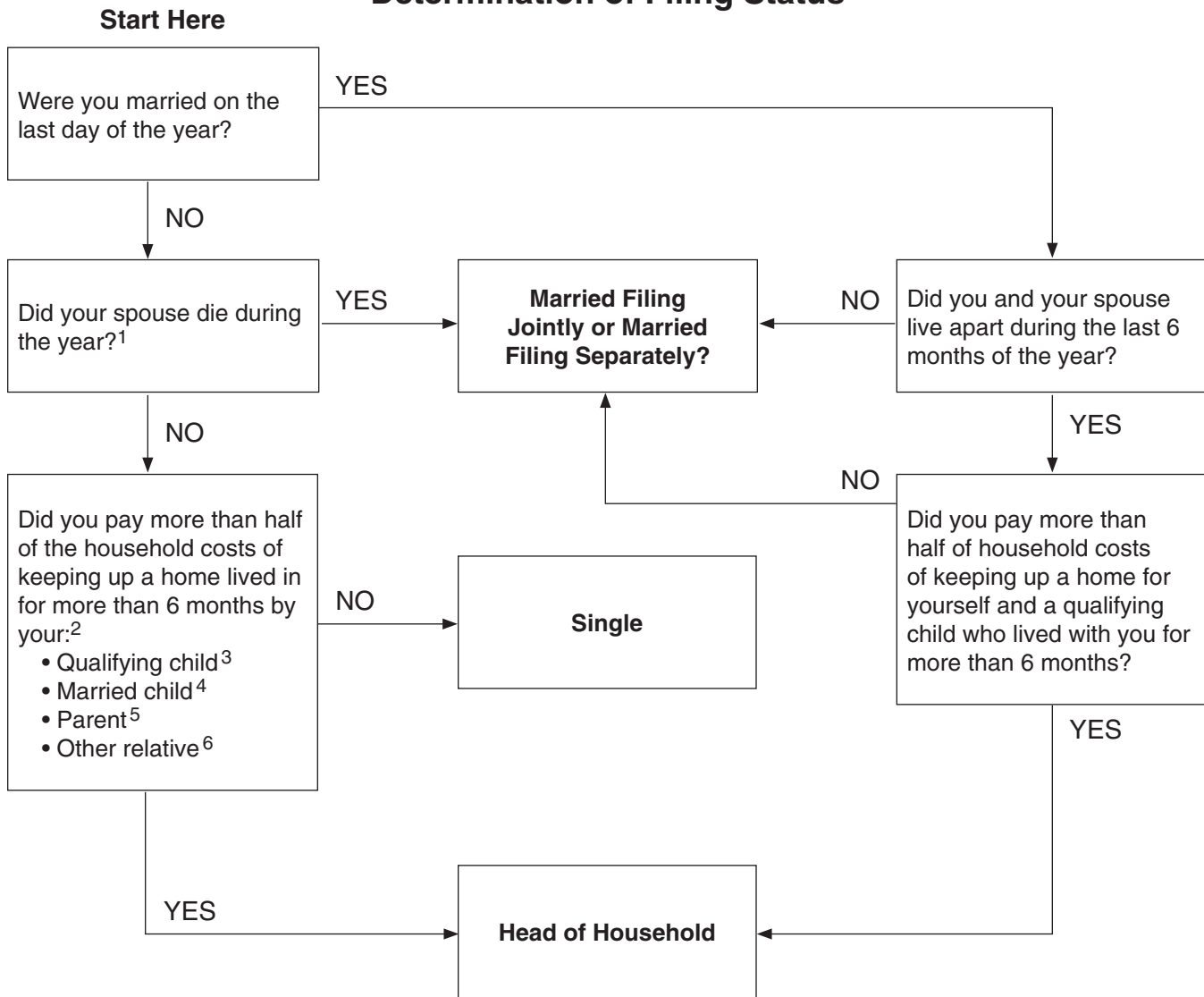
interview
tips

Probe/Action: Ask the taxpayer:

<p>step 1</p>	<p>Were you considered married in a legal union between a man and a woman as husband and wife on December 31st of the tax year (answer yes if state common law rules met)?</p>	<p>If YES, go to Step 2. If NO, go to Step 5.</p>
<p>step 2</p>	<p>Do you and your spouse wish to file a joint return?</p>	<p>If YES, STOP. Your filing status is Married Filing Jointly. If NO, go to Step 3.</p>
<p>step 3</p>	<p>Did you have a qualifying child or any other relative whom you can claim as a dependent living in your home during the tax year?*</p>	<p>If YES, go to Step 4. If NO, STOP. Your filing status is Married Filing Separately.</p>
<p>step 4</p>	<p>Can you be considered unmarried?</p> <ul style="list-style-type: none"> ■ You file a separate return ■ Paid more than half the cost of keeping up a main home ■ Your spouse did not live in your home during the last 6 months (including temporary absences) of the tax year ■ Your home was the main home of your child, stepchild, or foster child for more than half the year ■ You must be able to claim an exemption for the child (Exception – non-custodial parent correctly claims exemption) 	<p>If YES, STOP. Your filing status is Head of Household. If NO, STOP. Your filing status is Married Filing Separately.</p>
<p>step 5</p>	<p>Did your spouse die in 2003 or 2004?</p>	<p>If YES, go to Step 6. If NO, go to Step 7.</p>
<p>step 6</p>	<p>Can you be considered a qualifying widow(er) with a dependent child?</p> <ul style="list-style-type: none"> ■ You were entitled to file a joint return with your spouse for the year your spouse died ■ You did not remarry before the end of this tax year ■ You have a dependent child who is a son, daughter, stepson, or stepdaughter who you can claim as an exemption ■ You paid more than half the cost of keeping up a main home for you and that child for the entire year 	<p>If YES, STOP. Your filing status is Qualifying Widow(er) with Dependent Child. If NO, go to Step 7.</p>
<p>step 7</p>	<p>Do you have a qualifying person for Head of Household Filing status?</p> <ul style="list-style-type: none"> ■ You paid more than half the cost of keeping up a main home ■ A qualifying person* lived with you more than half the year (Exception for dependent parent, or kidnapped child) 	<p>If YES, STOP. Your filing status is Head of Household. If NO, STOP. Your filing status is Single.</p>

*You can not use head of household filing status based on any person who is your dependent only because he or she lived with you for all of 2005.

Determination of Filing Status



¹If you paid over half of household costs for a qualifying child, you can file as Qualifying Widow (er) for 2 years after the death of your spouse.

²See Pub. 17, *Filing Status*, for rules applying to birth, death, or temporary absence during the year. Military deployment/TDY is a temporary absence and he/she is considered to have lived in your home.

³A qualifying child includes grandchild, stepchild, adopted child, or foster child.

⁴A married child includes grandchild, stepchild, adopted child, but the child is not a qualifying person unless you can claim an exemption for the child. If you could claim an exemption for the child, except that the child's other parent claims the exemption under the special rules for a noncustodial parent, then the child is a qualifying person.

⁵A parent does not have to live with you if you paid more than half the cost of keeping up his or her main home for the entire year, but you must be able to claim an exemption for the parent.

⁶Other relatives include grandparent, brother, sister, stepbrother, stepsister, half brother, half sister, stepmother, stepfather, mother-in-law, father-in-law, brother-in-law, sister-in-law, son-in-law, daughter-in-law and, if related by blood, uncle, aunt, nephew, or niece. You must be able to claim an exemption for any of these individuals.

When using TaxWise to prepare a tax return, you will need to have the Social Security Number of anyone who qualifies the taxpayer for Head of Household filing status and is not the taxpayer's dependent.

For Qualifying Widow(er) filing status, you must enter the year of death of the deceased spouse.

For Married Filing Separate status, you will need the spouse's full name and Social Security number.

►► **Summing Up This Section** ◀◀

When completing their tax returns, taxpayers can use one of five filing statuses:

Tax Status

(from lowest tax to highest tax)

1. Married filing jointly*
2. Qualifying widow(er) with dependent child*
3. Head of household
4. Single
5. Married filing separately

* Tax Status 1 and 2 yield the same (lowest) tax.

Filing status is indicated on lines 1 through 5 of Forms 1040A and 1040. Selecting the correct filing status is one of the most important aspects of completing a tax return because the filing status factors in how much tax will be due. Remember that filing status requirements do not change, regardless of the tax form used. If a taxpayer is qualified to use more than one filing status, choose the one that will result in the lowest tax.

Exercises

1. Kay and Fred were married in 2004. They are not divorced, but lived apart all of 2005. They are not legally separated under a decree of divorce or separate maintenance. They have no children. Can they use the married filing jointly status?

2. Jerry does not know which filing status to use. You ask if he is married. He answers that he got divorced in December but supported his wife all year and has not remarried. Can Martin and his ex-wife file a joint return? _____
3. Ginger is single and paid more than half the cost of keeping up her home. Her grandmother lived with her all year. Ginger claims her grandmother as a dependent. What is Ginger's filing status? _____
4. Craig is single and lives alone. He paid over half the cost of maintaining a home for his father for the entire year. He claims his father as a dependent. What is Craig's filing status? _____
5. Rhonda is single and lives alone. She paid over half the cost of maintaining a separate home for her father. She cannot claim her father as a dependent. What is Rhonda's filing status?

6. Mrs. Calvin tells you that she is divorced and that her 21-year-old unmarried son lived with her all year. She paid for their rent and food and provided over half of her son's total support. She cannot claim her son as a dependent because he earned \$4,000 and is not a student. Her son used his earnings to pay for his car, clothing, and entertainment. Can Mrs. Calvin file as head of household? _____
7. Kathy lived with her unemployed roommate, Sandra, for the entire year. Kathy had to pay more than half of the cost of keeping up their apartment. Can Kathy file as head of household?

8. Jack has lived apart from his wife for several years. Their children live with his wife but Jack pays over half the children's support. What filing status can Jack use? _____
9. Lily left her husband in August 2005. She took her children with her. She supported the children during all of 2005 and will claim them as dependents. Lily will not file a joint return with her husband. Which filing status should Lily use in 2005? ____
10. Rose and her husband separated in October 2005, but were still married on December 31, 2005. What filing status can she use?

11. Dick's wife died in 2003. Dick has not remarried. Dick provides all of the support for his two dependent children. What will be Dick's filing status for 2006? _____

Exercise 1

Yes

Exercise 2

No

Exercise 3

Head of household

Exercise 4

Head of household

Exercise 5

Single

Exercise 6

No, the son is too old to be a qualifying child and has too much income for his mother to be entitled to claim him as an exemption.

Exercise 7

No; Sandra is not a qualifying person.

Exercise 8

Married filing jointly or married filing separately.

Exercise 9

Married filing separately; she lived with her husband during part of the last six months of 2005.

Exercise 10

Either married filing jointly or married filing separately.

Exercise 11

Head of household; he could claim qualifying widower for 2004 and 2005 only.

WHO MUST FILE—WHO SHOULD FILE

WHO MUST FILE

To decide who must file a tax return, you will need to know the individual's:

- filing status,
 - age,
 - gross income,
- and if:
- special taxes might be owed on different types of income,
 - some of the income is excludable or exempt,
 - the individual can be claimed as a dependent on another's tax return,
 - the individual is blind, or
 - the individual received advance earned income credit payments.

You may not be familiar with some of the terms used on the list. These terms will be explained in later lessons. For now, concentrate on learning how to use the charts and checklists.

How to Use the Charts and Flowcharts

You will use a set of charts to determine who must file. An individual who cannot be claimed as a dependent on another taxpayer's return will use *Chart A—For Most People*. Based on the individual's circumstances, a person who can be claimed as a dependent on another taxpayer's return will use one of the other charts. *Chart C—Other Situations When You Must File* should be reviewed for every individual.

ALERT



Even if you do not otherwise have to file a return, you should file one to get a refund of any federal income tax withheld. You should also file if you are eligible for the earned income tax credit, or the health coverage tax credit.

Chart A—For Most People

IF your filing status is . . .	AND at the end of 2005 you were* . . .	THEN file a return if your gross income** was at least . . .
Single	under 65	\$8,200
	65 or older	9,450
Married filing jointly***	under 65 (both spouses)	\$16,400
	65 or older (one spouse)	17,400
	65 or older (both spouses)	18,400
Married filing separately	any age	\$3,200
Head of household	under 65	\$10,500
	65 or older	11,750
Qualifying widow(er) with dependent child	under 65	\$13,200
	65 or older	14,200

* If you were born on January 1, 1941, you are considered to be age 65 at the end of 2005.

** **Gross income** means all income you received in the form of money, goods, property, and services that is not exempt from tax, including any income from sources outside the United States (even if you may exclude part or all of it). **Do not** include social security benefits unless you are married filing a separate return and you lived with your spouse at any time in 2005.

*** If you did not live with your spouse at the end of 2005 (or on the date your spouse died) and your gross income was at least \$3,200, you must file a return regardless of your age.

POTENTIAL PITFALLS



If a checklist or chart indicates that a person must file a return, he or she should do so even if no tax is owed. If a minor child must file a return but cannot do so, the child's parent or guardian must complete and sign a return for the child.

Chart B—For Children and Other Dependents

If your parent (or someone else) can claim you as a dependent, use this chart to see if you must file a return.

In this chart, **unearned income** includes taxable interest, ordinary dividends, and capital gain distributions. **Earned income** includes wages, tips, and taxable scholarship and fellowship grants. **Gross income** is the total of your unearned and earned income.

See IRS Publication 501 for additional information.



If your gross income was \$3,200 or more, you usually cannot be claimed as a dependent unless you were a qualifying child (a) under age 19 at the end of 2005, (b) under age 24 at the end of 2005 and a student, or (c) any age and permanently and totally disabled.

Single dependents. Were you **either** age 65 or older **or** blind?

- No.** You must file a return if **any** of the following apply.
 - Your **unearned income** was over \$800.
 - Your **earned income** was over \$5,000.
 - Your **gross income** was more than the **larger** of—
 - \$800, or
 - Your earned income (up to \$4,750) plus \$250.
- Yes.** You must file a return if **any** of the following apply.
 - Your unearned income was over \$2,050 (\$3,300 if 65 or older **and** blind).
 - Your earned income was over \$6,250 (\$7,500 if 65 or older **and** blind).
 - Your gross income was more than—

The larger of:	Plus	This amount:
<ul style="list-style-type: none"> • \$800, or • Your earned income (up to \$4,750) plus \$250 	}	\$1,250 (\$2,500 if 65 or older and blind)

Married dependents. Were you **either** age 65 or older **or** blind?

- No.** You must file a return if **any** of the following apply.
 - Your unearned income was over \$800.
 - Your earned income was over \$5,000.
 - Your gross income was at least \$5 and your spouse files a separate return and itemizes deductions.
 - Your gross income was more than the **larger** of—
 - \$800, or
 - Your earned income (up to \$4,750) plus \$250.
- Yes.** You must file a return if **any** of the following apply.
 - Your unearned income was over \$1,800 (\$2,800 if 65 or older **and** blind).
 - Your earned income was over \$6,000 (\$7,000 if 65 or older **and** blind).
 - Your gross income was at least \$5 and your spouse files a separate return and itemizes deductions.
 - Your gross income was more than—

The larger of:	Plus	This amount:
<ul style="list-style-type: none"> • \$800, or • Your earned income (up to \$4,750) plus \$250 	}	\$1,000 (\$2,000 if 65 or older and blind)

DEPENDENTS WHO MUST OR SHOULD FILE A RETURN—CHECKLIST

The dependents listed in the following checklist must or should file a return.

Exhibit 7

Checklist—Children and Other Dependents

- A married dependent with at least \$5 of income whose spouse itemizes deductions on a separate return on Form 1040 must file a return.
- A dependent with at least \$400 of net self-employment income must file a return. **Self-employment income** is earned income from a trade, business, farming or profession that is not paid by an employer. For example, seamstresses and lawncare workers who work for themselves (and not for someone else) are considered self-employed.
- A dependent who is not required to file but had income tax withheld should file a return to get a refund.
- A dependent who has to pay a tax, such as tax on tips, must file a return.
- If a taxpayer can be claimed as a dependent by another person, the taxpayer cannot claim any dependents on the tax return whether or not actually claimed by the other person.

OTHER SITUATIONS

Remember to review the *Chart C—Other Situations For When You Must File* chart after you use the other charts.

Exhibit 8

Chart C—Other Situations When You Must File

You must file a return if any of the conditions below apply for 2005.	
1.	You owe any special taxes, including any of the following. <ul style="list-style-type: none">• Alternative minimum tax.• Additional tax on a qualified plan, including an individual retirement arrangement (IRA), or other tax-favored account. But if you are filing a return only because you owe this tax, you can file Form 5329 by itself.• Household employment taxes. But if you are filing a return only because you owe this tax, you can file Schedule H by itself.• Social security and Medicare tax on tips you did not report to your employer.• Write-in taxes, including uncollected social security and Medicare or RRTA tax on tips you reported to your employer or on group-term life insurance, additional tax on health savings account distributions, and additional tax on deferred compensation under a nonqualified deferred compensation plan due to plan failures.• Recapture taxes.
2.	You received any advance earned income credit (EIC) payments from your employer. These payments are shown in Form W-2, box 9.
3.	You had net earnings from self-employment of at least \$400.
4.	You had wages of \$108.28 or more from a church or qualified church-controlled organization that is exempt from employer social security and Medicare taxes.

WHO SHOULD FILE A RETURN?

The charts, noted previously in this lesson, may indicate that an individual does not have to file a tax return. However, in three instances, individuals *should* file a return:

- to claim a refund of withheld taxes,
- to claim an earned income credit, and
- to claim the additional child tax credit.

HELPING THOSE WHO DON'T NEED TO FILE

The Reduce Unnecessary Filing Program (RUF) is intended to help certain individuals determine their need to file a federal income tax return. Use Form 9452, *Filing Assistance Program Worksheet*, to help potential unnecessary filers determine whether or not they need to file.

Thank you for helping to save time and effort for your VITA and TCE clients and for helping to reduce the cost to all taxpayers of processing unnecessary returns by helping your clients with Form 9452 and related materials, as needed.

TAXWISE HINT

After completing the tax return refer back to the Main Information screen and select the appropriate tax form.

▶▶ **SUMMING UP THIS SECTION** ◀◀

Use the charts provided in this section to determine who *must* and who *should* file a tax return.

Exercises

- 12.** Emily is married and has one dependent child. She has not lived with her husband since May and is head of household. She is under 65 and not blind. Her gross income from wages is \$15,000. Is she required to file a tax return? _____
- 13.** Larry and Zelda are married but will not file a joint return. Both are under 65 and not blind. Larry's gross income from wages is \$30,150. Zelda's gross income is \$3,500.
- A.** Is Larry required to file? _____
- B.** Is Zelda required to file? _____

WHO MUST FILE WHO SHOULD FILE

ANSWERS TO EXERCISES

Exercise 12

Yes

Exercise 13

A. Yes

B. Yes

WHICH FORM TO USE?



FORM 1040EZ

Form 1040EZ is for single and joint filers with no dependents. The form instructions booklet has a worksheet for taxpayers who can be claimed as dependents.

ALERT



Form 1040EZ should not be used by taxpayers who are age 65 or older or blind.

FORM 1040A

Form 1040A is a two-page form. Page 1 of the form shows the filing status, exemptions, income, and adjusted gross income. Page 2 of the form shows the standard deduction, exemption amount, taxable income, tax, credits, payments, amount owed or refund, and signature. Form 1040A may have four schedules. Use **Schedule 1** to report interest and/or dividend income that is more than \$1,500. Use **Schedule 2** to report child and dependent care expenses and to figure the credit. Claim the credit for the elderly or the disabled on **Schedule 3**. This credit is explained in Lesson 6. If the taxpayer can take the earned income credit and has a qualifying child, use **Schedule EIC** to give information about that child. Schedule EIC is discussed and illustrated in Lesson 10.

FORM 1040

Form 1040 is a two-page form. Page 1 of the form shows the filing status, exemptions, income, and adjusted gross income. Page 2 shows the standard deduction or itemized deductions, the exemption amount, taxable income, tax, credits, other taxes, payments, and the amount owed or refund due.

IRS *e-file* offers quick and easy alternatives to traditional paper returns. These options include filing electronically through an authorized tax practitioner, and by personal computer. For those expecting a refund, these options all offer Direct Deposit to a bank account. For those with a balance due, paying is made easier with the option of payment by credit card or a direct debit to their bank account.

Why e-file? Because IRS *e-file* makes filing faster and more accurate and gets the taxpayer their refund in half the usual time.... even faster with Direct Deposit!

As a volunteer, you should become familiar with this option as there will be occasions when you are called upon to answer questions from taxpayers regarding it. You may even have the opportunity to volunteer at a VITA or TCE site that has been set up to offer electronic tax filing. If so, you will receive additional specialized training on using return preparation software and on other procedures unique to this type of site.

ALERT

IRS ended its TeleFile program after August 16, 2005. Increasing costs to maintain the system and the growth of other electronic filing options led to the decision to end the program.



Military/International students continue.

All others go to Lesson 3, page 3-1.

STUDENT NOTES

Lined writing area for student notes.

INTRODUCTION AND OBJECTIVES

This lesson will explain additional factors to consider in selecting the married filing joint and head of household filing status for taxpayers who are U.S. citizens or resident aliens. The criteria for selecting the married filing separate, single and head of household filing status are the same as discussed in the basic text.

At the end of this segment, you will be able to:

- Determine the correct filing status for resident aliens.
- Explain how to treat a nonresident alien's spouse as a resident.

MARRIED NON-RESIDENTS FILING JOINTLY

In order to file Married Filing Jointly, the taxpayers must be married on the last day of the tax year and agree to file a joint return. However, "A joint return generally cannot be made if either spouse is a nonresident alien at any time during the tax year." (Pub 17).

Treating Non-Resident Spouse as a U.S. Resident

If, at the end of the tax year, the taxpayer is married and one spouse is a U.S. citizen or a resident alien and the other spouse is a nonresident alien, the taxpayer can elect to treat the non-resident spouse as a U.S. resident. This includes situations in which one spouse is a nonresident alien at the beginning of the tax year, but a resident alien at the end of the year, and the other spouse is a nonresident alien at the end of the year.

If this choice is made, the taxpayer and spouse are treated for income tax purposes as residents for the entire tax year.

For example, neither the taxpayer nor the spouse can claim tax treaty benefits as a resident of a foreign country for a tax year for which the choice is in effect. Taxpayers must file a joint income tax return for the year the choice is made, but the taxpayer and spouse can file joint or separate returns in later years.

Example 1

Debra Green, a U.S. citizen for all of tax year 2005, is married to Charles, a nonresident alien. Debra and Charles make the choice to treat Charles as a resident alien by attaching a statement to their joint return for 2005. Debra and Charles must report their world-wide income in 2005 and later years unless the choice is ended or suspended. Although they must file a joint return for 2005, they can file joint or separate returns for later years.

Example 2

Jim and Judy Adams are married and both are nonresident aliens. In June 2005, Jim became a resident alien and remained a resident for the rest of the year. Jim and Judy both choose to be treated as resident aliens by attaching a statement to the 2005 joint return. Jim and Judy must report their world-wide income in 2005 and later years unless the choice is ended or suspended. They must file a joint return for 2005, but they can file either joint or separate returns for later years.

THE "CHOICE" DECLARATION

A statement containing the following information must be signed by both spouses and attached to the joint return for the first tax year for which the choice applies.

1. A declaration that one spouse was a nonresident alien and the other spouse a U.S. citizen or resident alien on the last day of the tax year, and that the taxpayer and spouse chose to be treated as U.S. residents for the entire tax year, and
2. The name, address, and social security number or ITIN of each spouse. (If one spouse died, include the name and address of the person making the choice for the deceased spouse.)

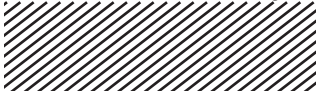
The choice can also be made by filing a joint amended return. Publication 54 contains specifics on this option.

Suspending the Choice

The choice to be treated as a resident alien does not apply to any later tax year if neither spouse is a U.S. citizen or resident alien at any time during the tax year.

Example 3

Dick Brown was a resident alien on December 31, 2002, and married to Judy, a nonresident alien. They chose to treat Judy as a resident alien and filed joint returns for tax years 2002 and 2003. On January 10, 2004, Dick became a nonresident alien. Judy had remained a nonresident alien throughout the period. Dick and Judy can file joint or separate returns for 2004. However, since neither Dick nor Judy is a resident alien at any time during 2005, their choice is suspended for that year. If either has U.S. source income or foreign source income effectively connected with a U.S.



trade or business in 2005, they must file separate returns as non-resident aliens. If Dick becomes a resident alien again in 2006, their choice is no longer suspended.

Ending the Choice

Once made, the choice to be treated as a resident applies to all later years unless suspended or ended in one of the ways shown below. If the choice is ended for any of these reasons, neither spouse can make a choice in any later tax year.

Revocation	<ul style="list-style-type: none"> • Either spouse can revoke the choice for any tax year. • The revocation must be made by the due date for filing the tax return for that year. • The spouse who revokes must attach a signed statement declaring that the choice is being revoked. If the spouse revoking the choice does not have to file a return and does not file a claim for refund, send the statement to the Internal Revenue Service Center where the last joint return was filed. • The statement revoking the choice must include the following: <ul style="list-style-type: none"> • The name, address, and social security number (or taxpayer identification number) of each spouse. • The name and address of any person who is revoking the choice for a deceased spouse. • A list of any states, foreign countries, and possessions that have community property laws in which either spouse is domiciled or where real property is located from which either spouse receives income.
Death	<ul style="list-style-type: none"> • The death of either spouse ends the choice, beginning with the first tax year following the year the spouse died. • If the surviving spouse is a U.S. citizen or resident and is entitled to the joint tax rates as a surviving spouse, the choice will not end until the close of the last year for which these joint rates may be used. • If both spouses die in the same tax year, the choice ends on the first day after the close of the tax year in which the spouses died.
Divorce or Legal Separation	<ul style="list-style-type: none"> • A divorce or legal separation ends the choice as of the beginning of the tax year in which the legal separation occurs.
Inadequate records	<ul style="list-style-type: none"> • The Internal Revenue Service can end the choice for any tax year that either spouse has failed to keep adequate books, records, and other information necessary to determine the correct income tax liability, or to provide adequate access to those records.

HEAD OF HOUSEHOLD

In general, in order to claim Head of Household status, the taxpayer must:

1. Be unmarried or considered unmarried on the last day of the year and
2. Have paid more than half the cost of keeping up a home for the year and
3. Have a qualifying person in the home for more than half the year.

These general rules are discussed in the basic text and in more detail in Publication 17.



SPECIAL RULE

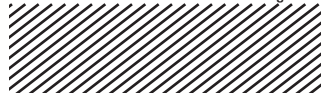
For Head of Household purposes, “you are considered unmarried if your spouse was a nonresident alien at any time during the year, and you do not choose to treat your spouse as a resident alien.” All of the other qualifications for Head of Household must also be met.

Example 4

Raul is in the U.S. Army in Japan. His wife and children live with him and he is able to claim the children as dependents. Raul’s wife (a citizen of Japan) chooses not to be treated as a resident alien. Even though Raul is married, he can claim Head of Household status because of the rule above. If Raul had not passed all of the other qualifications for Head of Household, he would have to file as a married person (either as Married Filing Separate or Married Filing Joint).

▶▶ SUMMING UP THIS SEGMENT ◀◀

- ▶ The taxpayer may be considered unmarried if the spouse was a nonresident alien at any time during the year and the taxpayer does not choose to treat the spouse as a resident alien.



INTRODUCTION AND OBJECTIVES

In this lesson you will learn to distinguish between taxable and nontaxable income. You will also learn where to report the different types of income. In addition, you will learn to make income entries on Forms 1040EZ, 1040A, and 1040.

This lesson will help you achieve the following objectives.

- Determine what is taxable and nontaxable income.
- Determine where to report income on Forms 1040, 1040A, and 1040EZ.
- Identify who can file Schedule C-EZ.
- Identify who must file Schedule SE.

TAXABLE AND NONTAXABLE INCOME

Taxable income is any income that is subject to tax. It must be reported on a tax return, unless the amount is so small that the individual is not required to file a return.

The following types of income are taxable:

- Wages, salaries, bonuses, and commissions
- Certain fringe benefits
- Tips and other compensation for personal services
- Interest*
- Dividends
- Refunds of state and local taxes**
- Alimony received or separate maintenance payments received
- Business income
- Hobby income (a hobby loss is not deductible)
- Capital gains
- Gain from the sale of property
- IRA distributions (part or all may be nontaxable)
- Pensions and annuities (part may be nontaxable)
- Rental income
- Royalties

ALERT



This lesson contains tax law and information relating to all levels of training. Your course facilitator will only teach the information required to assist taxpayers you will serve.

- Estate or trust income
- Supplemental unemployment benefits
- Unemployment compensation
- Railroad retirement benefits (part may be taxable)
- Social security benefits (part may be taxable)
- Jury duty pay
- Executors' fees
- Gambling winnings (including lotteries, contests, raffles, etc.)
- Nonqualifying scholarships and fellowships
- Payments for punitive damages and compensatory damages not attributable to physical injuries or sickness
- Certain long-term care benefits. If the taxpayer received copy B of Form 1099-LTC, refer him or her to a paid professional preparer because some of the benefits may be taxable.

*Some interest is not taxable (for example, interest on certain state and local bonds and on qualified Series EE and Series I savings bonds used to pay for higher education expenses).

**Refunds of state and local taxes are taxable only if the taxpayer itemized deductions in the year the taxes were paid and the individual's tax liability was REDUCED because of the deduction.

Nontaxable income is income that is exempt from tax. If a return must be filed, some types of nontaxable income will be shown on the return but will not be added into the amount of income subject to tax.

The following types of income are nontaxable:

- Child support
- Federal income tax refunds
- Certain dividends on life insurance
- Gifts, bequests, and inheritances (may be subject to other taxes)
- Insurance and certain other payments for physical injury and sickness
- Interest on certain Series EE and Series I savings bonds redeemed to pay for qualified higher education expenses
- Interest on certain state and local obligations (municipal bonds)
- Most life insurance proceeds paid upon death (and certain accelerated death benefits or payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death)
- Public assistance payments (certain TANF payments)
- Certain railroad retirement benefits (part may be exempt)
- Social security benefits (part may be exempt)

- Supplemental Security Income (SSI)
- Veterans' disability benefits
- Workers' compensation
- Qualified scholarships and fellowships
- Certain dependent care services provided by employer
- Interest on insurance dividends left with the VA
- Certain employer-provided educational benefits (up to \$5,250)
- Employer-provided assistance for qualifying adoption expenses. (Refer taxpayers with adoption expenses to a paid professional tax preparer and to Publication 968, *Tax Benefits for Adoption*)
- Restitution payments and excludable interest received by Holocaust victims, their heirs, or their estates, for persecutions are not taxable.
- Certain long-term care benefits. If the taxpayer received copy C of Form 1099-LTC, he or she is not the policyholder. The form is for information only and should be disregarded because none of the benefits are taxable to him or her. If the taxpayer received copy B of Form 1099-LTC, refer him or her to a paid professional preparer because some of the benefits may be taxable.

Example 1

Robert received the following income: wages, interest, child support, alimony, inheritance, workers' compensation, and lottery winnings.

The wages, interest, alimony, and lottery winnings are taxable income and will appear on Robert's tax return.

Child support, inheritance, and workers' compensation are nontaxable income and will not appear on Robert's tax return.

Exercise 1

Indicate whether the income listed is taxable or nontaxable.

Type of Income	Nontaxable	Taxable
1. Wages	_____	_____
2. Dividends from stock	_____	_____
3. Veterans' disability benefits	_____	_____
4. Child Support	_____	_____
5. Credit union dividends	_____	_____
6. Cash bonuses	_____	_____
7. Inheritances	_____	_____
8. Tips	_____	_____
9. Worker's compensation	_____	_____
10. Veteran's life insurance dividends	_____	_____

WHERE TO REPORT INCOME

Taxpayers can report only wages, salaries, tips, unemployment compensation, qualified state tuition program payments, Alaska Permanent Fund dividends, taxable scholarship and fellowship grants, and interest income of \$1,500 or less on Form 1040EZ.

In addition to the types of income that can be reported on Form 1040EZ, ordinary and qualified dividends, capital gains distribution, interest income greater than \$1,500, IRA distributions, pension and annuity income, and taxable social security and equivalent railroad retirement benefits can be reported on Form 1040A.

These and all other types of income can be reported on Form 1040.

EARNED INCOME

Wages and Salaries

The total of wages, salaries, tips, and taxable scholarships and fellowships are reported on Form 1040EZ, line 1, Form 1040A or Form 1040, line 7.

Wages, salaries, and tips are primary examples of earned income received for services performed. Wages and salaries are compensation received. Tips are money and goods received as a gratuity by food servers, maids, porters, etc.

Form W-2. Form W-2, *Wages and Tax Statement*, shown in Exhibit 1, reports the employee's earned income for the year. Employers should issue Form W-2 to every employee and a copy to the Social Security Administration. Box 1, *Wages, tips, and other compensation*, shows the amount of payments received in cash, goods and services, bonuses, supplemental unemployment benefits, awards, and taxable employee benefits. This amount should be included on the return.

An individual taxpayer or a couple filing jointly might have one or more Forms W-2 from various employers. When the taxpayer and/or spouse receive Forms W-2 from their employers, add the amounts from Box 1 of each Form W-2 and report the total amount on the return.

Generally, if a **household employee** earned less than \$1,400 a year while working in the employer's home, the employer is not required to provide the taxpayer with a Form W-2 but, the income must be included on line 7 (Form 1040A or 1040) or line 1 (Form 1040EZ). However, a Form W-2 is required if the employer withheld federal income taxes.

If a taxpayer does not get a Form W-2, or if the one he or she gets is not correct, the taxpayer will have to contact his or her employer as soon as possible. Only an employer can **issue** a Form W-2 or a Form W-2c.

In the event that the employer prepared an incorrect W-2, a Form W-2c, *Corrected Wage and Tax Statement*, should be issued. Use the Form W-2c amounts on the return. Be sure to attach the Form W-2c to the taxpayer's return.

All wage, salary, and tip income must be reported on the return, even if the employee did not receive a Form W-2.

If the taxpayer does not receive a Form W-2 by January 31, he or she should first contact the employer and find out if or when the Form W-2 was mailed. If after allowing a reasonable amount of time for the employer to issue or reissue the Form W-2, the Form W-2 still has not been received, he or she should contact the IRS for assistance at 1-800-829-1040, but not before February 15.

If after requesting a Form W-2 from the employer the taxpayer does not receive it by the due date of the return, he or she should file a Form 4852, *Substitute for Form W-2, Wage and Tax Statement or Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRA's, Insurance Contracts, Etc.*


The taxpayer should keep a copy of Form 4852 for his or her records and file a copy with the Social Security Administration to ensure proper social security credit.

POTENTIAL PITFALLS

Volunteers should be alert to the following possible indications of fraudulent activity:

- Forms W-2 that are typed, handwritten or have noticeable corrections
- Form W-2 from a firm in the area that is different from other Forms W-2 issued by the same firm
- Suspicious person accompanying the taxpayer and observed on other occasions
- Multiple refunds directed to the same address or P.O. Box
- Employment or earnings, that are a basis for refundable credits, that are not well documented
- Similar returns (e.g. same amount of refund, or same number of dependents, or same number of Forms W-2)

Exhibit 1

a Control number		OMB No. 1545-0008		Safe, accurate, FAST! Use 		Visit the IRS website at www.irs.gov/efile .	
b Employer identification number (EIN) XX-XXXXXXX		1 Wages, tips, other compensation 15,000.00		2 Federal income tax withheld 1,500.00			
c Employer's name, address, and ZIP code Allen Company 11 Avert Street Your City, State, Zip Code		3 Social security wages 15,000.00		4 Social security tax withheld 930.00			
		5 Medicare wages and tips 15,000.00		6 Medicare tax withheld 218.00			
		7 Social security tips		8 Allocated tips			
d Employee's social security number XXX-XX-XXXX		9 Advance EIC payment		10 Dependent care benefits			
e Employee's first name and initial Last name Douglas Brown 12 Harvard Street Your City, State, Zip Code		11 Nonqualified plans		12a See instructions for box 12			
		13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b			
		14 Other		12c			
				12d			
f Employee's address and ZIP code							
15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name	

Form W-2 Wage and Tax Statement 2005 Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Form 1099-MISC. Taxpayers with earnings reported on Form 1099-MISC, Miscellaneous Income, shown in Exhibit 2, may be considered self-employed. These amounts are reported on Schedule C-EZ or Schedule C. Net losses and profits are reported on line 12 of Form 1040. Self-employment income is discussed later in this lesson.

Some employers misclassify workers as independent contractors and report their earnings on Form 1099-MISC. Taxpayers who believe they have been misclassified should contact the IRS.

Exhibit 2

CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. Oakdale Company 345 Oakwood Drive Your City, State and Zip Code		1 Rents \$	OMB No. 1545-0115 2005	Miscellaneous Income
		2 Royalties \$		
		3 Other income \$	4 Federal income tax withheld \$	Form 1099-MISC Copy B For Recipient
PAYER'S Federal identification number XX-XXXXXXX	RECIPIENT'S identification number XXX-XX-XXXX	5 Fishing boat proceeds \$	6 Medical and health care payments \$	
RECIPIENT'S name Shelton Wagner Street address (including apt. no.) 897 Wabash Street City, state, and ZIP code City, State and Zip Code		7 Nonemployee compensation \$ 7,000.00	8 Substitute payments in lieu of dividends or interest \$	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
		9 Payer made direct sales of \$5,000 or more of consumer products to a buyer (recipient) for resale <input type="checkbox"/>	10 Crop insurance proceeds \$	
		11	12	
Account number (see instructions)		13 Excess golden parachute payments \$	14 Gross proceeds paid to an attorney \$	
15a Section 409A deferrals \$	15b Section 409A income \$	16 State tax withheld \$	17 State/Payer's state no.	18 State income \$

Form **1099-MISC** (keep for your records) Department of the Treasury - Internal Revenue Service

Tip Income

All tip income is taxable. Individuals who receive **\$20 or more per month in tips** while working one job must report their tip income to their employer. Tips that are reported to employers are included with wages on Form W-2, box 1. If the taxpayer received tip income of \$20 or more in a month and did not report all of those tips to the employer, he or she must report the social security and Medicare taxes on the unreported tips as additional tax on Form 1040. Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*, should be used to compute and report the additional tax.

Individuals who receive **less than \$20 per month in tips** while working one job do not have to report their tip income to their employer. Additionally, noncash tips (for example, tickets or passes) do not have to be reported to the employer. Tips of less than \$20 per month or noncash tips are not subject to social security and Medicare taxes. However, this tip income is subject to federal income taxes and must be reported on line 7 of Form 1040 or Form 1040A, or line 1 of Form 1040EZ.

Allocated tips are tips an employer assigns to an employee. They are in addition to the tips the employee reported to the employer. The taxpayer may have allocated tips if he or she worked in a restaurant, cocktail lounge, or similar business that must allocate tips to employees.

POTENTIAL PITFALLS

If the taxpayer fails to report tip income as required to the employer, the taxpayer may be subject to a penalty equal to 50% of the social security and Medicare taxes owed on unreported tips.

POTENTIAL PITFALLS



The following individuals cannot file Form 1040EZ or 1040A; they must file Form 1040:

- (1) Individuals who received \$20 or more in tips in any month while working for one employer and who did not report the full amount to the employer. (These tips are subject to social security and Medicare tax.)
- (2) Taxpayers whose Form W-2 has an amount entered in box 8, *Allocated tips*, that they must report as income. For more information, see Publication 531, *Reporting Tip Income*.

Allocated tips are shown separately in box 8 of Form W-2. They are not included in the amount in box 1. The taxpayer must report allocated tips on his or her tax return unless either of the following exceptions applies.

- 1) The taxpayer kept a daily tip record, or other evidence that is as credible and as reliable as a daily tip record, as required. (See Pub. 531, Reporting Tip Income).
- 2) The taxpayer's tip record is incomplete, but it shows that his or her actual tips were more than the tips reported to his or her employer plus the allocated tips.

If either exception applies, report actual tips on the return. Do not report the allocated tips.

If the taxpayer is required to report allocated tips on the return, the amount on Form W-2, box 8, should be added to the amount in box 1. The total is reported on line 7 of Form 1040. Allocated tips cannot be reported on Form 1040EZ or 1040A, and are subject to social security and Medicare taxes. Form 4137 should be used to compute and report the additional tax.

The taxpayer should keep a copy for his or her records and file a copy with the local Social Security Administration to ensure proper social security credit.

Example 2

Fred works as a repairman during the week and as a barber on alternate Saturdays. His tips are less than \$20 in any month and he does not report them to his employer. The amounts from box 1 on his Forms W-2 show income of \$23,500 (repairman) and \$1,950 (barber). His unreported tip income was \$200.

Fred will report \$25,650 on Form 1040A, line 7. This is the total of his Forms W-2, box 1 income and his unreported tip income (\$23,500 plus \$1,950 plus \$200).

If Fred reported his tip income to his employer, the tips would be included in box 1 of the Form W-2. The amount in box 1 of that Form W-2 would be \$2,150 (\$1,950 plus \$200). Fred would still enter \$25,650 on line 7 (\$23,500 plus \$2,150).

Scholarships and Fellowships

Some scholarships and fellowships may be partially taxable. If the taxpayer received a Form W-2 for the scholarship or fellowship, add the amount in box 1 to any other box 1 amounts. Enter the total on line 1, Form 1040EZ, or line 7, Form 1040A or 1040.

Scholarship or fellowship money used for tuition and fees to enroll at or attend an educational institution or fees, books, supplies and equipment required for courses at the educational institution is nontaxable. Amounts used for room and board do not qualify for the exclusion and therefore are taxable.

Even if the taxpayer did not receive a Form W-2 for the scholarship or fellowship, the taxable portion of the scholarship or fellowship must be reported. Add the taxable portion to other Form W-2, box 1 amounts and unreported tip income. Enter the total on line 7 (Form 1040 or 1040A) or line 1 (Form 1040EZ). Write "SCH" and the amount not reported on Form W-2 in the space to the left of line 7 or line 1, whichever applies.

Exercise 2

- A.** Mike worked two jobs. He was a quality inspector during the week and a bartender on the weekends. He reported all of his tip income (\$3,000) to his employer. His Forms W-2, box 1, showed income of \$21,000 (quality inspector) and \$8,250 (bartender). What amount will Mike report on his Form 1040A, line 7? _____
- B.** John works as a food server in an expensive restaurant. He tells you that he did not report his tip income of \$18,100 to his employer. Can John file Form 1040A? _____
- C.** Randy had several employers during the tax year. On February 3, 2006, he comes into the VITA site to have his return prepared. He tells you that he has not received the Form W-2 for XYZ Inc. What should you tell Randy? _____

INTEREST INCOME

Money earns interest when it:

- is deposited in accounts in banks, savings and loans, credit unions,
- is used to buy certificates of deposit or bonds, or
- is lent to another person or business.

Interest income is considered unearned income. Money, not a person, is working to earn the income.

TAXABLE INTEREST INCOME

Savings Accounts

Interest is reported in the year that it is credited to the taxpayer's account and is available for withdrawal by the taxpayer. The taxpayer should report all interest received during the year, even if the interest is not entered in the taxpayer's passbook.

POTENTIAL PITFALLS

Some savings and loans, credit unions, cooperative banks, and mutual savings banks call their distributions "dividends." These "dividends" are really interest and are reported as interest. True dividends are different and will be discussed later in this lesson.

U.S. Savings Bonds

Interest on U.S. savings bonds is earned in one of two ways.

- Some bonds are issued at a “discount” and the interest earned equals the increase in the bond’s value over a period of time.
- Some bonds pay interest at stated intervals of time.

Series EE and Series I Bonds. Series EE bonds are the most common type. They are issued at a discount; this means that the purchase price is less than the face value (the amount shown on the bond). The interest is the difference between the purchase price and the amount received when the bonds are redeemed (cashed in).

Series I bonds were first offered in 1998. They are issued at face value with a maturity period of 30 years. Interest on these bonds is paid when the bond is redeemed.

Taxpayers can choose one of two ways to report interest income from these bonds.

- Report the increase in value when the bond is cashed in or when the bond matures, whichever is earlier.
- Report the increase in the bond’s value each year.

Generally, taxpayers must use the same method for all Series EE and Series I bonds they own.

If a U.S. savings bond is issued in the names of co-owners, such as the taxpayer and child, or the taxpayer and spouse, interest on the bond is generally taxable to the co-owner who purchased the bond. To determine who is responsible for paying the tax on a bond see the table below.

Exhibit 3

Who Pays Tax on U.S. Savings Bond Interest	
IF...	THEN tax on the bond interest must be paid by...
You use your funds to buy a bond in your name and the name of another person as co-owners.	You.
You buy a bond in the name of another person, who is the sole owner of the bond.	The person for whom you bought the bond.
You and another person buy a bond as co-owners, each contributing part of the purchase price.	Both you and the other co-owner, in proportion to the amount each paid for the bond.
You and your spouse, who live in a community property state, buy a bond that is community property.	You and your spouse. If you file separate returns, both you and your spouse generally pay tax on one-half.

Example 3

Barbara owns a \$500 U.S. Series EE savings bond. She paid \$250 for the bond. When the bond matures, Barbara will receive \$500. At the end of the first year, the bond was worth \$265.

Barbara can report interest income in one of two ways.

- She can report \$250 of interest income when the bond matures. This is the difference between the \$500 value at maturity and the \$250 she paid for the bond. Barbara would report interest income only once, at maturity.
- She can 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). Barbara would report interest income each year until maturity.

Excludable Interest on U.S. Savings Bonds. Taxpayers may be able to exclude from income all or part of the interest received from certain qualified U.S. savings bonds. The taxpayer must have paid for qualified higher education expenses the same year the bonds are cashed. The bonds must be either Series EE bonds issued after 1989 or Series I bonds in the taxpayer's name or, if married, the taxpayer's name or spouse's name. The individual in whose name the bonds were issued must be 24 years of age or older before the bonds were issued. The taxpayer cannot file married filing separately.

Qualified higher education expenses include tuition and fees paid to an eligible educational institution for the bond owner, the bond owner's spouse, or the bond owner's dependent for whom the bond owner claims an exemption. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education.

Qualified expenses include any **contribution** to a qualified state tuition program or to a Coverdell ESA. (For more information, see Publication 970, *Tax Benefits for Higher Education*).

Use Form 8815, *Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989 (For Filers with Qualified Higher Education Expenses)*, to report the exclusion of interest income. The excludable amount is transferred from Form 8815 to Part I, line 3 of Schedule 1 (Form 1040A) or to Schedule B (Form 1040).

Series HH Bonds. The interest on these bonds is paid twice a year. Report the interest on these bonds in the year in which it is received.

Other U.S. Obligations. Interest on other U.S. obligations, such as U.S. Treasury notes and bonds, is fully taxable when received.

Savings Certificates, Money Market Certificates, and Other Deferred Interest Accounts

Interest that is paid at fixed intervals of one year or less is included in taxable income when it is received or when the taxpayer could receive it (that is, when it is credited to the account, even if it is not withdrawn) without paying a substantial penalty. If an account matures in one year or less and provides a single interest payment at maturity, include the interest in taxable income when the account matures and the interest is received.

Example 4

Duane has a six-month certificate of deposit (CD) that matures in January 2006. He will receive \$75 in interest income.

Duane will report the interest income on the certificate of deposit on his 2006 tax return. It matures in one year or less with a single interest payment at maturity.

Certificates of Deposit with Maturities of Over One Year

If interest on a CD is deferred for more than one year, the taxpayer must include a part of the interest in income each year. The taxpayer should receive Form 1099-INT stating the amount to report.

Example 5

Deborah has a two-year CD that pays interest every three months. She bought the CD on March 1, 2005. It matures on February 29, 2007.

For 2005, Deborah reports the interest income earned from March through December. For 2006, she will report 12 months of interest. For 2007, she will report two months of interest.

Original Issue Discount. Long-term obligations that pay no interest before maturity are considered to be issued at a discount. **Original Issue Discount (OID)** is the amount by which the principal amount (redemption price at maturity) of a long-term debt instrument, such as a bond or note, exceeds its issue price. Taxpayers generally report a portion of the OID each year until the obligation matures.

Example 6

Roger purchased a \$1,000 U.S. Treasury Zero Coupon Bond for \$350. When the bond matures, Roger will receive \$1,000. He will receive no interest income until the bond matures many years later.

The difference between the redemption amount (\$1,000) and the issue price (\$350) is the OID (\$650). Each year until maturity, Roger must recognize part of the OID as taxable interest income.

Interest on Insurance Proceeds

Life insurance proceeds may include interest. Taxpayers can receive life insurance policy benefits paid upon the death of the insured either in a lump sum or in installments. Generally, if the payments are received in installments, the portion that is interest must be included in the taxpayer's income. However, if the insured individual died before October 23, 1986, and was the taxpayer's spouse, the first \$1,000 of interest income received each year is not taxed if the payments are received in installments. This exclusion does not apply if proceeds are left on deposit with the insurance company and only interest is paid.

Life insurance dividends generally are not taxable. These dividends may be used to reduce life insurance premiums due, purchase additional paid-up insurance, or earn interest. In general, the interest earned on life insurance dividends is taxable when it is credited to the taxpayer's account.

Interest on insurance dividends that have been left on deposit with the Department of Veterans Affairs (VA) is **not** taxable. Do not include this interest in taxable income.

COVERDELL ESA

Contributions to a Coverdell ESA are not deductible. Amounts in the ESA grow (tax deferred) until they are distributed. Generally, if the beneficiary has qualified education expenses that are greater than the distribution during the year, then no tax is due.

If the taxpayer received Form 1099-Q, showing a distribution from a Coverdell ESA, ask the taxpayer if the funds were used for qualified education expenses. Coverdell ESA qualified education expenses include elementary, secondary, and postsecondary (higher) education expenses.

If the entire amount of the distribution was spent on qualified elementary and secondary expenses, the distribution is tax-free. Tax-free distributions are not reported. If the taxpayer paid for qualified higher (postsecondary) education expenses, the taxpayer may be eligible for the Hope Credit or Lifetime Learning Credit, which may be more beneficial.

Refer the taxpayer/beneficiary to a paid professional tax preparer and/or Publication 970, *Tax Benefits for Higher Education*, if:

- The funds were not used for qualified education expenses.
- The distribution is more than the amount spent for qualified expenses.

- Part or all of the distribution is taxable and earnings must be computed.
- The taxpayer/beneficiary received other education benefits such as a distribution from a Qualified Tuition Program, employer provided educational assistance, or a scholarship, or used U.S. Savings Bonds to pay for qualified education expenses.
- If any amount needs to be reported, report it on Form 1040, line 21. Additional tax may be due. Use Part II of Form 5329, *Additional Taxes on Qualified Plans (including IRAs) and Other Tax Favored Accounts*, to figure any additional tax.

TAX-EXEMPT INTEREST

Certain types of interest are exempt from federal income tax. Bonds issued by the following entities generally pay **tax-exempt interest**:

- State and political subdivisions (county or city),
- District of Columbia, and
- U.S. possessions and political subdivisions.

Examples of tax-exempt bonds are those issued by:

- Port authorities
- Toll-road commissions
- Utility service authorities
- Community redevelopment agencies
- Qualified volunteer fire departments
- Amounts indicated on broker statements as tax-exempt interest or dividends

Although tax-exempt interest is not taxable, the taxpayer must report all tax-exempt interest on Form 1040, 1040A or 1040EZ.

Form 1099-INT

Interest income is reported to the taxpayer on Form 1099-INT, *Interest Income*, shown in Exhibit 4. A copy of Form 1099-INT is also sent to the IRS.

Box 1 shows taxable interest income from various institutions.

Some taxpayers withdraw funds from a time deposit before the maturity date of the account and, therefore, incur an interest penalty. The early withdrawal penalty is reported on Form 1099-INT in box 2. Report the total interest earned, shown in box 1 of Form 1099-INT, on line 8a of Form 1040. Do not subtract the penalty from the total interest. The early withdrawal penalty is an adjustment to income and is entered on line 30 of Form 1040.

Box 3 shows U.S. savings bond and Treasury obligations interest. Be sure to ask the taxpayer about this interest income. The amount shown on Form 1099-INT may be too high if the taxpayer was not the original owner of the bond or if the taxpayer has reported the interest income each year as it was earned.

Some Forms 1099-INT will have entries in box 4 indicating that federal income tax has been withheld from the interest paid. Be sure to include the amount shown in box 4 with other tax withheld on Form 1040EZ, line 7, Form 1040A, line 39, or Form 1040, line 64.

Exhibit 4

Form 1099-INT

<input type="checkbox"/> CORRECTED (if checked)		2005		Interest Income
PAYER'S name, street address, city, state, ZIP code, and telephone no. Sterling Bank 125 Tyler Drive Your City State Zip Code		Payer's RTN (optional)	OMB No. 1545-0112 Form 1099-INT	
PAYER'S Federal identification number XX-XXXXXXX	RECIPIENT'S identification number XXX-XX-XXXX	1 Interest income not included in box 3 \$ 100		Copy B For Recipient This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
RECIPIENT'S name Madison Morris Street address (including apt. no.) 465 Wells Street City, state, and ZIP code Your City State Zip Code		2 Early withdrawal penalty \$	3 Interest on U.S. Savings Bonds and Treas. obligations \$ 50	
		4 Federal income tax withheld \$	5 Investment expenses \$	
Account number (see instructions)		6 Foreign tax paid \$	7 Foreign country or U.S. possession	
Form 1099-INT		(keep for your records)		Department of the Treasury - Internal Revenue Service

Form 1099-OID

Form 1099-OID, *Original Issue Discount*, reports the amount of Original Issue Discount income that a taxpayer should report as income for the year. A copy of Form 1099-OID is also sent to the IRS.

Box 1 shows the amount of interest (OID) for the year if the taxpayer bought the obligation at its original issue and held the issue all year.

Box 2 shows regular interest paid on the obligation other than the OID income.

Generally, if a 1099OID was received, you report the entire amount in boxes 1 and 2 of the 1099OID as interest income. If the taxpayer needs to report the OID in an amount less than the amount shown on the 1099OID, referral should be made to a professional paid preparer.

Reporting Interest Income

If the taxpayer is a **1040EZ** filer, taxable interest income is reported on line 2. 1040EZ filers should report tax-exempt interest by writing “TEI” and the amount of tax-exempt interest on line 2 as shown in the example below. Do not include tax-exempt interest in the *Dollars/Cents* portion of line 2. If the taxpayer’s interest income is more than \$1500, he or she cannot file a Form 1040EZ.

Example 7

Jennifer received taxable interest income of \$65 and tax-exempt interest income of \$23. She would report her interest income on Form 1040EZ as shown in the exhibit below.

Exhibit 5

Jennifer’s 1040EZ

Income	1	Wages, salaries, and tips. This should be shown in box 1 of your Form(s) W-2. Attach your Form(s) W-2.	1		
	2	Taxable interest. If the total is over \$1,500, you cannot use Form 1040EZ. TEI=\$23.00	2	65	00
	3	Unemployment compensation and Alaska Permanent Fund dividends (see page 13).	3		
Attach Form(s) W-2 here. Enclose, but do not attach, any payment.	4	Add lines 1, 2, and 3. This is your adjusted gross income .	4		
	5	Can your parents (or someone else) claim you on their return? Yes. Enter amount from worksheet on back. <input type="checkbox"/> No. If single , enter \$8,200. If married filing jointly , enter \$16,400. See back for explanation. <input type="checkbox"/>	5		
Note. You must check Yes or No. }	6	Subtract line 5 from line 4. If line 5 is larger than line 4, enter -0-. This is your taxable income .	6		

Taxpayers who file **Forms 1040A or 1040**, report taxable interest income on line 8a and tax-exempt interest on line 8b.

If the taxpayer files Forms 1040A or 1040 and:

- Has interest income of more than \$1500,
- Wants to claim an exclusion for savings bond interest in the same year that he or she paid for qualified higher education expenses, or
- Receives a Form 1099-INT for tax-exempt interest,

Schedule 1, Part I (1040A) or Schedule B, Part I (1040) must be completed, before making an entry on line 8a or 8b.

If the tax-exempt interest is shown on a Form 1099-INT, and a Schedule 1 or B must be filed, the taxpayer must include tax-exempt interest on Schedule 1 or B. It should be reported on line 1 but it should not be included in the total on line 2. Instead, under the last entry on line 1, a subtotal of all interest listed should be made. Below the subtotal, the taxpayer should write “Tax-exempt interest” and show the amount. Subtract it from the subtotal and the result should be entered on line 2.

On Schedule 1 or Schedule B, Part I, list the interest payers’ names and the various amounts received for each form, even if there are two or more forms from the same source.

Exercise 3

- A. Randy and Ann have three Forms 1099-INT: Epping National Bank, \$62; Epping Credit Union, \$178; and Brenton Savings and Loan, \$760.
1. How much interest income will be reported on Schedule 1 (Form 1040A)? _____
 2. How much interest income will be reported on Form 1040A, line 8a? _____
- B. Catherine received \$398 interest income this year. She files Form 1040EZ. How much interest income is reported on her return, and where is it reported? _____
- C. Emily and Andrew file a joint return on Form 1040. They have the following interest income: City Savings and Loan (joint), \$320; Third National Bank (Andrew), \$100; U.S. Series HH Savings Bonds (joint), \$45; and Welder's Credit Union (Emily), \$30. _____
- How much interest is reported on their Form 1040, and where is it reported? _____

DIVIDEND INCOME AND OTHER CORPORATE DISTRIBUTIONS

Dividends are payments made by corporations to shareholders. Dividends can also be paid through partnerships, estates, or trusts.

There are several types of corporate distributions, including ordinary and qualified dividends, capital gain distributions, nontaxable distributions, stock dividends, and others. Ordinary dividends are paid out of the earnings and profits of a corporation and are ordinary income to you. Qualified dividends are the ordinary dividends received in tax years beginning after 2002 that are subject to the same 5% or 15% maximum tax rate that applies to net capital gain. Most dividends are paid in cash. Some dividends, however, are paid in property, services, or additional shares of stock. Only **ordinary and qualified dividends** can be reported on Form 1040A. Any other dividends or distributions received are reported on Form 1040. Taxpayers with dividend income may not use Form 1040EZ. Other types of dividends and distributions include the following:

- Dividend reinvestment — Through **dividend reinvestment**, instead of receiving cash (a dividend check), some stockholders ask the corporation to use their dividends to purchase more shares of the corporation's stock. The shareholders "reinvest" their dividends. The dividend is taxable at the time it would be paid if it were in cash.
- Mutual funds (regulated investment companies) and real estate investment trusts (REITs) pass capital gains to their investors in the form of capital gain distributions. These distributions

ALERT

Taxpayers who enter into Dividend Reinvestment Programs need to maintain a total of the value of all shares of stock purchased with reinvested dividends as an increase to their basis in the related share of stock. This will avoid their paying a capital gain tax when the shares of stock purchased with after tax dividends are sold.

should not be confused with capital gains or losses that occur when an owner of a mutual fund or other capital asset sells shares in a fund or other capital asset. For more information on capital gains and losses, see Lesson 12, Sale of Stock.

- Nondividend distributions can be made in the form of a return of capital or a tax-free distribution of additional shares of stock or stock rights. A return of capital is a return of some or all of an investment in the stock of a company. A return of capital reduces the basis of the stock and is not taxed until the basis in the stock is fully recovered. Once the basis of the stock has been reduced to zero any further return of capital is a capital gain. A tax-free distribution of additional share of stock or stock rights does not affect the basis in the stock, but will be taxed as a capital gain when the shares issued are sold.
- Stock dividends — **Stock dividends** increase the taxpayer's number of shares in the company. Generally, stock dividends are not taxable.

Other types of nontaxable dividends are:

- Exempt-interest dividends paid by mutual funds (This interest is listed on Form 1040, line 8b.)
- Dividends on insurance policies, as long as they do not exceed the total of all net premiums paid by the taxpayer
- Dividends on veterans' insurance
- Certain patronage dividends

Reporting Dividends and Capital Gain Distributions

The payer reports dividends and certain other distributions on **Form 1099-DIV, Dividends and Distributions**.

Ordinary dividends are reported in box 1a of Form 1099-DIV. Add the amounts in box 1a from all the Forms 1099-DIV the taxpayer received. If the total is:

- \$1500 or less, enter the total on line 9a of Form 1040A or 1040.
- over \$1500, complete Schedule 1 (Form 1040A), Part II, or Schedule B (Form 1040), Part II. Transfer the result to line 9a of Form 1040A or 1040.

On Schedule 1 or Schedule B enter the payer's name and the amount received for each Form 1099-DIV even if the same corporation used separate forms to report more than one distribution. If the taxpayer has a substitute Form 1099-DIV from a brokerage firm, it may show a total for dividends received. Enter the brokerage firm as the payer of the dividends and enter the total dividend amount. Do not list the dividends individually.

Some taxpayers receive dividend income from shares that the husband and wife own jointly. If they file a joint return, enter the total dividend in the appropriate place on the return. If they file separate tax returns, divide the dividend by two. Report half on the husband's return and half on the wife's return.

Qualified dividends. Report qualified dividends (box 1b of Form 1099-DIV) 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 that there is an obligation to make related payments for positions in substantially similar or related property.
- Payments in lieu of dividends, but only if it is known or reasonable to have known that the payments are not qualified dividends.

See chapter 1 of *Publication 550* for further details.

If qualified dividends are reported, tax must be figured by completing the Qualified Dividends and Capital Gain Tax Worksheet in the Form 1040 or 1040A instructions.

Capital gain distributions reported in Box 2a, form 1099-DIV are treated as long-term capital gains regardless of how long the taxpayer holds the shares. If, in addition to a capital gain distribution, the taxpayer has a capital gain or loss resulting from the disposition of a capital asset recorded on Schedule D, the capital gain distribution is entered on line 13 of Schedule D. If a Schedule D is not required, the capital gain distribution is entered directly on line 13 of Form 1040 with a check in the box next to line 13 or line 10 of Form 1040A. If a capital gain distribution is recorded, tax must be computed by completing the Qualified Dividends and Capital Gain Tax Worksheet unless there is a loss recorded at line 21 of Schedule D and there are not qualified dividends,

Capital gain distributions occur when a mutual fund (regulated investment company) sells assets for more than their cost, and the realized capital gain is distributed to the fund's shareholders. This should not be confused with a capital gain that occurs when the owner of a mutual fund or a capital asset sells shares in the fund or the asset for more than the cost and realizes a capital gain. For more information on capital gains and losses, see Lesson 12, *Sale of Stock*.

Payers report capital gain distributions in box 2a of Form 1099-DIV, see Exhibit 6. Taxpayers can report capital gain distributions directly on Form 1040A or Form 1040 if:

- The only amounts the taxpayer has to report on Schedule D are capital gain distributions (box 2a),
- The taxpayer does not have any unrecaptured section 1250 gain (box 2b), section 1202 gain (box 2c), or 28% collectibles (box 2d).

CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. Fairfield Investment Co. 34 Irvine Drive Your City, State Zip Code		1a Total ordinary dividends \$ 200	OMB No. 1545-0110 2005	Dividends and Distributions
		1b Qualified dividends \$ 200	Form 1099-DIV	
PAYER'S Federal identification number XX-XXXXXXX		RECIPIENT'S identification number XXX-XX-XXXX	2a Total capital gain distr. \$	2b Unrecap. Sec. 1250 gain \$
RECIPIENT'S name Jordan Knox		2c Section 1202 gain \$	2d Collectibles (28%) gain \$	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.) 255 Chapman Street City, state, and ZIP code Your City, State Zip Code		3 Nondividend distributions \$	4 Federal income tax withheld \$	
Account number (see instructions)		6 Foreign tax paid \$	5 Investment expenses \$	
		8 Cash liquidation distributions \$	7 Foreign country or U.S. possession	
			9 Noncash liquidation distributions \$	

**Copy B
For Recipient**

Form 1099-DIV

(keep for your records)

Department of the Treasury - Internal Revenue Service

If the taxpayer does not meet the requirements to report the capital gain distribution directly on Form 1040A or Form 1040, a Schedule D, *Capital Gains and Losses* must be filed. If a Schedule D is not required, the capital gain distributions can be reported directly on line 13 of Form 1040, or line 10 of Form 1040A. Capital gain distributions are not reported on Form 1040EZ.

If capital gain distributions are reported directly on Form 1040 or Form 1040A:

- Use the Qualified Dividend and Capital Gain Tax Worksheet from either the Form 1040A or 1040 instruction booklet to compute tax.

The volunteer should be careful not to ignore other boxes on the Form 1099-DIV.

- Box 4, *Federal income tax withheld*. Be sure to include this amount on line 39 of Form 1040A or line 64 of Form 1040.

- **Box 5, *Investment expenses*.** If the taxpayer files Form 1040 and itemizes deductions on Schedule A, report the amount from box 5 as a miscellaneous itemized deduction subject to the 2%-of-adjusted-gross-income limit. (See *Itemized Deductions* in Lesson 4.)
- **Box 6, *Foreign tax paid*.** If the taxpayer has an entry in box 6, see Lesson 6 for the proper treatment of the tax. The taxpayer may be able to claim the Foreign Tax Credit.

A capital gain distribution is reported on a Schedule D when the taxpayer has more than capital gain distributions to report. Taxpayers should be referred to a paid preparer if there are entries on Form 1099-DIV boxes 2b, 2c, 2d, 8, or 9. Capital gain distributions are always treated as long-term capital gains, regardless of how long the taxpayer holds the shares, and are reported on line 13, column (f) of the Schedule D.

GAMBLING WINNINGS

Taxpayers must include gambling winnings as income on Form 1040, line 21. If the taxpayer itemizes their deductions on Schedule A (Form 1040), they can deduct gambling losses they had during the year, but only up to the amount of their winnings.

Taxpayers must keep an accurate diary or similar record of their losses and winnings. The diary should contain at least the following information:

1. The date and type of specific wager or wagering activity.
2. The name and address or location of the gambling establishment.
3. The names of other persons present with you at the gambling establishment.
4. The amount(s) you won or lost.

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

Form W-2G. Taxpayers may receive a Form W-2G, Certain Gambling Winnings, showing the amount of their 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 1 on Form 1040, line 64, as federal income tax withheld.

UNEMPLOYMENT COMPENSATION

Unemployment compensation includes benefits to unemployed individuals that a state or the District of Columbia paid from the Federal Unemployment Trust Fund. It is reported to the recipient on Form 1099-G, *Certain Government Payments*. All unemployment compensation is taxable. Transfer the amount in (See Exhibit 7) box 1 of Form 1099-G to line 3 of Form 1040EZ, line 13 of Form 1040A, or line 19 of Form 1040.

POTENTIAL PITFALLS



If the state or local income tax refund reflects any deductions, credits, or payments for years other than 2004, refer the taxpayer to a paid professional tax preparer.

Supplemental benefits provided from an employer's fund to which the employee did not contribute are sometimes thought of as unemployment benefits also. They are reported to the employee on Form W-2. Include them on line 7 of Form 1040A or 1040, or on line 1 of Form 1040EZ.



Stop here for the basic course.
Go to Lesson 4, page 4-1.

All others continue.

STATE AND LOCAL TAX REFUNDS

Taxpayers who receive a refund of state or local taxes may receive a Form 1099-G, *Certain Government Payments*, see Exhibit 7. If the taxpayer claimed the standard deduction on the 2004 return and received a refund of 2004 state or local tax, the taxpayer does not have to include the refund in taxable income for tax year 2005. However, if the taxpayer itemized deductions **and** received a state or local tax refund, the taxpayer may have to include part or all of the refund in taxable income in 2005. Use the *State and Local Income Tax Refund Worksheet—Line 10* in the Form 1040 instruction booklet to determine what part, if any, of the refund is taxable. Enter the taxable portion of state and local refunds on Form 1040, line 10.

Exhibit 7

Form 1099-G

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1 Unemployment compensation		OMB No. 1545-0120	
Georgia Department of Revenue 76 Butler Street Atlanta, GA 30345		\$ 4,000.00		2006 Form 1099-G	
		2 State or local income tax refunds, credits, or offsets			
PAYER'S Federal identification number XX-XXXXXXX		RECIPIENT'S identification number XXX-XX-XXXX		3 Box 2 amount is for tax year	
RECIPIENT'S name Clark Fisk		5 ATAA payments		4 Federal income tax withheld \$ 400.00	
Street address (including apt. no.) 87 Bluefield Avenue City, state, and ZIP code New York, NY 10001		7 Agriculture payments		6 Taxable grants	
Account number (see instructions)		8 Box 2 is trade or business income <input type="checkbox"/>		Copy B For Recipient This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.	
Form 1099-G		(keep for your records)				Department of the Treasury - Internal Revenue Service

ALIMONY RECEIVED

Alimony or separate maintenance payments made under a court decree are taxable income to the person receiving them. They are reported on Form 1040, line 11. The person making the payments deducts them on Form 1040, line 31a, as an adjustment to gross income.

Child support payments are not alimony. The person making the payments cannot deduct them. The person receiving child support payments does not have to include them in income.

- When an entry is made for Alimony paid, TaxWise requires the Social Security Number of the spouse receiving the alimony.
- Form 4852, Substitute for Form W-2, Wage and Tax Statement or Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRA's, Insurance Contracts, etc. is available and can be completed in TaxWise.

EARLY DISTRIBUTIONS FROM QUALIFIED RETIREMENT PLANS

Part of pension and annuities income may be taxable. To discourage the use of pension funds for purposes other than normal retirement, the law imposes additional taxes on early distributions of the taxable part of those funds.

An early distribution from qualified retirement plans and nonqualified annuity contracts is a distribution made before the taxpayer reaches age 59 ½. These distributions may be subject to an additional tax of 10%. This tax applies to the part of the distribution that you must include in gross income. It does not apply to any part of a distribution that is tax free, such as amounts that represent a return of the taxpayer's cost or that were rolled over to another retirement plan.

For this purpose, a qualified retirement plan is:

- A qualified plan (including a qualified cash or deferred arrangement (CODA) under Internal Revenue Code section 401(k),
- A qualified employee annuity plan,
- A tax-sheltered annuity plan (403(b) plan), or
- An eligible state or local government section 457 deferred compensation plan (to the extent that any distribution is attributable to amounts the plan received in a direct transfer or rollover from one of the other plans listed here).

If a taxpayer must pay this tax, report it on Form 5329. However, the taxpayer does not have to file Form 5329 if they owe only the tax on early distributions and their Form 1099-R correctly shows a "1" in box 7. Instead, enter 10% of the taxable part of the distribution on Form 1040, line 60 and write "No" under the heading "Other Taxes" to the left of line 60.

Exceptions to tax. Certain early distributions are excepted from the early distribution tax. If the payer knows that an exception applies to the early distribution, distribution code “2,” “3,” or “4” should be shown in box 7 of the Form 1099-R and the taxpayer does not have to report the distribution on Form 5329. If an exception applies but distribution code “1” (early distribution, no known exception) is shown in box 7, the taxpayer must file form 5329. Enter the taxable amount of the distribution shown in box 2a of the Form 1099-R on line 1 of Form 5329. On line 2, enter the amount that can be excluded and the exception number shown in the Form 5329 instructions.

ALERT



If distribution code “1” is incorrectly shown on Form 1099-R for a distribution received when a taxpayer was 59 1/2 or older, include that distribution on Form 5329. Enter exception “11” on line 2.

General exceptions. The tax does not apply to distributions that are:

- Made as part of a series of substantially equal periodic payments (made at least annually) for the taxpayer’s life or the joint lives of the taxpayer and the taxpayer’s designated beneficiary.
- Made because the taxpayer is totally and permanently disabled or
- Made on or after the death of the plan participant or contract holder.

See Publication 575 for additional exceptions.

INCOME FROM BUSINESS

Business income or loss is reported first on Schedule C (Form 1040), *Profit or Loss From Business*, or Schedule C-EZ, *Net Profit From Business*, and then transferred to Form 1040, line 12. Taxpayers who must file a Schedule C should see a paid professional tax preparer.

Generally, if a taxpayer receives a 1099MISC with an amount of \$400 or more in Box 7, Nonemployee Compensation, it should be reported as self-employment income. Exceptions are reported on line 21 and include: medical subject, Americorps, hobby not done for profit (put expenses under other expenses on Sch A, ln 22), one-time estate administrator, Board of Directors (if only one Board); and newspaper carrier whose income goes on line 7 (if limited prep/no billing): do Form 4137 (“wages” for “tip income”) for 1040/ln 53 and Form 2106 for Sch A expenses.

VITA and TCE volunteers who have received training on this topic, at the discretion of the site coordinator, may assist self-employed individuals who qualify to use Schedule C-EZ, shown in Exhibit 8.

Who Can Use Schedule C-EZ

A taxpayer can use Schedule C-EZ only if he or she:

- Had business expenses of \$5,000 or less,
- Uses the cash method of accounting,
- Did not have an inventory at any time during the year,
- Did not have a net loss from his or her business,
- Had only one business as a sole proprietor, or is a statutory employee,
- Had no employees during the year,
- Is not required to file Form 4562, *Depreciation and Amortization*, for this business (See the instructions for Schedule C, line 13, to find out if the taxpayer must file.),
- Does not deduct expenses for business use of his or her home, and
- Does not have prior year unallowed passive activity losses from this business.

POTENTIAL PITFALLS

Many taxpayers erroneously report amounts from Form 1099-MISC, *Miscellaneous Income*, with wages or other income. This income should instead be reported on Schedule C or C-EZ and on Schedule SE, *Self-Employment Tax*. If the income is reported incorrectly, IRS may later issue a notice of proposed tax increase for the self-employment income and tax.

Completing Schedule C-EZ

Schedule C-EZ has three parts:

Part I: General Information

Part II: Figure Your Net Profit

Part III: Information on Your Vehicle

Part I: General Information

Part I is used to determine whether or not the taxpayer is eligible to use this form instead of Schedule C for reporting self-employment income. If all the criteria are met, the taxpayer then completes Part I.

Line B, Principal Business Code, is determined by looking at the code list in the *Instructions for Schedule C, Profit or Loss From Business*.

Line D, Employer ID Number, is a number that the Internal Revenue Service supplies to businesses and other professional activities. If the taxpayer does not have one, the space should be left blank. The taxpayer cannot use the taxpayer's social security number.

Part II: Figure Your Net Profit

Gross receipts are all receipts from a trade or business including income reported on a Form 1099-MISC, *Miscellaneous Income*, Box 7, Nonemployee Compensation. All items of taxable income actually or constructively received during the year are included. Gross receipts are entered on line 1.

If the Taxpayer is a statutory employee, check the box next to line 1 of Schedule C-EZ and report the amount shown in box 1 of the taxpayer's Form W-2 in box 1 of Schedule C-EZ. Examples of statutory employees include full-time life insurance salespeople, certain agent or commission drivers, traveling salespeople, and certain homemakers. The Statutory Employee checkbox in Box 13 of the taxpayer's Form W-2 should be checked.

ALERT



The 2005 rate for business use of your vehicle is 40.5 cents a mile.

Total expenses include the total amount of all deductible business expenses actually paid during the year. Examples of these expenses include advertising, car and truck expenses, commissions, insurance, interest, legal and professional services and fees, office expense, rent or lease expense, repairs and maintenance, supplies, taxes, travel, 50% of business meals and entertainment, and utilities (including telephone). Total expenses of \$5,000 or less are entered on line 2.

If the taxpayer uses his or her car or truck for business purposes, he or she can deduct expenses related to using the car or truck. To determine the amount of car and truck expenses that can be deducted, the taxpayer must use either the:

- Standard Mileage Rate, or
- Actual Car Expenses.

Standard Mileage Rate. If the taxpayer can and does choose to use the standard mileage rate, business miles are multiplied by the applicable mileage rate and added to the deductible parking and tolls. Car expenses using the standard mileage rate are computed as follows:

$$\begin{aligned} & \text{Business miles incurred during the year} \times \mathbf{40.5\text{¢}} \text{ per mile} \\ + & \text{ Parking and tolls incurred while on business } \begin{array}{l} (40.5\text{¢ per mile from} \\ 01/01/2005 \text{ to} \\ 08/31/2005 \text{ and } \mathbf{48.5\text{¢}} \\ \text{per mile from} \\ 09/01/2005 \end{array} \end{aligned}$$

Actual Car Expenses. If the taxpayer chooses to use the actual car expenses, only the business portion of the expenses is deductible. Deductible expenses under the actual method are computed as follows:

1. Compute the percentage of business use:

$$\frac{\text{Business miles}}{\text{Total miles}} = \% \text{ of business use}$$

2. Determine the deductible expenses:

$$\begin{aligned} & (\% \text{ of business use} \times \text{total actual expenses}) \\ + & \text{ Parking and tolls incurred while on business } \end{aligned}$$

NOTE: If taxpayers depreciate their car or truck, or their total expenses are more than \$5,000, they cannot use Schedule C-EZ and should be referred to a paid professional tax preparer.

Subtract line 2 from line 1 and enter the net amount on line 3 to determine the net profit or loss.

If line 3 shows a profit, transfer this amount to Form 1040, line 12, and to Schedule SE, line 2 (except statutory employees). Attach Schedule C-EZ to Form 1040 in the correct sequence.

If line 3 is zero, show zero amount on Form 1040, line 12.

If line 3 shows a loss, the taxpayer cannot use Schedule C-EZ and should be referred to a paid professional tax preparer.

Part III: Information on Your Vehicle

Part III should be completed if the taxpayer is claiming car and truck expenses in Part II.

**SCHEDULE C-EZ
(Form 1040)**

Net Profit From Business
(Sole Proprietorship)

OMB No. 1545-0074

2005

Attachment
Sequence No. **09A**

Department of the Treasury
Internal Revenue Service

▶ **Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.**
▶ **Attach to Form 1040 or 1041.** ▶ **See instructions on back.**

Name of proprietor
Coe Curry

Social security number (SSN)
XXX XX XXXX

Part I General Information

**You May Use
Schedule C-EZ
Instead of
Schedule C
Only If You:**

- Had business expenses of \$5,000 or less.
- Use the cash method of accounting.
- Did not have an inventory at any time during the year.
- Did not have a net loss from your business.
- Had only one business as either a sole proprietor or statutory employee.

And You:

- Had no employees during the year.
- Are not required to file **Form 4562**, Depreciation and Amortization, for this business. See the instructions for Schedule C, line 13, on page C-4 to find out if you must file.
- Do not deduct expenses for business use of your home.
- Do not have prior year unallowed passive activity losses from this business.

A Principal business or profession, including product or service
Hair Salon

B Enter code from pages C-7, 8, & 9
▶ 1 1 2 1 1 1

C Business name. If no separate business name, leave blank.
Coe Curry

D Employer ID number (EIN), if any
X X X X X X X X

E Business address (including suite or room no.). Address not required if same as on Form 1040, page 1.
2525 Clemson Lane
City, town or post office, state, and ZIP code
Your City, State and Zip Code

Part II Figure Your Net Profit

1 Gross receipts. Caution. If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see Statutory Employees in the instructions for Schedule C, line 1, on page C-3 and check here <input type="checkbox"/>	1	25,000	0
2 Total expenses (see instructions). If more than \$5,000, you must use Schedule C.	2	1,400	0
3 Net profit. Subtract line 2 from line 1. If less than zero, you must use Schedule C. Enter on Form 1040, line 12 , and also on Schedule SE, line 2 . (Statutory employees do not report this amount on Schedule SE, line 2. Estates and trusts, enter on Form 1041, line 3.)	3	23,600	0

Part III Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 2.

- 4** When did you place your vehicle in service for business purposes? (month, day, year) ▶ 01 / 01 / 2005.
- 5** Of the total number of miles you drove your vehicle during 2005, enter the number of miles you used your vehicle for:
a Business 10,000 **b** Commuting (see instructions) 15,000 **c** Other _____
- 6** Do you (or your spouse) have another vehicle available for personal use? **Yes** **No**
- 7** Was your vehicle available for personal use during off-duty hours? **Yes** **No**
- 8a** Do you have evidence to support your deduction? **Yes** **No**
- b** If "Yes," is the evidence written? **Yes** **No**

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 14374D


Schedule C-EZ (Form 1040) 2005

Self-Employment Tax

Self-employment tax is a social security tax for persons who work for themselves. It is similar to the social security tax and Medicare tax withheld from employees' wages.

Special exemptions from self-employment tax may apply to members of the clergy, members of certain religious sects, and certain nonclergy church employees.

The tax is computed on Schedule SE and transferred to the Form 1040 to be added to other taxes owed. The Schedule SE is attached to the Form 1040.

ALERT 
Statutory employees have social security and medicare tax withheld and do not owe self-employment tax. See Schedule C instructions for details.

Who Must File Schedule SE

A taxpayer must file Schedule SE if he or she has:

- Net earnings from self-employment of \$400 or more, other than church employee income (line 4 of Short Schedule SE),

OR

- Church employee income of \$108.28 or more (line 5a of Long Schedule SE).

Exception: If the only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner AND the taxpayer has filed Form 4361, Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners, and has received IRS approval not to be taxed on these earnings, he or she does not have to file Schedule SE. Instead, write "Exempt—Form 4361" on Form 1040, line 57.

Most taxpayers will need to complete only Section A of Schedule SE, also known as the Short Schedule SE. Follow the chart on the form to determine whether the taxpayer qualifies to file the short form. Anyone who does not qualify and who must file the long form should be referred to a paid professional tax preparer.

If the taxpayer qualifies for the short form, enter the net profit from Schedule C-EZ, line 3, on lines 2 and 3 of the Schedule SE.

Follow the instructions on the form to determine net earnings from self-employment on line 4 and the self-employment tax on line 5.

Enter the amount from line 5 on Form 1040, line 58.

Deduction of Self-Employment Tax

Self-employed people may claim an adjustment to income of one-half of the social security and Medicare taxes they pay.

Enter the amount from Schedule SE, line 6, on Form 1040, line 27 as an adjustment to income.

SCHEDULE SE (Form 1040) <small>Department of the Treasury Internal Revenue Service</small>	Self-Employment Tax ▶ Attach to Form 1040. ▶ See Instructions for Schedule SE (Form 1040).	OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold;">2005</div> Attachment Sequence No. 17
Name of person with self-employment income (as shown on Form 1040) Coe Curry		Social security number of person with self-employment income ▶ XXX XX XXXX

Who Must File Schedule SE

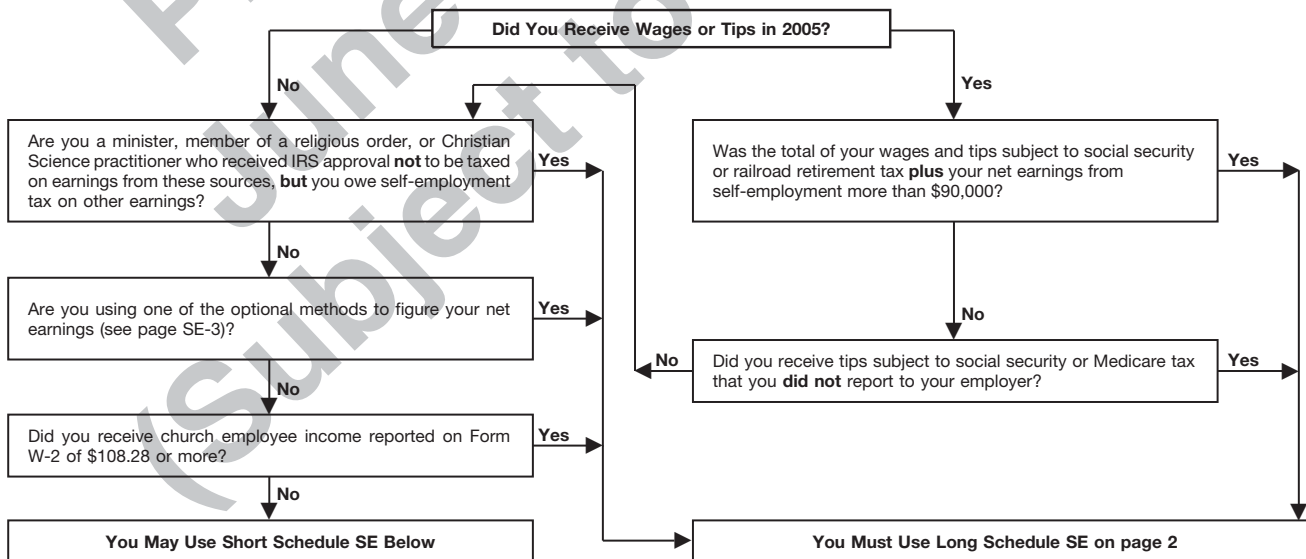
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more **or**
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income (see page SE-1).

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-3).

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 58.

May I Use Short Schedule SE or Must I Use Long Schedule SE?



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1 Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1		
2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	23,600	
3 Combine lines 1 and 2	3	23,600	
4 Net earnings from self-employment. Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax ▶	4	21,795	
5 Self-employment tax. If the amount on line 4 is: <ul style="list-style-type: none"> • \$90,000 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 58. • More than \$90,000, multiply line 4 by 2.9% (.029). Then, add \$11,160.00 to the result. Enter the total here and on Form 1040, line 58. 	5	3,335	
6 Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 27	6	1,668	00

CAPITAL GAINS AND LOSSES

Both the sale of stock and the sale of a home are reported on Form 1040, line 13. The amount entered on Form 1040, line 13, is transferred from Schedule D (Form 1040), *Capital Gains and Losses*. See Lesson 12, Sale of Stock and Lesson 13 Sale of Home for more information about these types of sales.

SALE OF BUSINESS PROPERTY

The sale or involuntary conversion of business property is reported on Form 1040, line 14. If taxpayers are reporting the sale of business property, they should be referred to a paid professional tax preparer.

PENSION AND ANNUITY INCOME

Generally, payers of pension and annuity income send Form 1099R to the recipients. The total pension or annuity income is reported on Form 1040A, line 12a, or Form 1040, line 16a; the taxable portion is reported on line 12b (1040A) or 16b (1040). If all of the pension or annuity is taxable, make an entry on line 12b or 16b only.

For more information on pension and annuity income, see Lesson 12, *Pensions*.

RENTS, ROYALTIES, PARTNERSHIPS, ESTATES, AND TRUSTS

Income from rental property, royalties, partnerships, estates, and/or trusts is reported on Form 1040, line 17. See the Military and International sections of this lesson for more information.

FARM INCOME

Farm income is reported on Form 1040, line 18. Advise taxpayers with farm income to see a paid professional tax preparer.

TAXWISE HINTS

- When entering wages for the taxpayer you have the following three choices:
 - Go to Line 7 and click F9 (Link),
 - Click the right mouse and select “Link” or
 - Click on add form and select “W-2”.
- Enter all information into Taxwise exactly as it appears on Forms W-2, 1099, etc.
- When entering self-employment income from Form 1099 Misc, select the parent form (Form Schedule C or C-EZ) and then link to Form 1099 Misc.

Note: TaxWise automatically rounds numbers.

POTENTIAL PITFALLS

Form 1099-R reports pension income, not earned income. Form 1099-R amounts are not included on line 7 of Form 1040. They are reported on Form 1040A, lines 12a and 12b or Form 1040, lines 16a and 16b. You will learn how to report pensions in Lesson 11, *Pensions*.

▶▶ SUMMING UP THIS LESSON ◀◀

Form 1040EZ can be used to report only income from wages, salaries, tips, qualified tuition program earnings, Alaska Permanent Fund dividends, taxable scholarships and fellowship grants, interest of \$1500 or less, and unemployment compensation.

You can report several types of income on Form 1040A:

- ▶ Wages, salaries, tips, scholarships and fellowship grants, qualified tuition program payments, and Alaska Permanent Fund dividends
- ▶ Interest income
- ▶ Dividend income
- ▶ Capital gain distributions
- ▶ unemployment compensation

Use Form 1040A, Schedule 1, or Form 1040, Schedule B, to report:

- ▶ Interest and/or dividend income over \$1500 and
- ▶ Interest from Series I and/or Series EE savings bonds, issued after 1989, that is excluded from taxable income.

Report any early withdrawal penalties on Form 1040, line 30, as an adjustment to income. Do not subtract penalties from interest income.

Report capital gain distributions directly on Form 1040, line 13 or Form 1040A, line 10, if the taxpayer is not required to file Schedule D.

State and local tax refunds are included in taxable income if:

- ▶ the taxpayer itemized deductions AND
- ▶ received a tax benefit by including the state and local tax in itemized deductions.

Alimony and separate maintenance payments are taxable income to the person receiving these payments. The person paying these payments can subtract them as an adjustment to income.

▶▶ **SUMMING UP THIS LESSON** ◀◀

(continued)

Business income or loss is generally beyond the scope of VITA or TCE. However, in some cases, trained volunteers may help self-employed taxpayers who qualify to use Schedule C-EZ.

Taxpayers with net self-employment income of \$400 or more must complete Schedule SE to compute self-employment tax.

Some nontaxable income is reported but is not included in taxable income:

- ▶ Tax-exempt interest
- ▶ Nontaxable portion of IRA distributions, including rollovers

Other income, such as prizes, awards, lottery winnings, and jury duty pay, is reported on line 21 of Form 1040, including the amount and description.

Volunteers should refer taxpayers with any of the following items to paid professional tax preparers:

- ▶ Sales of business property
- ▶ Farm income

Exercise 1

1. Taxable
2. Taxable
3. Nontaxable
4. Nontaxable
5. Taxable
6. Taxable
7. Nontaxable
8. Taxable
9. Nontaxable
10. Nontaxable

Exercise 2

- (A) Mike will report \$29,250 on line 7. The tip income is included in the \$8,250.
- (B) No; John must file Form 1040 to pay social security and Medicare tax on his tip income.
- (C) Randy should be advised to contact the employer and request that a Form W-2 be issued or reissued. If after waiting a reasonable amount of time, it still has not been received, Randy should contact the IRS (but not before February 15th).

Exercise 3

- (A) 1. None
2. \$1,000
- (B) \$398 is reported on line 2 of Form 1040EZ.
- (C) \$495 is reported on line 8a of Form 1040.



Military/International students continue.

All others go to Lesson 4, page 4-1.

INTRODUCTION AND OBJECTIVES

This segment discusses whether to include specific items in gross income. You should be aware, however, that certain items related to moving or travel expenses generally must be accounted for even if they are not considered income.

This lesson includes information about the combat zone exclusion. For additional tax benefits, see *Tax Options for Combat Zone Participants* in Lesson 14, *Finishing the Return*.

This segment will help you to achieve the following objectives:

1. Determine which items received by Armed Forces members are includible in gross income.
2. Determine if an amended return must be filed for a taxpayer who received medical separation pay.
3. Determine who qualifies for exclusion of pay from income because of service in a combat zone.
4. Identify qualifying items of military pay received for service in a combat zone.

FORM W-2

Includible military income will generally be the amount shown in box 1 of Form W-2, *Wage and Tax Statement*. **If this amount differs from the last Leave and Earnings Statement for 2005, advise the person to contact his or her local accounting and finance or payroll office for an explanation.**

The wages shown in box 1 of the 2005 Form W-2 should not include military pay excluded from an individual's income under the combat zone exclusion provisions. Tax exempt earned income, basic allowance for subsistence (BAS), basic allowance for housing (BAH), and certain in-kind allowances are no longer reported in box 12 of Form W-2.

INCLUDIBLE INCOME

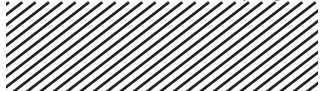
Members of the Armed Forces receive many different types of pay and allowances. Some are includible in gross income while others are excludable from gross income. Includible items are subject to tax and must be reported on the taxpayer's tax return. Excludable items are not subject to tax, but may have to be shown on the tax return. The following items are includible in gross income, **unless** the pay is for service in a combat zone declared by an executive order of the President or in a qualified hazardous duty area declared by statute:

Table 1 – Includible Income

<p>Basic pay</p> <ul style="list-style-type: none"> • Active duty • Attendance at a designated service school • Back wages • CONUS COLA • Drills • Reserve training • Training duty 	<p>Bonuses</p> <ul style="list-style-type: none"> • Career status • Enlistment • Officer • Overseas extension • Reenlistment
<p>Special pay</p> <ul style="list-style-type: none"> • Aviation career incentives • Career sea • Diving duty • Foreign duty (outside the 48 contiguous states and the District of Columbia) • Foreign language proficiency • Hardship duty • Hostile fire or imminent danger • Medical and dental officers • Nuclear-qualified officers • Optometry • Pharmacy • Special duty assignment pay • Veterinarian 	<p>Other payments</p> <ul style="list-style-type: none"> • Accrued leave • High deployment per diem • Personal money allowances paid to high-ranking officers • Student loan repayment from programs such as the Department of Defense Educational Loan Repayment Program when year's service (requirement) is not attributable to a combat zone <p>Incentive pay</p> <ul style="list-style-type: none"> • Submarine • Flight • Hazardous duty • High altitude/Low altitude (HALO)

* Enlistment and reenlistment bonuses fall under the category of taxable income. Income tax will be deducted from these entitlements before they are paid to the service member. Income tax is withheld at a flat rate of 27% as bonuses are treated as supplemental wages. Service members will not need to account for enlistment and reenlistment bonuses separately when preparing their tax returns as the payments and withholdings will be reflected on their Form W-2. If a service member feels this information is incorrect they will need to contact their local accounting and finance or payroll office.

A reenlistment bonus may be tax free if the voluntary extension or reenlistment occurs in a month the service member served in a combat zone.



EXCLUDABLE INCOME

The following qualified military benefits do not have to be reported as income on Form 1040, 1040A, or 1040EZ. The exclusion applies whether the item is furnished in kind or is a reimbursement or allowance. The personal use of a vehicle cannot be excluded from gross income as a qualified military benefit.

Table 2 – Excludable Income

<p>Living allowances</p> <ul style="list-style-type: none"> • BAH (Basic Allowance for Housing). You can deduct mortgage interest and real estate taxes on your home even if you pay these expenses with your BAH • BAS (Basic Allowance for Subsistence) • Housing and cost-of-living allowances abroad whether paid by the U.S. Government or by a foreign government • OHA (Overseas Housing Allowance) 	<p>Combat zone pay</p> <ul style="list-style-type: none"> • Compensation for active service while in a combat zone or a qualified hazardous duty area. Note: Limited amount for officers
<p>Moving allowances</p> <ul style="list-style-type: none"> • Dislocation • Military base realignment and closure benefit paid after November 11, 2003 (the exclusion is limited as described on page 5) • Move-in housing • Moving household and personal items • Moving trailers or mobile homes • Storage • Temporary lodging and temporary lodging expenses 	<p>Family allowances</p> <ul style="list-style-type: none"> • Certain educational expenses for dependents • Emergencies • Evacuation to a place of safety • Separation <p>Death allowances</p> <ul style="list-style-type: none"> • Burial services • Death gratuity payments to eligible survivors • Travel of dependents to burial site
<p>Travel allowances</p> <ul style="list-style-type: none"> • Annual round trip for dependent students • Leave between consecutive overseas tours • Reassignment in a dependent restricted status • Transportation for you or your dependents during ship overhaul or inactivation • Per diem 	<p>Other payments</p> <ul style="list-style-type: none"> • Defense counseling • Disability, including payments received for injuries incurred as a direct result of a terrorist or military action • Group-term life insurance • Professional education • ROTC educational and subsistence allowances • Survivor and retirement protection plan premiums • Uniform allowances • Uniforms furnished to enlisted personnel <p>In-kind military benefits</p> <ul style="list-style-type: none"> • Dependent-care assistance program • Legal assistance • Medical/dental care • Commissary/exchange discounts • Space-available travel on government aircraft

Note: If the person you are helping is a member of the Armed Forces and was provided a commuter highway vehicle (such as a van) by his or her employer in 2005, refer the taxpayer to Publication 525, Taxable and Nontaxable Income, and to a paid professional preparer.

MEDICAL SEPARATION PAY

Service members who have been separated from the service for years of service or medical reasons are given severance pay, which is taxable as wages. If any portion of their pay is subject to medical

disability, only the Veteran's Affairs (VA) can make that determination and assign what percentage is attributable to medical disability pension due. This process takes several months and sometimes years. The service member will receive the total "pension" which is taxable until the VA makes the determination and sends the discharged service member a letter of determination.

Disability compensation is a monetary benefit paid to veterans who are disabled by injury or disease incurred or aggravated during active military service. The service of the veteran must have been terminated through separation or discharge under conditions that were other than dishonorable. Disability compensation varies with the degree of disability and the number of dependents, and is paid monthly. The benefits are not subject to federal or state income tax.

Once the letter of determination is received, any future pension payments will be off-set by that percentage and paid directly from the VA. The payments received directly from the VA are not taxable and will not be included in the Form W-2. However, the payments received prior to the letter of determination being issued have already been taxed and the letter also exempts that percentage of pay already received from taxes. The service member needs to file an amended return, if a return has already been filed, and attach a copy of the letter of determination to the Form 1040X.

The payment of military retirement pay, disability severance pay and separation incentive payments known as SSB and VSI (Special Separation Benefits and Voluntary Separation Incentives) also affects the amount of VA compensation paid.

Example 1

Anita Bennett, an active duty service member, was separated due to a medical condition in February 2004. At the time of her separation she was given medical separation pay or severance pay in the amount of \$10,000.00. She receives a service pension in the amount of \$3000 per month. Her 2004 Form W-2 showed \$48,000 in wages of which \$43,000 ($\$10,000 + (\$3000 \times 11 \text{ months})$) was considered pension. She filed and claimed the full amount on her 2004 tax return. In 2005 the Veteran's Administration (VA) determined that due to her medical condition she was entitled to a VA disability pension of 50% from the date of her discharge. She receives her determination letter from the VA in March 2005, the tax return that includes her severance pay should be amended to exclude the 50% of the pension pay she received in 2004, $\$21,500.00 ((\$10,000 + 33,000) \times 50\%)$. She would attach a copy of the letter of determination to the amended return. She also will need to adjust her pension received January thru March 2005 by the 50%, the other months will reflect the correct taxable amount. In 2005 she will also need to attach a copy of the letter to her return to show why the amount is different from the Form W-2. The Form W-2 that she receives in 2006 and forward will show the correct amount of taxable wages.



COMBAT ZONE EXCLUSION

Members of the U.S. Armed Forces who serve in a combat zone (defined later) may exclude certain pay from their income. They do not have to receive the pay while in a combat zone, in a hospital, or in the same year they served in a combat zone. However, the entitlement to the pay must have fully accrued in a month during which they served in the combat zone or were hospitalized as a result of wounds, disease, or injury incurred while serving in the combat zone. The following military pay can be excluded from their income.

- Active duty pay earned in any month during which they served in a combat zone.
- Imminent danger/hostile fire pay
- A reenlistment bonus if the voluntary extension or reenlistment occurs in a month during which they served in a combat zone.
- Pay for accrued leave earned in any month during which they served in a combat zone. The Department of Defense must determine that the unused leave was earned during that period.
- Pay received for duties as a member of the Armed Forces in clubs, messes, post and station theaters, and other nonappropriated fund activities. The pay must be earned in a month during which they served in a combat zone.
- Awards for suggestions, inventions, or scientific achievements to which members are entitled to because of a submission they made in a month during which they served in a combat zone.
- Student loan repayments that are attributable to their period of service in a combat zone.

Retirement pay does not qualify for the combat zone exclusion.

Partial (month) service. Members of the U.S. Armed Forces who serve in a combat zone for one or more days during a particular month, are entitled to an exclusion for that entire month.

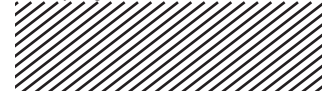
Combat Zone

A combat zone is any area the President of the United States designates by Executive Order as an area in which the U.S. Armed Forces are engaging or have engaged in combat. An area usually becomes a combat zone and ceases to be a combat zone on the dates the President designates by Executive Order.

Afghanistan area. By Executive Order No. 13239, Afghanistan (and airspace above) is designated as a combat zone beginning September 19, 2001.

Yemen area. Executive Order No. 13239 was extended to include Yemen as a designated combat zone beginning April 10, 2002.

The Kosovo area. By Executive Order No. 13119 and Public Law 106-21, the following locations (including air space above) were designated as a combat zone and a qualified hazardous duty area beginning March 24, 1999.



- Federal Republic of Yugoslavia (Serbia/Montenegro)
- Albania
- The Adriatic Sea
- The Ionian Sea—north of the 39th parallel (including all of the airspace in connection with the Kosovo operation.)

Persian Gulf area. By Executive Order No. 12744, the following locations (and airspace above) were designated as a combat zone beginning January 17, 1991.

- The Persian Gulf,
- The Red Sea,
- The Gulf of Oman,
- The part of the Arabian Sea that is north of 10 degrees north latitude and west of 68 degrees east longitude,
- The Gulf of Aden, and
- The total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates.

In addition, the Department of Defense has certified these locations for combat zone tax benefits due to their direct support of military operations, beginning on the listed dates:

In support of Operation Enduring Freedom (Afghanistan combat zone):

- Pakistan, Tajikistan and Jordan – September 19, 2001
- Incirlik Air Base, Turkey – September 21, 2001
- Kyrgyzstan and Uzbekistan – October 1, 2001
- Philippines – January 9, 2002
- Yemen – April 10, 2002
- Djibouti – July 1, 2002

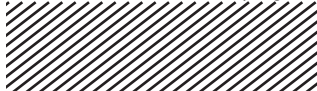
In support of Operation Iraqi Freedom (Arabian Peninsula Areas combat zone):

- Israel and Turkey – January 1, 2003
- The Mediterranean

Qualified hazardous duty area. Beginning November 21, 1995, a qualified hazardous duty area in the former Yugoslavia is treated as if it were a combat zone. The qualified hazardous duty area includes:

- Bosnia and Herzegovina,
- Croatia, and
- Macedonia.

Members of the Armed Forces deployed overseas away from their permanent duty station in support of operations in a qualified hazardous duty area, or performing qualifying service outside



the qualified hazardous duty area, are treated as if they are in a combat zone solely for the purposes of the extension of deadlines discussed in Lesson 16. These personnel are not entitled to other combat zone tax benefits.

Serving in a Combat Zone

Service in a combat zone includes any periods that military members are absent from duty because of sickness, wounds, or leave. If, as a result of serving in a combat zone, a person becomes a prisoner of war or is missing in action, that person is considered to be serving in the combat zone so long as he or she keeps that status for military pay purposes.

Qualifying service outside combat zone. Military service outside a combat zone is considered to be performed in a combat zone if:

- The service is in direct support of military operations in the combat zone, and
- The service qualifies a member for special military pay for duty subject to hostile fire or imminent danger.

Military pay received for this service will qualify for the combat zone exclusion if the other requirements are met.

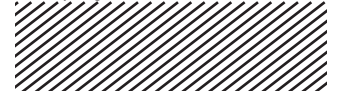
Non-qualifying presence in combat zone. The following military service does not qualify as service in a combat zone.

- Presence in a combat zone while on leave from a duty station located outside the combat zone,
- Passage over or through a combat zone during a trip between 2 points that are outside a combat zone, and
- Presence in a combat zone solely for a member's personal convenience.

Note. Military Members are considered to be serving in a combat zone if they are either assigned on official temporary duty to a combat zone or they qualify for hostile fire/imminent danger pay while in a combat zone.

Amount of Exclusion

Enlisted members. Enlisted members, warrant officers, or commissioned warrant officers who serve in a combat zone during any part of a month, can exclude all of their military pay for that month from their income. They can also exclude military pay earned while they are hospitalized as a result of wounds, disease, or injury incurred in the combat zone. The exclusion of their military pay while they are hospitalized does not apply to any month that begins more than 2 years after the end of combat activities in that combat zone. Their hospitalization does not have to be in the combat zone.



Officers. Commissioned officers (including Limited Duty Officers), may exclude their pay according to the rules just discussed. However, the amount of their exclusion is limited to the highest rate of enlisted pay plus the amount of imminent danger/hostile fire pay they received for each month during any part of which they served in a combat zone or were hospitalized as a result of their service there.

Hospitalized while serving in the combat zone. If a member is hospitalized while serving in the combat zone, the wound, disease, or injury causing the hospitalization will be presumed to have been incurred while serving in the combat zone unless there is clear evidence to the contrary.

Example 2

Ron Brady is hospitalized for a specific disease after serving in a combat zone for 3 weeks, and the disease for which he is hospitalized has an incubation period of 2 to 4 weeks. The disease is presumed to have been incurred while he was serving in the combat zone. On the other hand, if the incubation period of the disease were one year, the disease would not have been incurred while he was serving in the combat zone.

Hospitalized after leaving the combat zone. In some cases the wound, disease, or injury may have been incurred while serving in the combat zone, even though the member was not hospitalized until after he/she left.

Example 3

Martha Marshall was hospitalized for a specific disease 3 weeks after she left the combat zone. The incubation period of the disease is from 2 to 4 weeks. The disease was considered incurred while serving in the combat zone.

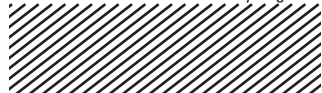
COMMUNITY PROPERTY

The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Special rules apply to married persons who file separate returns or who were divorced during the tax year and were domiciled in a community property state.

For military personnel in community property states, the key word is “domicile.” Domicile describes someone’s legal, permanent residence. It is not always where the person presently lives.

Whether an item is subject to community property laws depends on the nature of the payment.

Armed Forces pay. State community property laws apply to active military pay. Generally, the character of the pay as separate to community income is determined by the marital status and domicile of the Armed Forces member and his or her spouse while the member is in active military service.



Armed Forces retired or retainer pay. Retired or retainer payments to a member of the Armed Forces may be subject to community property laws.

For more information, see Publication 555, *Community Property*.

Exercise 1

Which of the following should be included in gross income?

- A. Basic Allowance for Subsistence (BAS)
- B. Overseas Housing Allowance
- C. Lump sum for accrued leave, paid on separation
- D. Foreign language proficiency pay
- E. Uniform allowance
- F. Foreign duty pay
- G. Reenlistment Bonus received while a service member was deployed to Qatar
- H. Hazardous duty pay
- I. Family Separation Allowance received while a service member was deployed to Italy

Answer _____

Exercise 2

Sergeant James Wells was medically separated, in November 2004, from active duty military service due to a medical condition that interfered with his ability to perform his military duties. James was entitled to and received \$12,000 in medical separation pay. After taxes he received \$8,640. Prior to his separation he submitted the required documentation to the Veteran's Affairs applying for disability pay. James filed his tax return in March 2005 and received a \$567 refund. In August of 2005 Sergeant Wells received his determination letter from VA informing him he was entitled to an \$800 disability pension per month from the date of his discharge. Sergeant Wells receives 100 percent VA disability.

- A. Does James need to file an amended tax return?

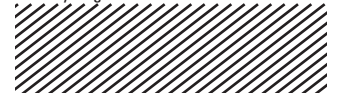
Answer _____

- B. What amount of pay will James need to exclude from his pay when he files an amended tax return?

Answer _____

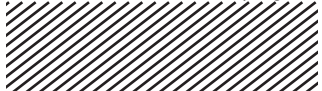
- C. When will James start receiving his disability pension?

Answer _____



▶▶ **SUMMING UP THIS SEGMENT** ◀◀

You have learned that certain items received by members of the Armed Forces are included in their gross income. Certain other items are specifically excluded by law. Pay for service in a combat zone is not taxed for an enlisted member of the U.S. military. The amount of income that is not taxed for commissioned officers serving in a combat zone is limited to the highest rate of enlisted pay plus the amount of imminent danger pay per month.



- Exercise 1 C, D, F, and H
- Exercise 2 A — yes
 B — \$12,000
 C — 15 months or March of 2006

STUDENT NOTES



INTRODUCTION AND OBJECTIVES

In the first part of this lesson we discussed what the definition of gross income is. Included in this definition was rental income. In this segment we will learn about rental income and how to report it.

When this segment is completed, we will be able to:

Explain when Schedule E must be filed.

SCHEDULE E

For the military, rental income and expenses is a frequent occurrence since many military members are not able to sell their homes when they get orders to relocate. Many homeowners rent out their old home. The income and the expenses from the rental of the property are recorded on Schedule E. This section will provide basic guidance on how to complete the Schedule E.

We will not discuss the calculation of depreciation. Depreciation is a complex subject. If the taxpayer provides you with the depreciation amount, you can enter it on the tax return. If the taxpayer does not know the depreciation amount, you may need to refer them to the military legal assistance office.

In the first year of the rental, you might have to divide the mortgage interest and real estate taxes between Schedule A and Schedule E. You simply divide the total mortgage interest and property taxes by twelve and multiply by the number of months the home was used for each purpose.

Example

Sgt. Judson lived in his home through September 2005. He received orders and rented his home out in October. Nine months of the mortgage interest and property taxes would go on his Schedule A and the other three months would go on the Schedule E. Remember, also, that three months of his property insurance is also a deductible item on Schedule E, even though this expense is not deductible when the home is his residence.

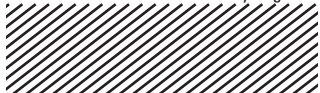
Other expenses that are deductible for rental property are: cleaning and maintenance, repairs, utilities that are paid for the tenant, legal and professional fees, management fees you pay a real estate company or individual to care for your property in your absence, auto and travel expense to check on the property, long distance phone calls, etc.

Once you deduct all of the expenses and the depreciation from the rent received, you may come up with a loss. The net income or loss from rental property is usually considered passive. If the taxpayer

actively participates in the renting of the property (such as making decisions, determining who can rent the property), the loss is fully deductible up to limit. Rental losses up to \$25,000 (\$12,500 for married taxpayers filing separate and living apart for the entire year) may be used to offset any and all nonpassive income if the taxpayer actively participates in the residential rental activity.

▶▶ **SUMMING UP THIS SEGMENT** ◀◀

- ▶ Schedule E is used to report rent and royalty income.



FOREIGN EARNED INCOME EXCLUSION

INTRODUCTION AND OBJECTIVES

This lesson will discuss the *foreign earned income exclusion*. Certain taxpayers can exclude income earned in foreign countries. For 2005, the maximum exclusion amount is \$80,000. However, the foreign earned income exclusion **does not apply** to wages and salaries of military and civilian employees of the U.S. Government. Employees of the U.S. Government, include those who work at Armed Forces post exchanges, officer and enlisted personnel clubs, and embassy commissaries. Other foreign income earned by military personnel or their spouses may be eligible for the exclusion.

To qualify for the foreign earned income exclusion, the taxpayer's tax home must be in a foreign country throughout your period of stay. This lesson will explain this requirement.

After completing this lesson, you should be able to:

- Determine whether the taxpayer qualifies for the foreign earned income exclusion.
- Calculate the foreign earned income exclusion.

REQUIREMENTS TO QUALIFY FOR THE FOREIGN EARNED INCOME EXCLUSION

There are two requirements to qualify for the foreign earned income exclusion. First, the taxpayer must show that his or her **tax home** is in a foreign country. ("Foreign country" does not include Puerto Rico, Guam, the Northern Mariana Islands, the Virgin Islands, or U.S. possessions such as American Samoa, Wake Island, the Midway Islands and Johnston Island.) The second requirement is that the taxpayer must meet either the **bona fide residence test** or the **physical presence test**.

Exercise 1

Miranda has lived in Puerto Rico since 1998. Is she eligible for the foreign earned income exclusion?

Answer _____

The requirements are applied separately to each individual. If a husband and wife are each working overseas, each must meet both requirements, to apply the exclusion. If they do so, each is entitled to an exclusion of up to \$80,000 (on qualified income) for 2005. **(Remember military pay is not eligible for the exclusion.)**

Tax Home. To claim the foreign earned income exclusion, the taxpayer's home must be in a foreign country. Generally, one's tax home is the area of the taxpayer's main place of business, employment or post of duty, regardless of where the taxpayer maintains his or her family home. If the taxpayer does not have a regular place of business because of the nature of the work, their tax home is the place where they regularly live.

Military Note: The tax home for military personnel is the permanent duty station, either land based or on a ship. This is true whether it is feasible or permissible for the taxpayer's family to live with him or her. **Generally, most military personnel and their dependents will not qualify for the Foreign Earned Income Exclusion.**

Example 1

John and Mary are both in the Armed Forces and have been permanently stationed in Germany since August 2002. Their tax home for 2005 would be Germany.

Exercise 2

Alan has lived and worked in China since August 16, 1999. For 2005, what country is his tax home?

Answer _____

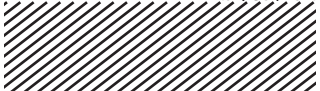
When the taxpayer has a tax home in the U.S. and goes overseas temporarily, or on business, the tax home has not changed. If the taxpayer is assigned overseas on business for an indefinite period, their tax home is overseas and the taxpayer may be eligible for the foreign earned income exclusion.

The law provides that the taxpayer will not be treated as temporarily away from home if the employment away from home exceeds one year. Therefore the person will generally be considered to have a tax home in a foreign country if the employment in the foreign country will be for more than one year. However for purposes of the foreign earned income exclusion a person will not be considered to have a tax home in a foreign country for any time during which they are living in the United States.

DETERMINING THE REGULAR PLACE OF ABODE

Three questions are important in showing whether or not a U.S. home is the regular place of abode. The questions that you should ask the taxpayer are:

1. Did you use your home in the United States as a residence while you worked at your job in the United States just before going abroad to your new job, and did you continue to maintain



work contacts, job seeking, leave of absence, ongoing business, etc.) in that area in the United States during the time you worked abroad?

2. Are your living expenses duplicated at the U.S. and foreign home because your work requires you to be away from your U.S. home?
3. Do you have a family member or members continuing to live at your U.S. home, or do you frequently use your U.S. home for lodging during the period you work abroad?

If the taxpayer **cannot** answer “yes” to at least two of these three questions, the taxpayer will be considered indefinitely assigned to the new location abroad. Thus, since the tax home is abroad, no expenses for travel, meals, or lodging while there are deductible. However, one may be able to exclude earnings from income under the foreign earned income exclusion rules.

If he/she realistically expects the job to last, and it does last, less than 1 year and that he/she will return to the U.S. home, and can answer “yes” to all three questions, the taxpayer is considered temporarily away from home. The taxpayer does not qualify for the foreign earned income exclusion, but may qualify to deduct away-from-home expenses.

If the taxpayer can answer “yes” to two of the questions, with the same expectation of job duration and return to the U.S. home, the location of the tax home depends on all the facts and circumstances.

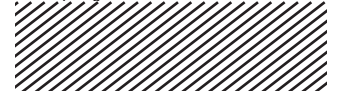
Example 2

Henry is in the Armed Forces. He was assigned to a post in Japan in 2005. This assignment was for an indefinite period. Margaret, his wife, accompanied him to Japan and has foreign earned income. Their tax home for 2005 would be Japan.

Period of Stay. Another qualification for the exclusion is the length of time the taxpayer stays overseas. This requirement can be satisfied in one of two ways.

The taxpayer must be:

1. A U.S. citizen or resident alien from a tax treaty country who is a **bona fide resident** of a foreign country (or countries) for an uninterrupted period that includes an entire tax year, or
2. A U.S. citizen or U.S. resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.



Exercise 3

Jennifer is a U.S. citizen who has lived in Israel since October 1, 2005. She expects to return to the U.S. in May, 2006. Does she meet either period of stay test?

Answer _____

Bona Fide Resident Test. To meet the test, the taxpayer must show that he or she has set up permanent quarters in a foreign country. The period must be for an uninterrupted period that includes an entire tax year. Taking a brief trip to the U.S. will not prevent the taxpayer from being a bona fide resident, as long as the intention is clear to return to the foreign country.

Example 3

Jane is a military spouse who has lived in England since 1999. Her mother still lives in the U.S. Jane came to the U.S. for two weeks in 2005 to be with her mother after she had surgery. Jane's trip to the U.S. does not affect her status as a bona fide resident of a foreign country.

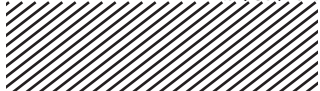
Physical Presence Test. The other test that may be met instead of the bona fide residence test is the physical presence test. To qualify, the taxpayer must be physically present in a foreign country 330 full days during a period of twelve consecutive months.

In order for a day to count for the test, it must be a full day in a foreign country. When arriving from the U.S., or returning to the U.S., any day in which part of the time is spent in the U.S. or over international waters does not count as a qualifying day in a foreign country.

The taxpayer may move about from one place to another in a foreign country, or to another foreign country without losing full days. But if any part of the taxpayer's travel is not within a foreign country or countries and takes 24 hours or more, the taxpayer will lose full days.

Example 4

The taxpayer leaves Southampton, England, by ship at 10:00 p.m. on July 6 and arrives in Lisbon at 6:00 a.m. on July 8. Since the trip takes more than 24 hours, the taxpayer loses as full days, July 6, 7, and 8. If the taxpayer remains in Lisbon, the first full day is July 9.



Exercise 4

Shauntell is using the twelve months of 2005 to determine if she qualifies for the physical presence test. She arrived in Kenya on January 3, 2005 and worked there until August 12, 2005 when she returned to the U.S. for 6 weeks. On October 1, 2005 she returned to Kenya and worked there until she permanently returned to the U.S. on January 1, 2006. Does she meet the physical presence test for 2005?

Answer _____

Figuring the 12 Month Period. Any 12-month period may be used if the 330 days in a foreign country fall within that period. If necessary, more than one period may be used, including periods that overlap. By using more than one period, it may be possible to meet the physical presence test for an entire stay, even though there may have been intervening visits to the U.S.

Waiver of Time Requirements. The minimum time requirements for period of stay may be waived, if the taxpayer is forced to leave a foreign country because of war, civil unrest, or similar adverse conditions in that country. The taxpayer must show that he/she could have met the minimum time requirements if it had not been for the adverse conditions.

QUALIFYING INCOME

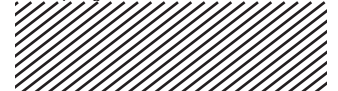
To qualify for the exclusion, income must be **earned income**. Examples of earned income are salaries, wages, commissions and professional fees. Earned income does not include dividends, interest, capital gains, alimony, social security benefits, pensions or annuities. To qualify for the exclusion, the earned income must be for services (other than military or U.S. government) performed in a foreign country.

Amounts paid by the United States or its agencies to its employees **do not qualify** for the exclusion. This includes military pay and payment for such activities as post exchanges, commissaries, and officers clubs.

Example 5

Maria, a U.S. resident, is in the Armed Forces and has lived in Lisbon since 1999. Her military pay is not eligible for the foreign earned income exclusion. In her spare time, she is a self-employed DJ in Lisbon and the surrounding area. The income from her self-employment may qualify for the exclusion.

Source of earned income. The source of earned income is the place where the services are performed. To qualify for the exclusion, services must be performed in a foreign country. Where the payments come from for the service or where they are deposited is not a factor in the determining source of the income. If a taxpayer



works predominantly in a foreign country, but does some work in the U.S., an adjustment must be made to the total of foreign earned income.

Example 6

Charles Thompson works and lives in the Bahamas. After vacation, he worked 50 weeks in 2005. For one week, he attended a business meeting in Florida. 1/50 or 2% of his wages are not foreign earned income, because that week was spent working in Florida.

Exercise 5

Maurice is stationed in Germany. His only income is from his U.S. military salary. Does he qualify for the foreign earned income exclusion?

Answer _____

Exercise 6

Juanita lives in Scotland. She is retired and her income consists of U.S. Social Security, a pension and several stock dividends. Does she qualify for the foreign earned income exclusion?

Answer _____

Exercise 7

Jose and Kim live in a foreign country. Jose has wages from the U.S. military. Kim has wages from a bank that she works at in the foreign country. Do they have qualifying income for the foreign earned income exclusion?

Answer _____

CHOOSING THE EXCLUSION

The foreign earned income exclusion is voluntary. (There are times when it may be to the taxpayer's advantage to not claim the exclusion. An example is that a taxpayer may not claim the Earned Income Tax Credit, if foreign income is excluded.) The initial choice of the exclusion on Form 2555 or Form 2555EZ must be filed with a timely return (including extensions). Exceptions do apply that allow the initial choice to be made after a return is filed. Taxpayers who wish to take advantage of these exceptions should seek professional tax assistance.

The taxpayer may revoke the election for any tax year. When the exclusion is revoked, the taxpayer may not claim the exclusion again for the next five tax years without the approval of the IRS.



COMPLETING AND FILING FORM 2555 OR FORM 2555EZ

If the taxpayer is qualified to, and wishes to claim the foreign earned income exclusion, it is necessary to complete Form 2555 or 2555EZ and attach it to Form 1040. The tax return should be filed with Internal Revenue Service Processing Campus, Philadelphia, PA, 19255.

To be able to use Form 2555EZ, the taxpayer must be a U.S. citizen or resident alien who has wages and salaries, but not self-employment income. The total foreign earned income must be \$80,000 or less, and the person cannot be claiming any business or moving expenses. Taxpayers, who do not meet these restrictions, should file Form 2555 to claim the credit.

Example 7

Michael and his wife Melissa have been stationed in Hong Kong since 2002. Michael is employed by the armed forces. Melissa operates a home day care business. Their tax home is Hong Kong. They meet the physical presence test. Melissa wants to exclude her self-employment income from U.S. taxation.

She will need to complete Form 2555 instead of Form 2555EZ, because her income is from self-employment.

Exercise 8

Assuming that the following taxpayers meet the period of stay test, should they file a Form 2555, or Form 2555EZ?

- a. Mallory has \$34,000 of foreign earned wages. She has no other income. Which form should she file?

Answer _____

- b. Jacob has U.S. military wages and self-employment income he earned in a foreign country. Which form should he file?

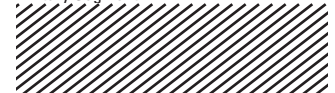
Answer _____

- c. Ramie has \$86,000 of foreign earned income. Which form should he file?

Answer _____

Taxpayers, who are eligible to file Form 2555EZ, should complete all four sections of the form.

On the following two pages, you will find a sample copy of Form 2555EZ for taxpayer Kenyon Napora, a U.S. citizen living and working in Germany for a German computer company.



Form **2555-EZ**

Foreign Earned Income Exclusion

OMB No. 1545-1326

2005

Attachment Sequence No. **34A**

Department of the Treasury
Internal Revenue Service (99)

▶ See separate instructions. ▶ Attach to Form 1040.

Name shown on Form 1040

Your social security number

Kenyon S. Napora

XXX : XX : XXXX

You May Use This Form If You:

- Are a U.S. citizen or a resident alien.
- Earned wages/salaries in a foreign country.
- Had total foreign earned income of \$80,000 or less.
- Are filing a calendar year return that covers a 12-month period.

And You:

- Do not have self-employment income.
- Do not have business/moving expenses.
- Do not claim the foreign housing exclusion or deduction.

Part I Tests To See If You Can Take the Foreign Earned Income Exclusion

1 Bona Fide Residence Test

- a Were you a bona fide resident of a foreign country or countries for a period that includes an entire tax year (see page 2 of the instructions)? Yes No
- If you answered "Yes," you meet this test. Fill in line 1b and then go to line 3.
 - If you answered "No," you **do not** meet this test. Go to line 2 to see if you meet the Physical Presence Test.
- b Enter the date your bona fide residence began ▶ _____, and ended (see instructions) ▶ _____.

2 Physical Presence Test

- a Were you physically present in a foreign country or countries for at least 330 full days during—
 { 2005 or any other period of 12 months in a row starting or ending in 2005? } Yes No
- If you answered "Yes," you meet this test. Fill in line 2b and then go to line 3.
 - If you answered "No," you **do not** meet this test. You **cannot** take the exclusion unless you meet the Bona Fide Residence Test above.
- b The physical presence test is based on the 12-month period from ▶ 01/01/2005 through ▶ 12/29/2005.

3 Tax Home Test.

- Was your tax home in a foreign country or countries throughout your period of bona fide residence or physical presence, whichever applies? Yes No
- If you answered "Yes," you can take the exclusion. Complete Part II below and then go to page 2.
 - If you answered "No," you **cannot** take the exclusion. **Do not** file this form.

Part II General Information

4 Your foreign address (including country)
 278345 Waldorf Lane
 Munich, Germany

5 Your occupation
 Computer Sales

6 Employer's name
 Wagner Computers

7 Employer's U.S. address (including ZIP code)

8 Employer's foreign address
 567524 Gannon Lane
 Munich, Germany

- 9 Employer is (check any that apply):
- a A U.S. business
 - b A foreign business
 - c Other (specify) ▶ _____
- 10a If you filed Form 2555 or 2555-EZ after 1981, enter the last year you filed the form. ▶ _____
- b If you did not file Form 2555 or 2555-EZ after 1981, check here ▶ and go to line 11a now.
- c Have you ever revoked the foreign earned income exclusion? Yes No
- d If you answered "Yes," enter the tax year for which the revocation was effective. ▶ _____
- 11a List your tax home(s) during 2005 and date(s) established. ▶ 1/2005 278435 Waldorf Lane, Munich, Germany
- b Of what country are you a citizen/national? ▶ United States of America

For Paperwork Reduction Act Notice, see page 3 of separate instructions.

Cat. No. 13272W

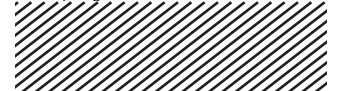
Form **2555-EZ** (2005)

Part III Days Present in the United States—Complete this part if you were in the United States or its possessions during 2005.

12 (a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)

Part IV Figure Your Foreign Earned Income Exclusion

13	Maximum foreign earned income exclusion	13	\$80,000	00
14	Enter the number of days in your qualifying period that fall within 2005	14	362	days
15	Did you enter 365 on line 14? <input type="checkbox"/> Yes. Enter "1.000." <input type="checkbox"/> No. Divide line 14 by 365 and enter the result as a decimal (rounded to at least three places).	15	×	.992
16	Multiply line 13 by line 15	16	79,360	
17	Enter, in U.S. dollars, the total foreign earned income you earned and received in 2005 (see instructions). Be sure to include this amount on Form 1040, line 7	17	21,000	
18	Foreign earned income exclusion. Enter the smaller of line 16 or line 17 here and in parentheses on Form 1040, line 21 . Next to the amount enter "2555-EZ." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 ▶	18	21,000	



For those who must file Form 2555, Part 1 of the form is for general information, and must be completed by all taxpayers who claim the exclusion.

Taxpayers who claim the bona fide residence test must complete Part II of Form 2555. Taxpayers who qualify under the physical presence test must complete Part III.

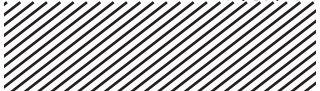
Part IV, completed by all taxpayers, is where foreign earned income is listed. It must be completed in U.S. dollars. If the taxpayer has difficulty in converting income, IRS can provide exchange rates to be used. However, the taxpayer is not required to use only rates provided by the IRS or the federal government. Note that earned income includes not only wages and salaries but also non-cash income and allowances and reimbursements received by the taxpayer.

Military Note: Do not list military wages in this section; they are not considered foreign earned income.

Page 3 of the form is where the exclusion is computed. Taxpayers claiming only the basic exclusion fill out Parts V and VII. Most of the lines are self-explanatory. The concept of qualifying period is essential. For those qualifying under the bona fide residence test, this qualifying period is the period of actual residence. For the physical presence test, the qualifying period or periods is chosen by the taxpayer. Any period may be chosen as long as 330 days are spent in a foreign country during the period.

Military Note: Generally, armed forces personnel and their spouses will not qualify for the housing exclusion (the housing allowance is already considered non-taxable income).

On the following three pages, you will find a sample Form 2555 for taxpayer Howard Humboldt, a U.S. citizen living and working in Germany for a Dutch pharmaceutical company.



Form **2555**

Foreign Earned Income

OMB No. 1545-0067

2005

Attachment Sequence No. **34**

Department of the Treasury Internal Revenue Service (99)

▶ See separate instructions. ▶ Attach to Form 1040.

For Use by U.S. Citizens and Resident Aliens Only

Name shown on Form 1040

Howard Humboldt

Your social security number

XXX : XX : XXXX

Part I General Information

- 1 Your foreign address (including country)
156782 Albion Lane, Munich Germany
- 2 Your occupation
Medical Sales
- 3 Employer's name ▶ Feagler Pharmacy
- 4a Employer's U.S. address ▶
- b Employer's foreign address ▶ 357631 Felrum Lane, Munich Germany
- 5 Employer is (check any that apply):
 - a A foreign entity
 - b A U.S. company
 - c Self
 - d A foreign affiliate of a U.S. company
 - e Other (specify) ▶
- 6a If, after 1981, you filed Form 2555 or Form 2555-EZ, enter the last year you filed the form. ▶
- b If you did not file Form 2555 or 2555-EZ after 1981 to claim either of the exclusions, check here ▶ and go to line 7.
- c Have you ever revoked either of the exclusions? Yes No
- d If you answered "Yes," enter the type of exclusion and the tax year for which the revocation was effective. ▶
- 7 Of what country are you a citizen/national? ▶ United States of America
- 8a Did you maintain a separate foreign residence for your family because of adverse living conditions at your tax home? See **Second foreign household** on page 3 of the instructions. Yes No
- b If "Yes," enter city and country of the separate foreign residence. Also, enter the number of days during your tax year that you maintained a second household at that address. ▶
- 9 List your tax home(s) during your tax year and date(s) established. ▶ 1/2005

Next, complete either Part II or Part III. If an item does not apply, enter "NA." If you do not give the information asked for, any exclusion or deduction you claim may be disallowed.

Part II Taxpayers Qualifying Under Bona Fide Residence Test (See page 2 of the instructions.)

- 10 Date bona fide residence began ▶ , and ended ▶
 - 11 Kind of living quarters in foreign country ▶ a Purchased house b Rented house or apartment c Rented room d Quarters furnished by employer
 - 12a Did any of your family live with you abroad during any part of the tax year? Yes No
 - b If "Yes," who and for what period? ▶
 - 13a Have you submitted a statement to the authorities of the foreign country where you claim bona fide residence that you are not a resident of that country? (See instructions.) Yes No
 - b Are you required to pay income tax to the country where you claim bona fide residence? (See instructions.) Yes No
- If you answered "Yes" to 13a and "No" to 13b, you do not qualify as a bona fide resident. Do not complete the rest of this part.**
- 14 If you were present in the United States or its possessions during the tax year, complete columns (a)-(d) below. Do not include the income from column (d) in Part IV, but report it on Form 1040.

(a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)	(a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)

- 15a List any contractual terms or other conditions relating to the length of your employment abroad. ▶
- b Enter the type of visa under which you entered the foreign country. ▶
- c Did your visa limit the length of your stay or employment in a foreign country? If "Yes," attach explanation Yes No
- d Did you maintain a home in the United States while living abroad? Yes No
- e If "Yes," enter address of your home, whether it was rented, the names of the occupants, and their relationship to you. ▶

For Paperwork Reduction Act Notice, see page 4 of separate instructions.

Cat. No. 11900P

Form **2555** (2005)

Part III Taxpayers Qualifying Under Physical Presence Test (See page 2 of the instructions.)

- 16 The physical presence test is based on the 12-month period from ► through ►
- 17 Enter your principal country of employment during your tax year. ►
- 18 If you traveled abroad during the 12-month period entered on line 16, complete columns (a)–(f) below. Exclude travel between foreign countries that did not involve travel on or over international waters, or in or over the United States, for 24 hours or more. If you have no travel to report during the period, enter “Physically present in a foreign country or countries for the entire 12-month period.” **Do not** include the income from column (f) below in Part IV, but report it on Form 1040.

(a) Name of country (including U.S.)	(b) Date arrived	(c) Date left	(d) Full days present in country	(e) Number of days in U.S. on business	(f) Income earned in U.S. on business (attach computation)

Part IV All Taxpayers

Note: Enter on lines 19 through 23 all income, including noncash income, you earned and actually or constructively received during your 2005 tax year for services you performed in a foreign country. If any of the foreign earned income received this tax year was earned in a prior tax year, or will be earned in a later tax year (such as a bonus), see the instructions. **Do not** include income from line 14, column (d), or line 18, column (f). Report amounts in U.S. dollars, using the exchange rates in effect when you actually or constructively received the income.

If you are a cash basis taxpayer, report on Form 1040 all income you received in 2005, no matter when you performed the service.

2005 Foreign Earned Income		Amount (in U.S. dollars)	
19	Total wages, salaries, bonuses, commissions, etc.	19	
20	Allowable share of income for personal services performed (see instructions):	20a	
	a In a business (including farming) or profession	20b	
	b In a partnership. List partnership's name and address and type of income. ►		
21	Noncash income (market value of property or facilities furnished by employer—attach statement showing how it was determined):		
	a Home (lodging).	21a	
	b Meals	21b	
	c Car	21c	
	d Other property or facilities. List type and amount. ►	21d	
22	Allowances, reimbursements, or expenses paid on your behalf for services you performed:		
	a Cost of living and overseas differential	22a	
	b Family	22b	
	c Education	22c	
	d Home leave	22d	
	e Quarters	22e	
	f For any other purpose. List type and amount. ►	22f	
	g Add lines 22a through 22f	22g	
23	Other foreign earned income. List type and amount. ►	23	
24	Add lines 19 through 21d, line 22g, and line 23	24	
25	Total amount of meals and lodging included on line 24 that is excludable (see instructions)	25	
26	Subtract line 25 from line 24. Enter the result here and on line 27 on page 3. This is your 2005 foreign earned income	26	

Part V All Taxpayers

27	Enter the amount from line 26	27	100,000	
Are you claiming the housing exclusion or housing deduction?				
<input type="checkbox"/> Yes. Complete Part VI.				
<input type="checkbox"/> No. Go to Part VII.				

Part VI Taxpayers Claiming the Housing Exclusion and/or Deduction

28	Qualified housing expenses for the tax year (see instructions)	28		
29	Number of days in your qualifying period that fall within your 2005 tax year (see instructions)	29		days
30	Multiply \$32.59 by the number of days on line 29. If 365 is entered on line 29, enter \$11,894.00 here	30		
31	Subtract line 30 from line 28. If the result is zero or less, do not complete the rest of this part or any of Part IX	31		
32	Enter employer-provided amounts (see instructions)	32		
33	Divide line 32 by line 27. Enter the result as a decimal (rounded to at least three places), but do not enter more than "1.000"	33		× .
34	Housing exclusion. Multiply line 31 by line 33. Enter the result but do not enter more than the amount on line 32. Also, complete Part VIII ▶	34		

Note: The housing deduction is figured in Part IX. If you choose to claim the foreign earned income exclusion, complete Parts VII and VIII before Part IX.

Part VII Taxpayers Claiming the Foreign Earned Income Exclusion

35	Maximum foreign earned income exclusion	35	\$80,000	00
36	• If you completed Part VI, enter the number from line 29. • All others, enter the number of days in your qualifying period that fall within your 2005 tax year (see the instructions for line 29).	36	365	days
37	• If line 36 and the number of days in your 2005 tax year (usually 365) are the same, enter "1.000." • Otherwise, divide line 36 by the number of days in your 2005 tax year and enter the result as a decimal (rounded to at least three places).	37		× . 200
38	Multiply line 35 by line 37	38	16,000	0
39	Subtract line 34 from line 27	39		
40	Foreign earned income exclusion. Enter the smaller of line 38 or line 39. Also, complete Part VIII ▶	40		

Part VIII Taxpayers Claiming the Housing Exclusion, Foreign Earned Income Exclusion, or Both

41	Add lines 34 and 40	41	79,126	
42	Deductions allowed in figuring your adjusted gross income (Form 1040, line 36) that are allocable to the excluded income. See instructions and attach computation	42		
43	Subtract line 42 from line 41. Enter the result here and in parentheses on Form 1040, line 21. Next to the amount enter "Form 2555." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 ▶	43	79,126	

Part IX Taxpayers Claiming the Housing Deduction—Complete this part only if (a) line 31 is more than line 34 and (b) line 27 is more than line 41.

44	Subtract line 34 from line 31	44		
45	Subtract line 41 from line 27	45		
46	Enter the smaller of line 44 or line 45	46		
Note: If line 45 is more than line 46 and you could not deduct all of your 2004 housing deduction because of the 2004 limit, use the worksheet on page 4 of the instructions to figure the amount to enter on line 47. Otherwise, go to line 48.				
47	Housing deduction carryover from 2004 (from worksheet on page 4 of the instructions)	47		
48	Housing deduction. Add lines 46 and 47. Enter the total here and on Form 1040 to the left of line 36. Next to the amount on Form 1040, enter "Form 2555." Add it to the total adjustments reported on that line ▶	48		

Although the exclusion may never be more than the foreign earned income, it may be less. The exclusion can be no more than \$80,000. If the number of qualifying days in the tax year is less than 365, the \$80,000 limit is lowered proportionally.

Example 8

Tina York is claiming the exclusion. Her qualifying period is March 15, 2004 to March 14, 2005. On line 36 of Form 2555, Tina enters 73 days because 73 days of her qualifying period fall in the 2005 tax year.

On line 37, she divides 73 by 365, and enters the result, “.200.”

On line 38, \$80,000 is multiplied by .200, which results in \$16,000.”

Exhibit 3

Form 2555, lines 35-40

Part VII Taxpayers Claiming the Foreign Earned Income Exclusion				
35	Maximum foreign earned income exclusion	35	\$80,000	00
36	<ul style="list-style-type: none"> If you completed Part VI, enter the number from line 29. All others, enter the number of days in your qualifying period that fall within your 2005 tax year (see the instructions for line 29). 	36	365	days
37	<ul style="list-style-type: none"> If line 36 and the number of days in your 2005 tax year (usually 365) are the same, enter “1.000.” Otherwise, divide line 36 by the number of days in your 2005 tax year and enter the result as a decimal (rounded to at least three places). 	37	×	.200
38	Multiply line 35 by line 37	38	16,000	0
39	Subtract line 34 from line 27	39		
40	Foreign earned income exclusion. Enter the smaller of line 38 or line 39. Also, complete Part VIII ▶	40		

Regardless of how much foreign earned income Tina had, her exclusion can be no more than \$16,000.

DEDUCTIONS ALLOCABLE TO EXCLUDED INCOME

In section VIII of Form 2555, the taxpayer is required to list the deductions allowed in figuring adjusted gross income that are allocable to the excluded income. To the extent a deduction that is allocable to the excluded income is claimed, the exclusion must be reduced by the deduction.

The three most common deductions that may affect the exclusion are **self-employment tax, itemized deductions** and **moving expenses**.

1. Self-Employment Tax. The taxpayer must take all earned income into account in figuring self-employment tax, even though the income is exempt from income tax because of the foreign earned income exclusion.

An individual is allowed a deduction for one-half of self-employment tax on the Form 1040. This deduction is related to the operation of the business. If foreign earned income is excluded, the deduction for S.E. tax must be allocated to the excluded income. The amount allocated to the excluded income reduces the Foreign Earned Income exclusion allowed.

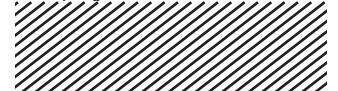
The following formula is used to determine the amount of the deduction allocable to excluded income:

$$\frac{\text{Excluded Earned Income}}{\text{Qualifying Earned Income}} \times \text{Self-Employment Tax Deduction (From Form 1040, Line 28)}$$

When the qualifying earned income is fully excluded, none of the self-employment tax deduction is allowed; therefore the full amount of this deduction is put on line 42 of Form 2555. This will reduce your Foreign Earned Income exclusion by the amount of the deduction. However, the self-employment tax deduction is still entered on line 27 of Form 1040.

- 2. Itemized Deductions.** The treatment for itemized deductions is somewhat different. In reporting itemized deductions on Schedule A (Form 1040) that are wholly or partly allocable to excluded income, the taxpayer must reduce the gross deduction by the disallowed amount in arriving at the net deduction shown on Schedule A. Then the taxpayer attaches a statement showing how the deductible amount was figured and writes "Form 2555" in the upper right corner of Schedule A. The most common itemized deductions that are allocable to excluded foreign earned income are unreimbursed employee business expenses. The same formula, as presented above, is used to determine the amounts allocable to the excluded foreign income.
- 3. Moving Expenses.** The rules for deducting moving expenses allocable to excluded income are still more complex. In the year of the move, if the taxpayer has at least 120 days of his qualifying period during the tax year, the moving expense is allocated solely to the year of the move. If the taxpayer has less than 120 full days in the tax year, the moving expense is allocated to income in the year of the move, and the year after. Taxpayers affected by this provision may want to seek assistance from the IRS or a paid tax preparer.

After adjusting the exclusion for any deductions allocable to excluded income the net exclusion needs to be carried to Form 1040. The amount from Form 2555 EZ line 18 or Form 2555 line 43 is entered in parenthesis on Form 1040 line 21. It is subtracted from other sources of income.



▶▶ SUMMING UP THIS LESSON ◀◀

The foreign earned income exclusion does not apply to income from the U.S. government, regardless of the tax home. The exclusion can be up to \$80,000 for income earned in a foreign country. It is necessary to complete either Form 2555 or 2555EZ to claim the exclusion.

In this lesson, we have discussed the basic examples of the exclusion. When a taxpayer has a more complex situation, he or she will need to seek professional tax assistance.



FOREIGN EARNED INCOME EXCLUSION

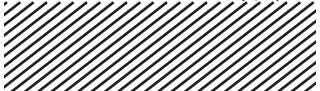
ANSWERS TO EXERCISES

1. No, Puerto Rico is not considered a foreign country.
2. His 2005 tax home is China.
3. No.
4. No, she was not present in the foreign country for a full 330 days.
5. No, U.S. military pay is not eligible.
6. No, only earned income is eligible.
7. Yes, Kim's salary.
8. **a.** Form 2555EZ
b. Form 2555
c. Form 2555

SUMMARY EXERCISES

1. List the two forms that the foreign earned income exclusion can be claimed on.
2. Is a taxpayer required to take the exclusion on foreign earned income?
3. Are military wages eligible for the foreign earned income exclusion?
4. Complete the form 2555EZ on the next two pages using the following information.

Robert (000-00-0001) and Sara (000-00-0002) Johnson (both U.S. citizens) have lived in Germany since August, 2004. Robert is employed by the U.S. Armed Forces. In 2005, Sara worked at a local bakery (Gulden's, 349028 Gannon Lane, Munich, Germany) in Germany and earned the equivalent of \$12,000. Robert and Sara do not consider themselves bona fide residents of Germany. During 2005, they resided in Germany for the full year, except for a three day vacation period in France. Their address in Germany is 239084 Menlo Lane, Munich, Germany. They have never claimed the foreign earned income exclusion before.



Form **2555-EZ**

Department of the Treasury
Internal Revenue Service (99)

Foreign Earned Income Exclusion

▶ See separate instructions. ▶ Attach to Form 1040.

OMB No. 1545-1326

2005

Attachment
Sequence No. **34A**

Name shown on Form 1040

Your social security number

- You May Use This Form If You:**
- Are a U.S. citizen or a resident alien.
 - Earned wages/salaries in a foreign country.
 - Had total foreign earned income of \$80,000 or less.
 - Are filing a calendar year return that covers a 12-month period.
- And You:**
- Do not have self-employment income.
 - Do not have business/moving expenses.
 - Do not claim the foreign housing exclusion or deduction.

Part I Tests To See If You Can Take the Foreign Earned Income Exclusion

1 Bona Fide Residence Test

- a Were you a bona fide resident of a foreign country or countries for a period that includes an entire tax year (see page 2 of the instructions)? Yes No
- If you answered "Yes," you meet this test. Fill in line 1b and then go to line 3.
 - If you answered "No," you **do not** meet this test. Go to line 2 to see if you meet the Physical Presence Test.
- b Enter the date your bona fide residence began ▶ _____, and ended (see instructions) ▶ _____.

2 Physical Presence Test

- a Were you physically present in a foreign country or countries for at least 330 full days during—
 { 2005 or any other period of 12 months in a row starting or ending in 2005? } Yes No
- If you answered "Yes," you meet this test. Fill in line 2b and then go to line 3.
 - If you answered "No," you **do not** meet this test. You **cannot** take the exclusion unless you meet the Bona Fide Residence Test above.
- b The physical presence test is based on the 12-month period from ▶ _____ through ▶ _____.

3 Tax Home Test.

- Was your tax home in a foreign country or countries throughout your period of bona fide residence or physical presence, whichever applies? Yes No
- If you answered "Yes," you can take the exclusion. Complete Part II below and then go to page 2.
 - If you answered "No," you **cannot** take the exclusion. **Do not** file this form.

Part II General Information

- 4 Your foreign address (including country) _____
- 5 Your occupation _____
- 6 Employer's name _____
- 7 Employer's U.S. address (including ZIP code) _____
- 8 Employer's foreign address _____
- 9 Employer is (check any that apply):
- a A U.S. business
 - b A foreign business
 - c Other (specify) ▶ _____
- 10a If you filed Form 2555 or 2555-EZ after 1981, enter the last year you filed the form. ▶ _____
- b If you did not file Form 2555 or 2555-EZ after 1981, check here and go to line 11a now.
- c Have you ever revoked the foreign earned income exclusion? Yes No
- d If you answered "Yes," enter the tax year for which the revocation was effective. ▶ _____
- 11a List your tax home(s) during 2005 and date(s) established. ▶ _____
- b Of what country are you a citizen/national? ▶ _____

For Paperwork Reduction Act Notice, see page 3 of separate instructions.

Cat. No. 13272W

Form **2555-EZ** (2005)

Part III Days Present in the United States—Complete this part if you were in the United States or its possessions during 2005.

12	(a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)

Part IV Figure Your Foreign Earned Income Exclusion

13	Maximum foreign earned income exclusion	13	\$80,000	00
14	Enter the number of days in your qualifying period that fall within 2005	14	days	
15	Did you enter 365 on line 14? <input type="checkbox"/> Yes. Enter "1,000." <input type="checkbox"/> No. Divide line 14 by 365 and enter the result as a decimal (rounded to at least three places).	15	×	.
16	Multiply line 13 by line 15	16		
17	Enter, in U.S. dollars, the total foreign earned income you earned and received in 2005 (see instructions). Be sure to include this amount on Form 1040, line 7	17		
18	Foreign earned income exclusion. Enter the smaller of line 16 or line 17 here and in parentheses on Form 1040, line 21 . Next to the amount enter "2555-EZ." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 ▶	18		

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FOREIGN EARNED INCOME EXCLUSION

ANSWERS TO EXERCISES

ANSWERS TO SUMMARY EXERCISE

1. Form 2555 and Form 2555EZ.
2. No, it is voluntary.
3. No.
4. See the completed form on the next two pages.

FOREIGN EARNED INCOME EXCLUSION

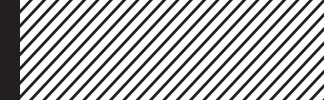
ANSWERS TO EXERCISES

Form 2555EZ, page 1

<p>Form 2555-EZ</p> <p>Department of the Treasury Internal Revenue Service (99)</p>	<p>Foreign Earned Income Exclusion</p> <p>▶ See separate instructions. ▶ Attach to Form 1040.</p>	<p>OMB No. 1545-1326</p> <p>2005</p> <p>Attachment Sequence No. 34A</p>
<p>Name shown on Form 1040 Robert and Sara Johnson</p>		<p>Your social security number XXX : XX : XXXX</p>
<p>You May Use This Form If You:</p> <ul style="list-style-type: none"> • Are a U.S. citizen or a resident alien. • Earned wages/salaries in a foreign country. • Had total foreign earned income of \$80,000 or less. • Are filing a calendar year return that covers a 12-month period. 		
<p>And You:</p> <ul style="list-style-type: none"> • Do not have self-employment income. • Do not have business/moving expenses. • Do not claim the foreign housing exclusion or deduction. 		
<p>Part I Tests To See If You Can Take the Foreign Earned Income Exclusion</p>		
<p>1 Bona Fide Residence Test</p> <p>a Were you a bona fide resident of a foreign country or countries for a period that includes an entire tax year (see page 2 of the instructions)? <input type="checkbox"/> Yes <input type="checkbox"/> No</p> <ul style="list-style-type: none"> • If you answered "Yes," you meet this test. Fill in line 1b and then go to line 3. • If you answered "No," you do not meet this test. Go to line 2 to see if you meet the Physical Presence Test. <p>b Enter the date your bona fide residence began ▶ _____, and ended (see instructions) ▶ _____.</p>		
<p>2 Physical Presence Test</p> <p>a Were you physically present in a foreign country or countries for at least 330 full days during— { 2005 or any other period of 12 months in a row starting or ending in 2005? } <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No</p> <ul style="list-style-type: none"> • If you answered "Yes," you meet this test. Fill in line 2b and then go to line 3. • If you answered "No," you do not meet this test. You cannot take the exclusion unless you meet the Bona Fide Residence Test above. <p>b The physical presence test is based on the 12-month period from ▶ <u>8/2004</u> through ▶ <u>12/31/2005</u>.</p>		
<p>3 Tax Home Test. Was your tax home in a foreign country or countries throughout your period of bona fide residence or physical presence, whichever applies? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No</p> <ul style="list-style-type: none"> • If you answered "Yes," you can take the exclusion. Complete Part II below and then go to page 2. • If you answered "No," you cannot take the exclusion. Do not file this form. 		
<p>Part II General Information</p>		
<p>4 Your foreign address (including country) 239084 Menlo Lane Munich, Germany</p>		<p>5 Your occupation Bakery Worker</p>
<p>6 Employer's name Gulden's Bakery</p>	<p>7 Employer's U.S. address (including ZIP code)</p>	<p>8 Employer's foreign address 349028 Gannon Lane Munich, Germany</p>
<p>9 Employer is (check any that apply):</p> <p>a A U.S. business <input type="checkbox"/></p> <p>b A foreign business <input checked="" type="checkbox"/></p> <p>c Other (specify) ▶ _____ <input type="checkbox"/></p>		
<p>10a If you filed Form 2555 or 2555-EZ after 1981, enter the last year you filed the form. ▶ _____</p> <p>b If you did not file Form 2555 or 2555-EZ after 1981, check here ▶ <input checked="" type="checkbox"/> and go to line 11a now.</p> <p>c Have you ever revoked the foreign earned income exclusion? <input type="checkbox"/> Yes <input type="checkbox"/> No</p> <p>d If you answered "Yes," enter the tax year for which the revocation was effective. ▶ _____</p>		
<p>11a List your tax home(s) during 2005 and date(s) established. ▶ <u>8/2001</u> <u>239084 Menlo Lane, Munich, Germany</u></p> <p>b Of what country are you a citizen/national? ▶ <u>United States of America</u></p>		
<p>For Paperwork Reduction Act Notice, see page 3 of separate instructions. Cat. No. 13272W Form 2555-EZ (2005)</p>		

FOREIGN EARNED INCOME EXCLUSION

ANSWERS TO EXERCISES



Form 2555EZ, page 2

Form 2555-EZ (2005)

Page 2

Part III Days Present in the United States—Complete this part if you were in the United States or its possessions during 2005.

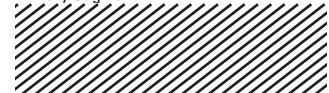
12 (a) Date arrived in U.S.	(b) Date left U.S.	(c) Number of days in U.S. on business	(d) Income earned in U.S. on business (attach computation)

Part IV Figure Your Foreign Earned Income Exclusion

13	Maximum foreign earned income exclusion	13	\$80,000	00
14	Enter the number of days in your qualifying period that fall within 2005	14	362	days
15	Did you enter 365 on line 14? <input type="checkbox"/> Yes. Enter "1.000." <input checked="" type="checkbox"/> No. Divide line 14 by 365 and enter the result as a decimal (rounded to at least three places).	15	X	.992
16	Multiply line 13 by line 15	16	79,360	
17	Enter, in U.S. dollars, the total foreign earned income you earned and received in 2005 (see instructions). Be sure to include this amount on Form 1040, line 7	17	12,000	
18	Foreign earned income exclusion. Enter the smaller of line 16 or line 17 here and in parentheses on Form 1040, line 21 . Next to the amount enter "2555-EZ." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22	18	12,000	

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Form 2555-EZ (2005)



STUDENT NOTES



INTRODUCTION AND OBJECTIVES

This lesson will provide insights into the misconception that a U.S. citizen or resident alien only files a U.S. tax return if he or she has income from the United States, especially if taxes are paid to another country.

At the end of this segment, you will be able to:

- Define worldwide income and compute the U.S. dollar value of a foreign currency if given an exchange rate table.
- Determine when to use average annual exchange figures.

WORLDWIDE INCOME

U.S. citizens and U.S. resident aliens are required to file a U.S. tax return based on their worldwide income. It has been a popular misconception that a person only has to file a U.S. tax return if he or she has income from the United States, especially if he or she pays taxes to another country. While U.S. citizens and U.S. resident aliens living abroad can claim tax benefits such as the foreign earned income exclusion and the foreign tax credit (later lessons), they have the same filing requirements as U.S. citizens living in the United States. This applies whether their income is from within or outside the U.S. Types of income, such as child support, which would not be taxed in the U.S., are generally not taxed if from outside the U.S. But, types of income which would be taxable if from within the U.S. are also taxable if from outside the U.S.

You may wish to refer to the lists of taxable and nontaxable income on the applicable pages of the basic Military Section of the text.

Example 1

In 2005, Joe Adams earned \$40,000 while working in Austin, Texas, for XYZ Corporation. In September 2005, he transferred to their office in Stuttgart, Germany. While in Germany, he earned \$30,000. His worldwide wages earned in 2005 would be \$70,000. Line 7 of his Form 1040 would show \$70,000.

Exercise 1

Marta Brener lives in Mussbach, Germany. Her 2005 income included \$22,000 in wages earned in Germany. She earned \$3,000 in interest from her U.S. bank and \$2,000 unemployment compensation from the state of Iowa. What is Marta's worldwide gross income?

Exercise 2

Mary Carlton lives in Belgium. Her 2005 income included \$10,000 in wages from her Belgian employer. She received \$2,000 interest from her U.S. bank, \$8,000 in alimony payments and \$8,000 in child support payments from her ex-spouse. What is her worldwide gross income?

Exercise 3

Would Marta Brener (Exercise 1) have to file a U.S. tax return for 2005? Would Mary Carlton (Exercise 2) have to file a U.S. tax return for 2005?

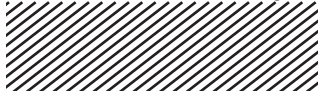
Exchange Rates

Another question that you will frequently be asked is "What exchange rate do I use?" The exchange rates of foreign currencies to the U.S. tax dollar change on a daily basis. **All amounts on the U.S. tax return must be stated in U.S. dollars.** Since most taxpayers abroad receive some kind of income in foreign currency, you will find situations when you will need to convert foreign income into U.S. dollars in order to put these income amounts on the return. Most countries have a medium of currency compared to which the value of the dollar is larger. Very few countries have mediums compared to which the U.S. dollar is smaller. Exchange rates are stated in two ways: the foreign currency to the U.S. dollar, and the dollar's value in the foreign currency.

When making a conversion, you should make sure that the exchange rate is stated in foreign currency to one U.S. dollar. To convert a sum of money into U.S. dollars, you would divide the foreign currency by the exchange rate.

Example 2

If you received 3,000 Euros on a day that the exchange rate was 1.7115 Euros to \$1 U.S., you would have \$1,752.85 in equivalent



U.S. dollar value ($3,000/1.7115 = 1,752.85$). To convert a sum of money into U.S. dollars when the currency unit is larger in value, you can use the same process.

Example 3

Caryn received 200 Euros on a day that the exchange rate was .5514 Euros to one U.S. dollar. In U.S. dollars, she would have \$362.71 ($200/.5514 = 362.71$).

Exercise 4

Convert the following amounts to U.S. dollars.

- a. 36,000 Euros (1.7115 exchange rate) _____
- b. 800 Euros (.5514 exchange rate) _____

When to Convert. Now that you have information on how to calculate exchange rates, we now need to discuss what exchange rates to use. Actually, what exchange rate to use is determined by the date of the transactions; that is the date on the check or the date money is credited to the taxpayer's account. If the taxpayer has income which was received evenly throughout the year, he or she can use the average annual exchange rate if the foreign exchange rate was relatively stable during the year. The average annual exchange rate is available from IRS offices throughout the world generally starting around January 15.

IRS also distributes information to its worldwide offices concerning the quarterly exchange rates for various currencies.

Example 4

Edward Pasco worked in Dallas for Megacorp Incorporated from January until September 2005. On September 29, he was transferred to their Mexico City office where he will be working for 3 years. While in the U.S., Edward earned his salary in U.S. dollars. When he moved to Mexico, he was paid in Mexican pesos. Since he did not receive his salary in foreign currency throughout the year, he should not use the annual average exchange rate. He should use the average rates for October, November, and December.

Where to Obtain Exchange Rates

To obtain exchange rates, you can call the IRS International office at 215-516-2000, or the overseas IRS offices. The phone numbers of these offices are listed in Publication 54. You may also contact banks who provide international currency exchange services. Since a taxpayer "should use the rate that most nearly reflects the value of the foreign currency" (Publication 54) at the time he or she receives the income, the taxpayer may use an exchange rate that is different from the rates posted in our worldwide offices if he finds it to be a truer representation.



Exercise 5

Deborah Vance lives and works in Manila, Philippines. In 2005, she had the following income: 16,000 Filipino pesos in wages, 1,200 Filipino pesos interest income and \$500 in U.S. interest from her U.S. bank. On June 7, 2005, she sold her car and made a profit of 2,000 Philippine pesos (fully taxable capital gain). Since these items are fully taxable, what is the total income to be reported on her U.S. tax return (in U.S. dollars)?

For this exercise assume that the 2005 average annual exchange rate for the Philippine peso is 40.25 pesos to 1.00

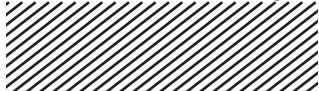
U.S. dollar and the exchange rate for June 7, 2005 was 32.55 pesos to 1.00 U.S. dollar.

Wages _____
Interest _____
Capital Gain _____
Total 2005 Income _____

Sometimes, you may get questions on exchanging money when there is “blocked income” or “soft currency”. **Questions on these issues should be referred to IRS.** “Blocked income” refers to a situation where a taxpayer cannot convert foreign currency to U.S. dollars. This is generally due to local law or local government policy. There are special tax rules that exist when there is blocked income which allows a person to choose to put off reporting part of their income. “Soft currency” refers to a situation where a person can only convert back to U.S. dollars an amount that equals what he brought into that country in U.S. dollars.

▶▶ SUMMING UP THIS SEGMENT ◀◀

- ▶ U.S. citizens (and resident aliens) are taxed on worldwide income and must file U.S. tax returns even if all the income is from foreign sources.
- ▶ You have learned how to convert foreign currency to U.S. dollar equivalent values.
- ▶ Exchange rates used should reflect the closest accurate rate.



1. \$27,000
2. \$20,000
3. Yes. Yes.
4. a. \$21,034.18
b. \$1,450.85
5. Wages $16,000.00 \div 40.25 = \underline{\$397.52}$
Interest $1,200.00 \div 40.25 = \$29.81$ from Philippines plus \$500
interest from U.S. = \$529.81
Capital Gain $2,000.00 \div 32.55 = \underline{\$61.44}$
Total 2005 Income – \$988.77

STUDENT NOTES



INTRODUCTION AND OBJECTIVES

This lesson will explain when a self-employed taxpayer living abroad is subject to U.S. income tax requirements and their filing obligations.

At the end of the segment, you will be able to:

1. Determine who is a self-employed individual.
2. Compute the self-employment tax for a U.S. citizen or resident abroad.
3. Compute the deduction for self-employment tax.

EMPLOYEE OR SELF-EMPLOYED

A self-employed person is generally one who either:

1. Carries on a trade or business as a sole proprietor or independent contractor.
2. Is a member of a partnership that carries on a trade or business.
3. Otherwise in business for himself or herself.

SELF-EMPLOYMENT TAX

The self-employment tax is a social security tax for individuals who work for themselves. It is similar to the social security tax withheld from the pay of wage earners.

Social security benefits are available to individuals who are self-employed just as they are to wage earners. Payments of self-employment tax contribute to an individual's coverage under the social security system.

Income Limits. You must pay self-employment tax if you have net earnings from self-employment of \$400 or more a year.

Self-employment tax consists of two parts, social security and medicare. For 2005, social security tax is paid on the first \$90,900 of net income. The medicare tax is imposed on the full amount of net earnings.

Note: If your self-employment income is \$400 or more, you must file a return even though your income is below the minimum amount for income tax filing purposes.

Effect of Foreign Earned Income Exclusion. You must take all of your earned income into account in figuring your self-employment tax, even though the income is exempt from income tax because of the foreign earned income exclusion.

Example 1

You are in business abroad as a consultant and qualify for the foreign earned income exclusion. Your foreign earned income is \$70,000, business expenses \$20,000, resulting in net earnings of \$50,000. You must pay self-employment tax on the net income even though you excluded all of your earned income.

Exemption from U.S. Self-Employment Tax. The United States may reach agreements with foreign countries to eliminate dual coverage and dual contributions (taxes) to social security systems for the same work. As a general rule, self-employed persons who are subject to dual taxation will only be covered by the social security system of the country where they reside.

For more information, consult Publication 54, “Tax Guide for U.S. Citizens and Resident Aliens Abroad.”

WHICH FORMS TO USE

Form 1040, U.S. Individual Income Tax Return, is used to report self-employment tax. Both income tax and self-employment tax are due at the same time. Schedule SE, Self-Employment Tax, is used to figure the tax. Even if the taxpayer is not otherwise required to file an income tax return, he or she must file both Form 1040 and Schedule SE to pay self-employment tax.

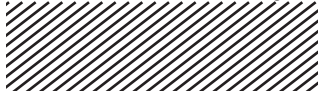
The Schedule SE includes a flowchart to determine if the short or long form is required.

COMPUTING THE SELF-EMPLOYMENT TAX

Although there are three methods available to compute self-employment tax, VITA volunteers will only use the regular method. Taxpayers who wish to use the other methods should seek paid—professional assistance. There are no limits on who may use the regular method. Most taxpayers use this method.

Under the regular method, the net income from your business or profession is generally your net self-employment earnings from Schedules C, C-EZ, F, and K-1 (Form 1065).

If you have more than one trade or business, your net earnings from self-employment are the combined net earnings from each of your businesses. A loss in one business will reduce the income earned in another. You must claim all allowable deductions including depreciation when figuring your net earnings from self-employment.



Even though the income may be exempt from income tax because of foreign earned income exclusion, you must take all of your earned income into account in figuring your self-employment tax. Refer to Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*, regarding the effect of the foreign earned income exclusion on U.S. self-employment tax.

Example 2

Susan J. Brown is sole proprietor of a dress shop, “Milady Fashions.” Her Schedule C shows a net profit of \$35,100. Susan’s completed Schedule SE is shown at the end of this section.

If Susan were the proprietor of more than one business, she would have combined the profits and losses from all of them and filled out only one Schedule SE. If, in addition to operating her dress shop, Susan had worked for wages totaling \$87,900 or more, she would have already paid the maximum amount of social security tax owed on her wages, but she would still be subject to the medicare portion (2.9%) of self employment tax. In this case, she would use the long Schedule SE.

The line numbers shown below in bold type refer to the line numbers on the sample filled-in Schedule SE on the following page.

Line 1. Since Susan has no earnings from farm self-employment, she leaves line 1 blank.

Line 2. Susan enters the net profit from her Schedule C, \$35,100.

Line 3. Since Susan has no farm income, she enters the same amount on line 3.

Line 4. Multiply the amount of line 3 by .9235 and enter the result.

Line 5. Susan determines her self-employment tax by using the first option on Line 5. She multiplies \$32,415 on Line 4 by 15.3%. She enters \$4,959 on Line 5. This is her self-employment tax. She also enters this amount on Line 58 of Form 1040.



SCHEDULE SE
(Form 1040)

Department of the Treasury
Internal Revenue Service

Self-Employment Tax

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule SE (Form 1040).**

OMB No. 1545-0074

2005

Attachment
Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040)
Susan J. Brown

Social security number of person
with **self-employment** income ▶

XXX XX XXXX

Who Must File Schedule SE

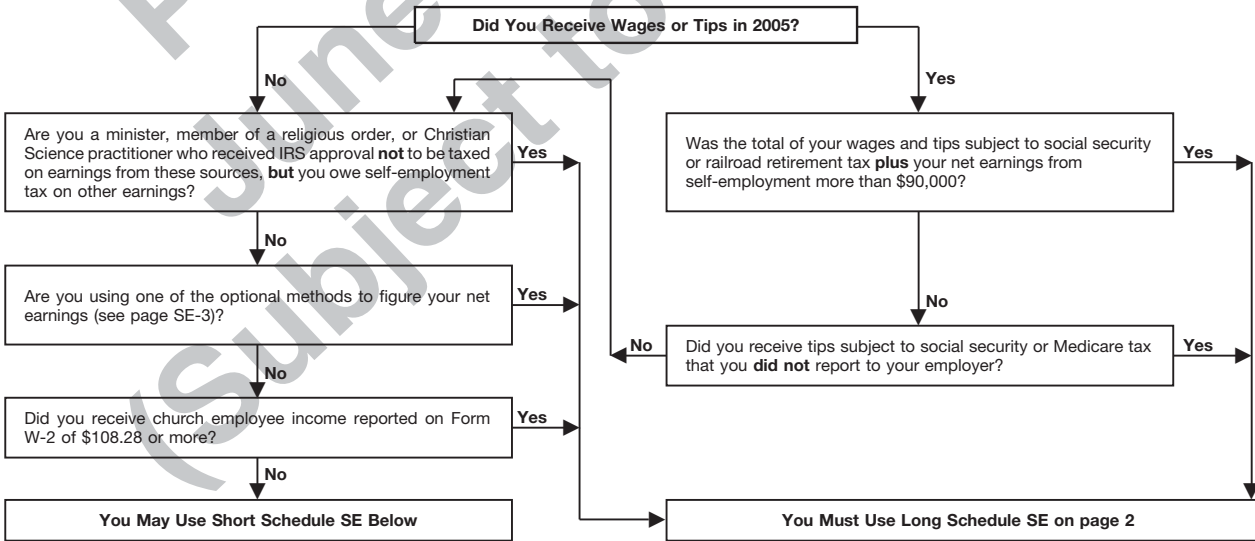
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more **or**
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income (see page SE-1).

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-3).

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 58.

May I Use Short Schedule SE or Must I Use Long Schedule SE?



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1 Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1		
2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	35,100	
3 Combine lines 1 and 2	3	35,100	
4 Net earnings from self-employment. Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax ▶	4	32,415	
5 Self-employment tax. If the amount on line 4 is: • \$90,000 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 58. • More than \$90,000, multiply line 4 by 2.9% (.029). Then, add \$11,160.00 to the result. Enter the total here and on Form 1040, line 58.	5	4,959	
6 Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 27	6	2,480	

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2005

The deduction for one-half of the SE tax will reduce Susan's income subject to income tax. However, if all of Susan's self-employment income qualifies for the foreign earned income exclusion, this deduction is allocable to the excluded income and must be included on line 42 the Form 2555. This prevents the deduction from reducing other taxable income. See the earlier chapter on foreign earned income exclusion for additional information.

▶▶ **SUMMING UP THIS SEGMENT** ◀◀

- ▶ As a volunteer assisting taxpayers abroad, you may be asked questions regarding self-employed tax. In this lesson you have learned how to determine if you are considered a self-employed individual and how to compute the self-employment tax.



SUMMARY EXERCISES

Exercise 1

You must pay self-employment tax if you have net earnings from self-employment of \$ _____ or more a year.

Exercise 2

John has a business abroad in 2005, as a private contractor and his self-employed income qualifies for the foreign earned income exclusion. His foreign earned income is \$64,000, business expenses \$19,000, and net earnings \$45,000. Since his foreign earned income is completely excluded, is he liable for self-employment tax? If yes, what amount of income is subject to self-employment tax?

Exercise 3

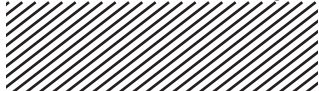
The United States may reach agreements with foreign countries to eliminate dual coverage and dual contributions (taxes) to social security systems for the same work. These agreements may be applicable to self-employed persons.

True/False

Exercise 4

Janice Thompson is a self-employed baby-sitter overseas. She is a U.S. citizen living with her husband. He is a U.S. Army officer and also a U.S. citizen. She operates her sole proprietor babysitting service out of their off base apartment. She has no wage income. Her Schedule C shows a net profit of \$9,500 in 2005. She qualifies for the foreign earned income exclusion. She receives no exemption from any agreement to exclude her self-employment tax.

Compute her self-employment tax for 2005 on the blank Schedule SE.



SCHEDULE SE
(Form 1040)

Department of the Treasury
Internal Revenue Service

Self-Employment Tax

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule SE (Form 1040).**

OMB No. 1545-0074

2005
Attachment
Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040)

Social security number of person
with **self-employment** income ▶

Who Must File Schedule SE

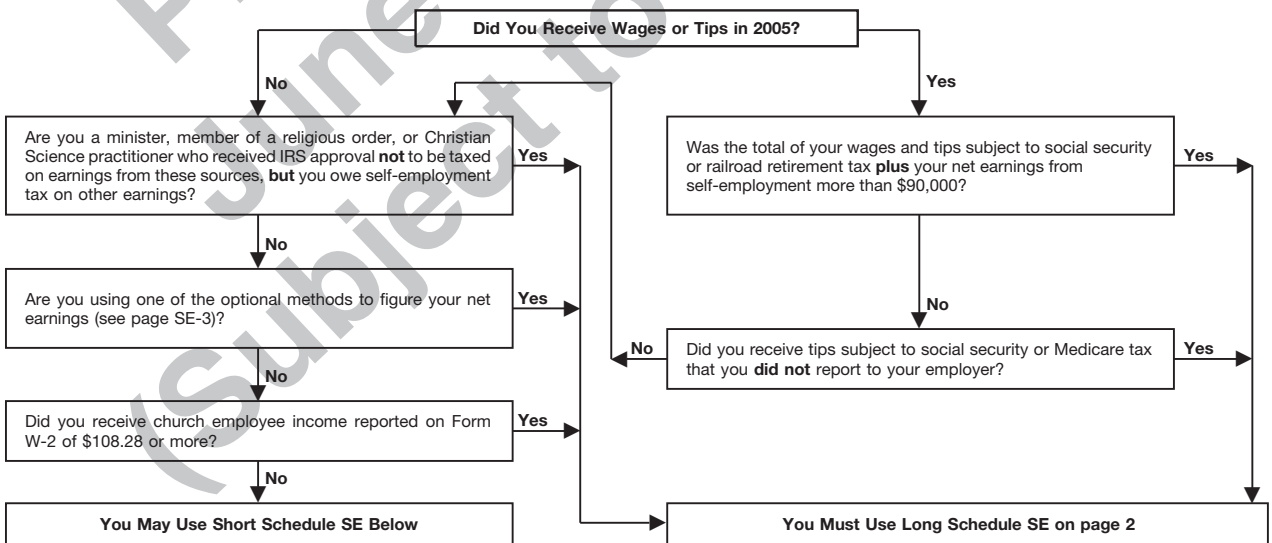
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more **or**
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income (see page SE-1).

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-3).

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 58.

May I Use Short Schedule SE or Must I Use Long Schedule SE?



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

- 1 Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A
- 2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report
- 3 Combine lines 1 and 2
- 4 **Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than \$400, **do not** file this schedule; you do not owe self-employment tax ▶
- 5 **Self-employment tax.** If the amount on line 4 is:
 - \$90,000 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 58.**
 - More than \$90,000, multiply line 4 by 2.9% (.029). Then, add \$11,160.00 to the result. Enter the total here and on **Form 1040, line 58.**
- 6 **Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 27**

1		
2		
3		
4		
5		
6		

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2005

SELF-EMPLOYMENT TAX

Lesson 3

ANSWERS TO EXERCISES

International Segment

Exercise 1

\$400

Exercise 2

Yes

John must take all of his earned income into account in figuring his self-employment tax, even though the income is exempt from income tax because of the foreign earned income exclusion. John's \$45,000 net earnings are subject to self-employment tax in 2005.

Exercise 3

True. Agreements may apply to self-employed persons.

Exercise 4

See complete form.

SCHEDULE SE
(Form 1040)

Department of the Treasury
Internal Revenue Service

Self-Employment Tax

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule SE (Form 1040).**

OMB No. 1545-0074

2005
Attachment
Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040)
Janice Thompson

Social security number of person with **self-employment** income ▶ XXX : XX : XXXX

Who Must File Schedule SE

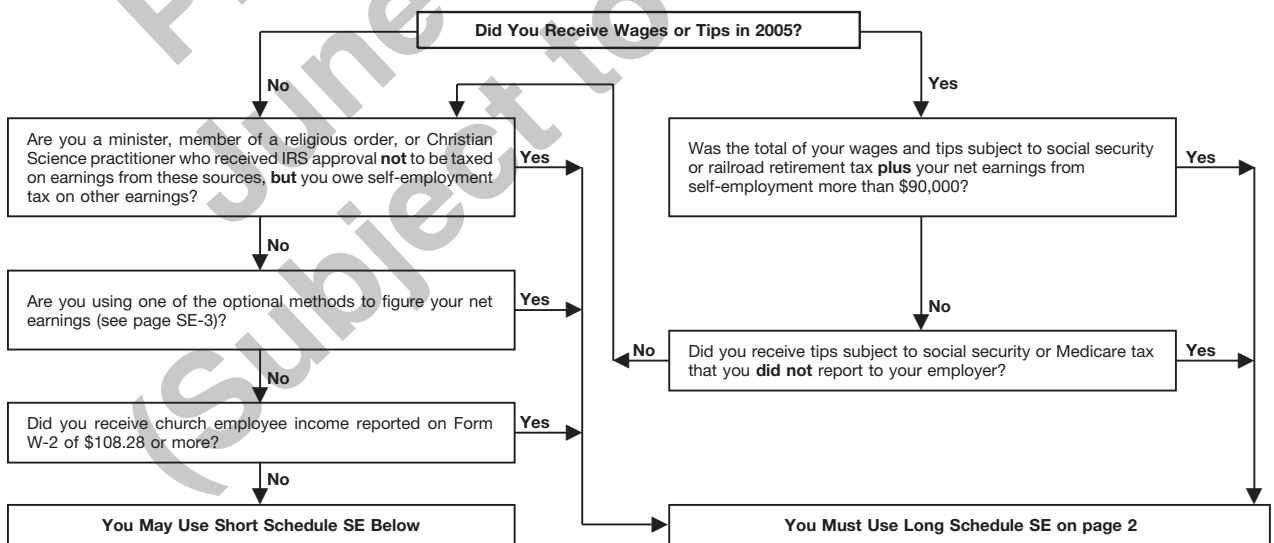
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- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income (see page SE-1).

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-3).

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 58.

May I Use Short Schedule SE or Must I Use Long Schedule SE?



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1		
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	9,500	
3	Combine lines 1 and 2	3	9,500	
4	Net earnings from self-employment. Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax ▶	4	8,773	
5	Self-employment tax. If the amount on line 4 is: <ul style="list-style-type: none"> • \$90,000 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 58. • More than \$90,000, multiply line 4 by 2.9% (.029). Then, add \$11,160.00 to the result. Enter the total here and on Form 1040, line 58. 	5	1,342	
6	Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 27	6	671	

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2005

STUDENT NOTES



RENTAL INCOME AND EXPENSES

Lesson 3

International Segment

INTRODUCTION AND OBJECTIVES

This lesson will explain the rental income reporting requirements for U.S. citizens and resident aliens. Generally, you must include in gross income all amounts received from rental properties, including rental receipts received from your former residence. Both United States citizens and resident aliens must report rental income, regardless whether the rental property is located in the United States or in a foreign country.

At the end of the segment, you will be able to:

1. Determine how to report rental income.
2. Determine how to report rental expenses.
3. Determine how to report rental income when property is used for personal purposes either part of the year or during the entire year.
4. Determine how to compute deductible depreciation expense.
5. Identify the application of at-risk and passive activity rules.

NOTE: The information and explanation of this issue is beyond the usual scope of Volunteer training. An exception has been made to serve the military and other Volunteers living abroad due to limited access to both resources and the professional preparers.

WHICH FORMS TO USE

Rental income and expenses are reported on Schedule E (Form 1040), Supplemental Income Schedule, Part 1. Additional information on rental income can be found in Publication 527, "Residential Rental Property," and Publication 946, "How to Depreciate Property."

RENTAL INCOME

Rental income may include other payments in addition to the normal and ordinary rents received. Include in gross rental income advance rent, security deposits, payments for canceling a lease, expenses paid by the tenant, and the fair market value of property or services received in exchange for rental payments. The security deposit is not included when the taxpayer plans on returning the deposit at the end of the lease. A taxpayer using the cash basis of accounting, reports the income when actually received. Taxpayers using the accrual accounting method report the income in the year they are entitled to receive payments.

RENTAL EXPENSES

The deductible rental expenses are reported on the Schedule E, Part I, (see Exhibit 1) lines 5 through 18.

Exhibit 1

Form 1040 Schedule E

SCHEDULE E (Form 1040) <small>Department of the Treasury Internal Revenue Service (99)</small>	Supplemental Income and Loss (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)	<small>OMB No. 1545-0074</small> <div style="font-size: 2em; font-weight: bold; text-align: center;">2005</div> <small>Attachment Sequence No. 13</small>																
<small>Name(s) shown on return</small>		<small>Your social security number</small>																
Part I Income or Loss From Rental Real Estate and Royalties <small>Note. If you are in the business of renting personal property, use Schedule C or C-EZ (see page E-3). Report farm rental income or loss from Form 4835 on page 2, line 40.</small>																		
1	List the type and location of each rental real estate property:	<table border="1" style="width:100%; border-collapse: collapse;"> <tr> <td style="width:5%;"></td> <td style="width:75%;"> 2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of: <ul style="list-style-type: none"> • 14 days or • 10% of the total days rented at fair rental value? (See page E-3.) </td> <td style="width:10%; text-align: center;">Yes</td> <td style="width:10%; text-align: center;">No</td> </tr> <tr> <td style="text-align: center;">A</td> <td></td> <td style="text-align: center;">A</td> <td></td> </tr> <tr> <td style="text-align: center;">B</td> <td></td> <td style="text-align: center;">B</td> <td></td> </tr> <tr> <td style="text-align: center;">C</td> <td></td> <td style="text-align: center;">C</td> <td></td> </tr> </table>		2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of: <ul style="list-style-type: none"> • 14 days or • 10% of the total days rented at fair rental value? (See page E-3.)	Yes	No	A		A		B		B		C		C	
	2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of: <ul style="list-style-type: none"> • 14 days or • 10% of the total days rented at fair rental value? (See page E-3.)	Yes	No															
A		A																
B		B																
C		C																
Income:		Properties	Totals <small>(Add columns A, B, and C.)</small>															
		A	B															
3	Rents received			3														
4	Royalties received			4														
Expenses:																		
5	Advertising																	
6	Auto and travel (see page E-4)																	
7	Cleaning and maintenance																	
8	Commissions																	
9	Insurance																	
10	Legal and other professional fees																	
11	Management fees																	
12	Mortgage interest paid to banks, etc. (see page E-4)			12														
13	Other interest																	
14	Repairs																	
15	Supplies																	
16	Taxes																	
17	Utilities																	
18	Other (list) ▶																	

Deductible expenses include any ordinary and necessary expenses, such as expenses for repairs, maintenance, certain operating expenses and depreciation.

Repairs vs. Improvements. The cost of a repair is a current year deduction, however, the cost of an improvement must be depreciated over the useful life of the improvement. The distinction between a repair and an improvement is that a repair keeps the property in good operating condition, whereas an improvement materially adds to the life or value of the property or adapts it to new uses. The following chart helps illustrate the difference between repairs and improvements.

IMPROVEMENTS

Adding a Room

Putting up a Fence

Putting in plumbing or wiring

Replacing hot water tank

Putting on a new roof

REPAIRS

Painting

Fixing Gutters

Repairing Driveways

Replacing Window Glass

Repairing the Roof

Since an improvement is a capital expenditure and must be depreciated, the total cost including material, labor, and installation increases the basis of the property. Depreciation will be discussed later in this chapter.

Other Expenses. Some of the other ordinary expenses that may be deducted from gross rental income include salary and wages, utilities, rental of equipment, insurance premiums, interest expense (mortgage interest), advertising, taxes, and commissions paid for collecting rental income. If any part of the property tax is for local benefits, such as putting in streets and sidewalks, that portion of the property tax is added to the basis of the property rather than deducted as an ordinary expense. Insurance premiums paid in advance must be prorated over the period covered by the policy by both the cash basis and accrual basis taxpayer. If the rental is a condominium or cooperative, the maintenance fee is deductible. See Publication 527, *Residential Rental Property*, for taxes and interest deductions on cooperatives. Generally, mortgage interest expense is fully deductible. However, if the taxpayer has interest expense other than mortgage interest, refer him or her to the Internal Revenue Service or a professional preparer.

Ordinary and necessary travel and transportation expenses attributable to the production of rental income are deductible. If a personal automobile is used, the taxpayer may use the standard mileage rate for business mileage. The standard mileage rate for the year 2005 is 40.5 cents per mile from 01/01/2005 to 08/31/2005 and 48.5 cents per mile from 09/01/2005 until 12/31/2005. When using the standard mileage rate, parking fees and tolls may also be deducted. The standard mileage rate method (MACRS) may be selected on a yearly basis. However, if changing to actual expense after using the standard mileage method, accelerated depreciation may not be used. In order to claim depreciation under the actual expense method for transportation expenses, the vehicle must be used more than 50 percent for business, including for the production of rental income. If the travel incurred on behalf of a rental property is into or outside of the United States, the trip may have a dual purpose. Substantiation of the pleasure vs. business purpose and allocation of the expenses may be required. When a tenant does not pay the rent, the cash-basis landlord cannot take a deduction for the unpaid rent, since a deduction can never be taken for a payment that has never been included in income.



SPECIAL ALLOCATION

Special rules apply when rental property is used for personal purposes, or as a rental without the intent to make a profit. When renting part of the property, certain expenses must be divided between rental use and personal use. When figuring the division of expenses, the taxpayer may use any reasonable method. The most common methods used are based on the number of rooms in the dwelling or on the total area of the dwelling.

Example 1

Mary Alma rents one room in her house. The total square footage of her house is 1,000 square feet. The rental room measures 10 feet by 10 feet (100 square feet). She may deduct 10% of any allowable expense that benefited the renter. She may deduct 100% of any expenses that relate only to the rental portion of the house, such as painting the rented room.

Exercise 1

Mary Alma, in the example above, has the following expenses attributable to the entire property:

Taxes	\$ 1,000
Utilities	\$ 600
Mortgage Interest	\$ 800
Depreciation	\$ 500

Also wallpapering expense of \$100 for the tenant's room only.

a. What are the allowable expense deductions on Schedule E?

Answer: _____

b. What are the allowable expense deductions on Schedule A?

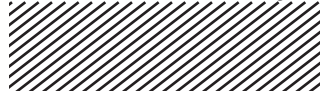
Answer: _____

For property changed to rental use in the tax year other than the beginning of the year, the allocation of expenses should be made between the number of days in the year for personal use and the number of days for rental use.

Example 2

John Princeton is transferred overseas and begins renting out his residence on October 1, 2005. For 2005, he may deduct three-twelfths (25 percent) of his yearly expenses such as taxes, interest and utilities as rental expenses.

Vacation Home and Other Dwelling Units. Certain limitations apply to rental expenses for vacation homes or other dwellings that are used by the taxpayer for personal use during the year. A dwelling unit for this purpose includes a house, apartment, condominium, mobile home, boat or similar property. However, the limitation



does not apply to hotel, motel, inn or similar dwelling unit. The limitation on deductions applies if a dwelling unit is used as a residence during the tax year for personal purposes for greater than:

1. 14 days or
2. 10 percent of the number of days during the tax year the property is rented at fair market value.

See Publication 527 for a discussion of the limitations.

Use as home before or after renting. If you use a dwelling unit as your main home before or after renting it, or trying to rent it, you may not have to count the days you use it as your main home as days of personal use.

12 months or more. If for 12 or more consecutive months, you rent or try to rent a dwelling unit at a fair rental price, some of the days on which you use the property as your main home are not counted as days of personal use.

Do not count as days of personal use the days you used the property as your main home.

- a) During the year in which you began renting it or offering it for rent, but before you began renting it or offering it for rent, or
- b) During the year in which you stopped renting it or offering it for rent, but after you stopped renting it or offering it for rent.

Example 3

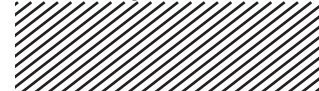
On February 28, 2003, you moved out of the house you had lived in for 6 years because you accepted a job in another town. You rent your house at a fair rental price from March 15, 2003, to May 14, 2005. On June 1, 2005, you move back to town and move back into your house.

Your use of the house as your main home from January 1 to February 28, 2003, and from June 1 to December 31, 2005, is not counted as personal use.

Since these days are not counted as days of personal use the limitations on deductions discussed above do not apply.

Depreciation

The cost of property with a useful life of one year or more and used in a trade or business or held for the production of income is recovered by allowing an annual deduction called depreciation. The most common methods for the depreciation are called ACRS (Accelerated Cost Recovery System) for property placed in service after 1980 and before 1987 and MACRS (modified ACRS) for property placed in service after 1986. Both of these depreciation methods have an alternative method that may be chosen that generally increases the number of years the property is depreciated over and



therefore decreases the annual deduction. The method used for property placed in service before 1981 is referred to as straight line or declining balance.

Depreciable property includes buildings, machinery, furniture, equipment and vehicles. As discussed earlier any cost for additions or improvements to the rental property must also be depreciated. Depreciation is allowed or allowable. What this means is, if you did not claim depreciation that you were entitled to claim in an earlier year you must still reduce your basis in the property by the amount of depreciation that you did not deduct. The depreciation deduction is determined by considering several factors. These factors are discussed next in this chapter. When depreciating real property the value of land is not depreciable.

Basis. The total of the yearly deductions for depreciation can never total more than the cost or other basis of the property. Generally, the cost (purchase price) of the property including the cost of improvements is the basis for depreciation. However, if the taxpayer acquired the property, other than buying it, the basis may be figured differently than using the original cost. An example is an acquisition through inheritance or gift. For further information on the basis of inherited or gifted property refer to Publication 551, Basis of Assets. When property is converted from personal use to rental use the basis is the lesser of the adjusted basis or fair market value (FMV) at the time of conversion.

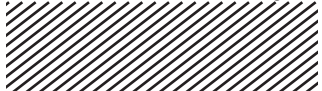
Example 4

Jen and Tom purchased a house in 1986 for \$85,000. In 2005, they were transferred overseas and decided to rent out their personal residence. The value in 2005 was \$125,000. The basis for depreciation is \$85,000. Assume that the value of land was excluded in determining the cost of the house.

Adjusted Basis. The basis of property must be increased or decreased to reflect certain adjustments before the depreciation deduction is computed. For example, to the purchase price of a home add the cost of any improvements, minus any casualty losses or depreciation previously deducted and minus the land value to find the adjusted basis. Since land can never be depreciated, an allocation between land and building must be done based generally on assessed value. Where property is acquired in a purchase along with a trade-in, the basis must be adjusted.

Example 5

Neil Bates traded in old appliances used for his rental property with an adjusted basis of \$500 and got new appliances with a fair market value of \$2,000. He paid \$1,000.00 in cash, his basis for depreciation in the new appliances is \$1,500 (the \$500 adjusted basis plus the \$1,000 cash).



Placed in Service. For depreciation purpose, property is considered placed in service when it is in a condition or state of readiness and availability for use. However, a depreciation deduction may not be claimed until the property is used in business or for the production of income.

Property Classes and Recovery Periods. The Accelerated Cost Recovery System (ACRS) and Modified Accelerated Cost Recovery System (MACRS) use the class life of depreciable property to determine the recovery period. If property was used as a personal residence before 1987 and converted to rental property after 1986, use the MACRS method to figure depreciation. Under MACRS, tangible property used in a rental activity generally falls into a 5-, 7-, or 27.5-year recovery period.

A home converted in 1998 to a rental property would be depreciated over a recovery period of 27.5 years. A stove also used in this same rental would be assigned a 7 year recovery period. Property, both real and personal, located outside the United States has a longer recovery period. Although the true physical life of the property may be less, under MACRS the recovery period is fixed. MACRS requires that a convention for half-year or mid-quarter be used. Under this special rule, in the year the property is placed in service the depreciation deduction is prorated. Publication 946, How to Depreciate Property, contains tables of depreciation with the conventions already incorporated. Examples of the tables are shown below.

MACRS charts

Table A

MACRS 5-Year Property

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	3.68



Table B**MACRS 7-Year Property**

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	14.29%	25.00%	17.85%	10.71	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06

Table I, II**Table 1****Residential Rental Property (27.5-year)**

Year	Use the column for the month of taxable year placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
1	3.485%	3.182%	2.879%	2.576%	2.273%	1.970%	1.667%	1.364%	1.061%	0.758%	0.455%	0.152%
2	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%
3	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%
4	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%

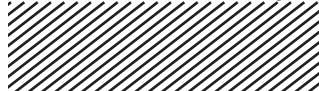
Table 2**Residential Rental Property (31.5-year)**

Year	Use the column for the month of taxable year placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
1	3.042%	2.778%	2.513%	2.249%	1.984%	1.720%	1.455%	1.190%	0.926%	0.661%	0.397%	0.132%
2	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%
3	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%
4	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%

For property located outside of the United States, the taxpayer must use an alternative method of depreciation under MACRS. Therefore, residential rental property located in a foreign country would be depreciated over a 40-year recovery period.

REPORTING DEPRECIATION

The depreciation deduction is shown on line 20 of Schedule E (see Exhibit 2). Use Form 4562, Depreciation and Amortization only if you placed an asset in service in the current year, you depreciate listed property or you claim a Section 179 expense.



19	Add lines 5 through 18	19						19	
20	Depreciation expense or depletion (see page E-4)	20						20	
21	Total expenses. Add lines 19 and 20	21							
22	Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-4 to find out if you must file Form 6198	22							
23	Deductible rental real estate loss. Caution. Your rental real estate loss on line 22 may be limited. See page E-4 to find out if you must file Form 8582 . Real estate professionals must complete line 43 on page 2	23	()	()	()	
24	Income. Add positive amounts shown on line 22. Do not include any losses	24							
25	Losses. Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here	25	()					
26	Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 41 on page 2	26							

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11344L

Schedule E (Form 1040) 2005

AT-RISK AND PASSIVE LOSS

Very often rental property shows a net loss because the rental expenses are greater than the rental income. In this situation there are two potential restrictions on how much of the loss can offset other sources of income.

The first restriction is the at-risk rule. This rule provides that you can claim a loss for no more than you could actually lose from the activity. That is, you can claim a loss only up to the amount for which you are personally at-risk in the activity. Generally you are considered at-risk for the amount of cash and property contributed to the activity from which you are not protected against personal liability with the exception of casualty insurance.

The Tax Reform Act of 1986 added other limitations to deducting rental losses. Prior to the law, losses from passive activities could offset all other income (for example wages, interest, and dividends) without any restrictions. Rental activities, by definition of the law, are always considered to be a passive activity. The passive activity law states that passive activity losses can only be deducted from passive activity income. A passive activity is a trade or business being conducted without that taxpayer materially participating. Material participation may be defined by the regular continuous and substantial involvement of the taxpayer in the operation of the trade or business, where for rental property active participation does not require regular, continuous and substantial involvement. Active participation requires that the taxpayer participate in making management decisions or arranging for others to provide services in a significant and bona fide sense. Management decisions include approving new tenants, setting rental terms, approving capital or repair expenditures and similar decisions.



It is important to understand the difference between active and material participation as it pertains to rentals, because of a special \$25,000 offset allowed for certain rental losses. Rental losses up to \$25,000 (\$12,500 for married taxpayers filing separate and living apart for the entire year) may be used to offset any and all non-passive income if the taxpayer actively participates in the residential rental activity. The following list is an example of nonpassive income.

1. Salaries, wages, commissions or tips.
2. Self-Employment income from a trade or business in which the taxpayer materially participates (may be partnership, but not limited partnership income).
3. Distributive shares of income through pass-through entities (such as S corporations) that is not income from a passive activity.
4. Portfolio income (gross income from interest, dividends, annuities, or some royalties).

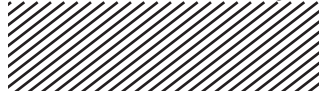
Example 6

Lynn Ferris, a United States citizen, lives in Europe and has wages paid by the U.S. Government of \$25,000 and interest income of \$100. She rented out her home located in the United States in 2005, and incurred \$1,000 in rental loss. Although her sister collects the rent, Lynn makes all of the bottom line decisions as to whom, and, for what amount, the property will be rented. While Lynn is outside of the United States, she pays her sister to manage the property. The rental loss of \$1,000 may be offset against her gross income of \$25,100 because she is considered to be an active participant in the rental activity.

Phase-Out of Offset. The amount allowed to offset nonpassive income is reduced once the taxpayer's adjusted gross income exceeds \$100,000 (\$50,000 for married filing separately). It is completely phased out when AGI exceeds \$150,000 (\$75,000 for married filing separately). Refer taxpayers with an AGI over \$100,000 to the Internal Revenue Service or a professional preparer.

REPORTING RENTAL LOSS

Form 8582, Passive Activity Loss Limitations is filed to summarize losses and income from all passive activities. Check the instructions for Form 1040 to determine if the taxpayer is required to file Form 8582 when he or she has rental losses. Generally, taxpayers who have only one passive loss generated from a rental activity and an adjusted income of less than \$100,000 will not be required to file Form 8582. If any questions arise beyond the scope of this lesson regarding filing Form 8582, refer the taxpayer to the Internal Revenue Service or a professional preparer.



SELLING RENTAL PROPERTY

The sale of rental property is reported on Form 4797, Sales of Business Property. A gain is the amount realized minus the adjusted basis of the property.

Example 7

Pat Drake sold her rental property for \$60,000. She had purchased the house for \$30,000 and had claimed \$10,000 for depreciation. Her gain is \$40,000.

The gain is figured as follows:

1. Selling price		\$60,000
2. Less selling expenses		<u>0</u>
3. Amount realized		<u>\$60,000</u>
4. Basis	\$30,000	
5. Less depreciation	<u>\$10,000</u>	
6. Adjusted basis	\$20,000	<u>\$20,000</u>
7. Gain (line 3 minus 6)		<u>\$40,000</u>

The gain may be either capital gain or ordinary gain depending on the depreciation claimed. If part of the property was also used for personal uses, the sale is reported as two separate sales. A loss is the adjusted basis of the property minus the amount realized. A loss for any personal use of property cannot be deducted.

▶▶ SUMMING UP THIS SEGMENT ◀◀

As a volunteer, you will assist taxpayers who have rental properties. In this lesson you learned what qualified as rental income and rental expenses. You studied how to figure and report the following:

- ▶ The proration needed when the property is used both for personal and rental purposes.
- ▶ Depreciation expense.
- ▶ Rental losses.

ANSWERS

Exercise 1

- \$390 (10% of total expenses of \$2,900=\$290 plus \$100 for wallpaper)
- \$1,620 ($1,800 \times .90 = 90\%$ of mortgage interest and taxes)



STUDENT NOTES

DEDUCTIONS AND TAX COMPUTATIONS

Lesson 4

INTRODUCTION AND OBJECTIVES

In this lesson you will learn about the standard deduction, itemized deductions and tax computations. You will learn which expenses can be included in itemized deductions. You will also learn when the taxpayer will use the tax tables and the Qualified Dividends and Capital Gain Tax Worksheet to compute their total tax.

After completing this lesson you should be able to:

- Identify the correct standard deduction.
- Calculate and accurately report itemized deductions on Schedule A.
- Identify the miscellaneous deductions reported on Schedule A, line 27.
- Complete the Qualified Dividends and Capital Gain Tax Worksheet.
- Explain the process to calculate and report tax liability.

STANDARD DEDUCTION

The standard deduction is a dollar amount that reduces the amount of income on which you are taxed. The **standard deduction** depends on:

- the taxpayer's filing status,
- whether the taxpayer (or the taxpayer's spouse) is 65 or older and/or blind, and
- whether the taxpayer can be claimed as a dependent on another taxpayer's return.

Based on the taxpayer's situation, you will figure the standard deduction by using one of the following:

- *Standard Deduction Chart for Most People* (Exhibit 1),
- *Standard Deduction Chart for People Age 65 or Older or Blind*, (Exhibit 2) or
- *Standard Deduction Worksheet for Dependents* (Exhibit 3).

ALERT



This lesson contains tax law and information relating to all courses of training. Your course facilitator will only teach the information required to assist taxpayers you will serve.

ALERT



Remind students that Publication 4012, Volunteer Resource Guide, has the Standard Deduction charts, and amounts.

Exhibit 1 Standard Deduction Chart for Most People*

If Your Filing Status is...	Your Standard Deduction is...
Single or Married filing separate return	\$5,000
Married filing joint return or Qualifying widow(er) with dependent child	10,000
Head of household	7,300

*Do not use this chart if you were born before January 2, 1941, you are blind, or if someone else can claim an exemption for you (or your spouse if married filing jointly). Use Exhibit 2 or Exhibit 3 instead.

Exhibit 2 Standard Deduction Chart for People Born Before January 2, 1941 or Who Are Blind*

Check the correct number of boxes below. Then go to the chart.

You Born before January 2, 1941 Blind

Your spouse, if claiming spouse's exemption Born before January 2, 1941 Blind

Total number of boxes you checked

IF your filing status is...	AND the number in the box above is...	THEN your standard deduction is...
Single	1	\$6,200
	2	7,400
Married filing joint return or Qualifying widow(er) with dependent child	1	10,950
	2	11,900
	3	12,850
	4	13,800
Married filing separate return	1	5,950
	2	6,900
	3	7,850
	4	8,800
Head of household	1	8,500
	2	9,700

*If someone else can claim an exemption for you (or your spouse if married filing jointly), use Exhibit 3 instead.



If you are married filing a separate return and your spouse itemizes deductions, or if you are a dual-status alien, you cannot take the standard deduction even if you were born before January 2, 1941 or you are blind.

Exhibit 3 Standard Deduction Worksheet for Dependents*

If you were born before January 2, 1941 or you are blind, check the correct number of boxes below. Then complete the worksheet.

You Born before January 2, 1941 Blind

Your spouse, if claiming spouse's exemption Born before January 2, 1941 Blind

Total number of boxes you checked

1. Enter your earned income (defined below). If none, enter -0-.	1. _____
2. Additional amount	2. <u>\$250</u>
3. Add lines 1 and 2.	3. _____
4. Minimum amount.	4. <u>\$800</u>
5. Enter the larger of line 3 or line 4.	5. _____
6. Enter the amount shown below for your filing status. <ul style="list-style-type: none"> • Single or Married filing separately—\$5,000 • Married filing jointly or Qualifying widow(er) with dependent child—\$10,000 • Head of household—\$7,300 	6. _____
7. Standard deduction. <ul style="list-style-type: none"> a. Enter the smaller of line 5 or line 6. If under 65 and not blind, stop here. This is your standard deduction. Otherwise, go on to line 7b. b. If 65 or older or blind, multiply \$1,250 (\$1,000 if married or qualifying widow(er) with dependent child) by the number in the box above. c. Add lines 7a and 7b. This is your standard deduction for 2005. 	7a. _____ 7b. _____ 7c. _____

Earned income includes wages, salaries, tips, professional fees, and other compensation received for personal services you performed. It also includes any amount received as a scholarship that you must include in your income.

*Use this worksheet only if someone else can claim an exemption for you (or your spouse if married filing jointly).

ALERT



At the time this lesson went to print these charts were the most current. However, the charts have since been updated. All the answers to the exercises in this lesson are based on the charts that appear on this page. Publication 4012 has the final charts for 2005.

Example 1

Bob is 60 years old and is married to Janice, age 59. If they are filing a joint return and neither is blind, they can enter \$10,000 on either Form 1040 or Form 1040A for their standard deduction amount.

Example 2

John is 83 years old, blind, and files a single tax return. To find his standard deduction, use the *Standard Deduction Chart for People Age 65 or Older or Blind*. His standard deduction is \$7,400.

PERSONAL EXEMPTION IN CONNECTION WITH STANDARD DEDUCTION ON FORM 1040EZ

If the taxpayer (or spouse, if married filing a joint return) can be claimed as a dependent on another taxpayer's return, check the *Yes* box on line 5 of the Form 1040EZ. To fill in the amount on line 5 for this taxpayer, you must then turn the form over and complete the worksheet (Exhibit 4 shows a completed worksheet from Form 1040EZ, page 2).

If the taxpayer (or spouse, if filing a joint return) cannot be claimed as a dependent on another taxpayer's return, check the *No* box on line 5. Enter on line 5 the amount shown below that applies to the taxpayer (and spouse, if married filing jointly).

A. Single, enter \$8,200. This is the total of the taxpayer's standard deduction (\$5,000) and personal exemption (\$3,200).

B. Married, enter \$16,400. This is the total of the taxpayer's and spouse's standard deduction (\$10,000), exemption for the taxpayer (\$3,200), and exemption for the taxpayer's spouse (\$3,200).

Exhibit 4

Form 1040EZ, page 2

<p>Worksheet for dependents who checked "Yes" on line 5 (keep a copy for your records)</p>	Use this worksheet to figure the amount to enter on line 5 if someone can claim you (or your spouse if married filing jointly) as a dependent, even if that person chooses not to do so. To find out if someone can claim you as a dependent, use TeleTax topic 354 (see page 6).
	<p>A. Amount, if any, from line 1 on front <u>4,650.00</u></p>
	<p style="text-align: right;">+ <u>250.00</u> Enter total ▶</p>
	<p>B. Minimum standard deduction B. <u>800.00</u></p>
	<p>C. Enter the larger of line A or line B here C. <u>4,900.00</u></p>
	<p>D. Maximum standard deduction. If single, enter \$5,000; if married filing jointly, enter \$10,000 D. <u>5,000.00</u></p>
	<p>E. Enter the smaller of line C or line D here. This is your standard deduction E. <u>4,900.00</u></p>
	<p>F. Exemption amount.</p> <ul style="list-style-type: none"> ● If single, enter -0-. ● If married filing jointly and— <ul style="list-style-type: none"> —both you and your spouse can be claimed as dependents, enter -0-. —only one of you can be claimed as a dependent, enter \$3,200.
	<p>G. Add lines E and F. Enter the total here and on line 5 on the front . . . G. <u>4,900.00</u></p>
	<p>If you checked "No" on line 5 because no one can claim you (or your spouse if married filing jointly) as a dependent, enter on line 5 the amount shown below that applies to you.</p> <ul style="list-style-type: none"> ● Single, enter \$8,200. This is the total of your standard deduction (\$5,000) and your exemption (\$3,200). ● Married filing jointly, enter \$16,400. This is the total of your standard deduction (\$10,000), your exemption (\$3,200), and your spouse's exemption (\$3,200).

Example 3

Clarence is 21 years old and a full-time student. He is single and can be claimed as a dependent on his parents' tax return. Clarence works part-time and earned \$4,650 during 2005. His savings account earned \$56 in interest. Clarence's standard deduction is \$4,900. See Exhibit 4 above.

POTENTIAL PITFALLS



Entering an incorrect standard deduction amount is a frequently made error on tax returns. Take care to report the correct standard deduction amount.

Exercise 1

Use Exhibits 1 thru 3 on page 5-2 to determine the standard deduction amounts below.

- A.** James is 27 years old. He has two children who live with him and he files as head of household. What is James' standard deduction? _____
- B.** Paul is 47 years old. He was divorced in 2005. He is blind and has no dependent children. What is Paul's standard deduction? _____
- C.** Carl is 69 years old and married to Sue, who is 60 years old. Neither is blind. If they file a joint return, what is their standard deduction? _____
- D.** If they are filing separate returns, what is Carl's standard deduction? _____
- E.** If they are filing separate returns, what is Sue's standard deduction? _____
- F.** Shirley is 17 years old and is claimed as a dependent on her parents' tax return. She earned \$2,000 during the summer and deposited it all into her savings account, where she earned \$50 in interest. What is her standard deduction? _____

FINDING THE TAX

Taxpayers with taxable income of less than \$100,000 use the Tax Table to find their tax. The Tax Table is in Publication 678W. The tax is based on the person's filing status and taxable income. To find the tax, use the **taxable income** from the tax form 1040EZ, line 6. Tax forms 1040A and 1040 are discussed later.



Stop here for the basic course.

Go to Lesson 5, page 5-1.

All others continue.

Taxpayers can either claim the standard deduction or itemize their deductions. Both the standard deduction and itemized deductions reduce adjusted gross income. Most taxpayers choose the larger of their itemized deductions or the standard deduction. However, there are some exceptions:

- A married taxpayer filing a separate return cannot claim the standard deduction if the taxpayer's spouse itemizes deductions, and
- Nonresident aliens cannot claim the standard deduction.

When itemizing, you should complete the taxpayer's return through line 38 of Form 1040. Then figure itemized deductions on Schedule A.

Medical and Dental Expenses

Claim medical and dental expenses paid in 2005 on lines 1 through 4 of Schedule A. Include expenses incurred for:

- the taxpayer and spouse,
- dependents claimed on the return, and
- others who could have been claimed as dependents except that they had gross income of \$3,200 or more, or they filed a joint return.

If a child of divorced or separated parents is claimed as a dependent on either parent's return, each parent may deduct the medical expenses that he or she pays for the child.

Deductible expenses include:

- Prescription medicines and drugs (including insulin)
- Medical, dental, and nursing care, including amounts paid for unreimbursed qualified long-term care services (some senior residences have an amount in the monthly cost which is a medical or nursing care expense).
- Medical and hospital insurance premiums (if not paid with pre-tax dollars), including amounts paid for eligible long-term care (subject to certain limitations based on the insured person's age — see Exhibit 5, next page).
- Prescription eyeglasses, hearing aids, crutches, wheelchairs, braces, and guide dogs
- Transportation for medical care at 15 cents a mile, or actual out-of-pocket expenses, plus parking fees and tolls
- Certain lodging expenses
- Certain home improvements made for medical care purposes or to make the home suitable for a disabled person
- Medicare A premiums for persons not enrolled in Social Security
- Medicare B which is a supplemental medical insurance.

POTENTIAL PITFALLS

Explain to taxpayers that they can only deduct expenses in the year they are paid. They cannot deduct expenses that are owed but not paid.

ALERT

The standard mileage rate for operating a vehicle for medical transportation is 15 cents a mile.

- Certain weight-loss programs to treat disease diagnosed by a physician, including obesity
- Unreimbursed costs of smoking-cessation programs, including the cost of prescription drugs designed to alleviate nicotine withdrawal
- Expenses for admission and transportation to a medical conference relating to the chronic disease of a dependent (if the costs are primarily for and essential to the medical care of the dependent).
- Operations that are not for unnecessary cosmetic surgery.
- Cosmetic surgery if it is necessary to improve a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or a disfiguring disease. **Example.** An individual undergoes surgery that removes a breast as part of treatment for cancer. A surgeon is paid to reconstruct the breast. The surgery to reconstruct the breast corrects a deformity directly related to a disease. The cost of the surgery is includible in the individual's medical expenses.

Total medical and dental expenses must exceed 7.5 percent of a taxpayer's adjusted gross income (Form 1040, line 38) for Schedule A deduction.

Nondeductible expenses include:

- Medical expenses paid from a medical savings account (MSA). [Refer taxpayers with MSAs to Publication 969, *Medical Savings Accounts (MSAs)*, Publication 502, *Medical and Dental Expenses*, and a paid professional tax preparer.]
- Payroll tax paid for Medicare A
- Life insurance policy premiums
- Babysitting, child care, and nursing care for a normal healthy baby
- Controlled substances
- Nonprescription drugs or medicines
- The cost of purchasing diet food items
- Nonprescription nicotine gum and patches designed to stop smoking
- Funeral, burial, or cremation costs
- Unnecessary cosmetic surgery (surgery that does not correct a congenital abnormality or an abnormality caused by injury or disease)
- Income protection policies, including nursing home policy premiums, if the policy ensures a maximum out-of-pocket expense per day
- Meals and lodging while attending a medical conference relating to the chronic disease of a dependent.

Eligible Long-Term Care Premiums

Exhibit 5

IF the person was, at the end of 2005, age . . .	THEN the most you may deduct is . . .
40 or under	\$270
41-50	\$510
51-60	\$1,020
61-70	\$2,720
71 or older	\$3,400

Exercise 2

Sam and Paula Ferris file a joint return. Sam's social security number is xxx-xx-xxxx. Their adjusted gross income is \$45,000. They paid the following medical bills:

Unreimbursed doctor's bills	\$ 600
Unreimbursed orthodontist bill for braces	1,000
Hospital insurance premiums	200
Life insurance premiums	400
Unreimbursed prescription medicines	200
Vitamins	100
Hospital bill (before deducting \$500 reimbursed by insurance company)	1,000
Smoking cessation program	200

Complete the *Medical and Dental Expenses* section of Schedule A for the Ferris family.

Exhibit 6

Schedule A, lines 1 through 4

SCHEDULES A&B (Form 1040)		Schedule A—Itemized Deductions (Schedule B is on back)		OMB No. 1545-0074	
Department of the Treasury Internal Revenue Service (99)		▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).		2005 Attachment Sequence No. 07	
Name(s) shown on Form 1040				Your social security number	
Medical and Dental Expenses	Caution. Do not include expenses reimbursed or paid by others.				
1	Medical and dental expenses (see page A-2)	1			
2	Enter amount from Form 1040, line 38	2			
3	Multiply line 2 by 7.5% (.075)	3			
4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4			

Taxes

To be deductible, a tax must be imposed on and paid by the taxpayer. Taxpayers **cannot** deduct:

- a tax that they do not owe, but pay for someone else,
- a tax that they owe, but someone else pays, or
- a tax that was not paid in 2005.

Report deductible taxes on lines 5 through 9 of Schedule A.

State and Local Income or General Sales Taxes

The taxpayer can elect to deduct state and local general sales taxes instead of state and local income taxes. The taxpayer cannot deduct both.

State and Local Taxes — State and local taxes that are deductible are either withheld taxes, estimated tax payments, or other tax payments made during the year.

Taxpayers who receive a refund of state and local income taxes in a year after the year in which they were paid, may have to report the refund as income on line 10 of Form 1040, as taxable refunds.

If the taxpayer did not itemize their deductions in the previous year, then they are not required to include the refund as income.

If the taxpayer deducted taxes on Schedule A in the previous year, then the refund should be included on line 10 as taxable refunds. If the taxpayer deducts State and Local Income taxes check box “a” on line 5 and enter the state and local income taxes.

State and Local General Sales Taxes — If the taxpayer elects to deduct state and local general sales taxes he or she must check box “b” on line 5 of the Schedule A. To figure the state and local sales tax deduction, either the actual expenses or the tables contained in Publication 600, *Optional State Sales Tax Tables*, or the *Optional State and Certain Local Sales Tax Tables of the Schedule A Instructions* can be used.

The taxpayer may also be able to add the following items to the table amount.

- Local general sales tax if his or her locality imposes a general sales tax.
- State and local general sales taxes paid on certain specified items such as motor vehicles, boats, aircrafts, and a home or a substantial addition or major renovation to a home may be added to the taxable amount.

To compute the state and local general sales tax deduction using the *Optional State Sales Tax tables* the taxpayer must know his or her available income. Total available income is the amount shown on Form 1040, line 38 (AGI), plus any nontaxable items such as tax-exempt interest, veterans benefits, nontaxable combat pay, workers’ compensation, nontaxable part of social security and railroad retirement benefits, nontaxable part of IRA, pension, or annuity distributions (do not include rollovers), and public assistance payments.

Example 4

Tom and Mary Gordan are itemizing their deductions. Tom had wages of \$31,000 in 2005. Mary had wages of \$4,000 in 2005 before being injured at her job. She received \$6,300 of worker’s compensation benefits for 2005. Their total available income for purposes of computing the *Optional Sales Tax* is \$41,300.

Real Estate Taxes — State, local, or foreign taxes on real property, such as the taxpayer's house or land, are deductible. Any rebate of property taxes received in the tax year must be subtracted from property taxes. Real estate taxes are deductible when paid. If the taxes are paid with a mortgage payment and held in escrow, do not deduct the taxes until they are paid by the bank or mortgage lender.

Members of the clergy and military personnel can deduct real estate taxes even if they receive a housing allowance that is excluded from income. Also, they can deduct allowable mortgage interest even if the interest was paid from a nontaxable housing allowance.

Assessments to pave a street or install lighting or a sewer generally are not deductible.

Personal Property Taxes — Taxes that state and local governments charge on the value of personal property are deductible (for example, ad valorem taxes paid on car tags). A portion of the cost of personal vehicle registration may fall in this category.

Nondeductible Taxes — Many federal, state, and local government taxes are not deductible. The following taxes are not deductible:

- Federal taxes—income tax, social security (FICA), Medicare, railroad retirement tax, gift tax, and excise taxes or customs duties
- Hunting licenses and dog licenses
- Water and sewer taxes
- Taxes on alcoholic beverages, cigarettes, and tobacco
- State, local, and federal taxes on gasoline, diesel, and other motor fuels used in a nonbusiness vehicle
- Utility taxes — telephone, gas, electricity, etc.

Interest

Interest is the amount that is paid in order to borrow money. Only taxpayers who are legally liable for the debt can deduct the interest in the year it is paid or accrued. Interest expenses are reported on lines 10 through 14 of Schedule A.

Home Mortgage Interest — The amount of mortgage interest that a taxpayer can deduct depends on the:

- date of the loan,
- amount of the loan, and
- use of the proceeds of the loan.

POTENTIAL PITFALLS

Personal interest cannot be claimed as an itemized deduction. Personal interest includes interest on car loans, credit card balances, and installment plan loans that are incurred for personal use or for personal expenses.

If the mortgage debt was incurred on or before October 13, 1987, and was secured by a main or second home, the interest on that debt is fully deductible, regardless of the amount of the loan or the use of the loan proceeds.

If the mortgage debt was incurred after October 13, 1987, and was secured by a main or second home, the interest is fully deductible if:

- the loans plus any grandfathered debt do not exceed \$1 million (\$500,000 if married filing separate returns), and
- the proceeds were used to buy, build, or improve the home or homes.

In addition to loans used to buy, build, or improve a main or second home, taxpayers can deduct interest on other loans secured by a main or second home, regardless of the use of the proceeds, if:

- the total of these loans does not exceed \$100,000 (\$50,000 if married filing separate returns), and
- the total amount of the secured debt is not more than the home's fair market value minus any outstanding acquisition debt and any grandfathered debt on the home.

Points. Certain charges paid by a borrower and/or a seller to a lender to secure a loan are called points. They are also called loan origination fees (including VA and FHA loan origination fees), maximum loan charges, premium charges, loan discount, or discount points.

Points paid only for the use of money are considered prepaid interest. This interest, even if it qualifies as home mortgage interest, must be spread over the life of the mortgage and is considered paid and deductible over that period unless it meets the following exception.

Exception. A taxpayer may fully deduct points in the year he or she pays them only if all of the following conditions apply:

- The taxpayer itemizes deductions.
- The taxpayer's loan is secured by his or her main home. (The main home is the one the taxpayer lives in most of the time.)
- Paying points is an established business practice in the area where the loan was made.
- The points paid were not more than the points generally charged in that area.
- The taxpayer uses the cash method of accounting. (The cash method means that the taxpayer reports income in the year received and deducts expenses in the year paid.)
- The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.

- The taxpayer uses his or her loan to buy or build his or her main home.
- The points were computed as a percentage of the principal amount of the mortgage.
- The amount is clearly shown on the settlement statement (such as Form HUD-1) as points charged for the mortgage.
- The points may be shown as paid from either the taxpayer's or the seller's funds.
- The funds the taxpayer provided at or before closing, plus any points the seller paid, were at least as much as the points charged. The funds the taxpayer provided do not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds the taxpayer paid at or before closing for any purpose. The taxpayer cannot have borrowed these funds from his or her lender or mortgage broker.

Charges by the lender for specific services, such as appraisal fees, preparation costs, VA funding fees, or notary fees, may be called points. However, these charges are not considered interest and are not deductible.

Points paid by the seller are deductible as interest by the buyer.

Points paid to refinance a mortgage are generally not deductible in full in the year the taxpayer paid them (unless they are paid in connection with the improvement of a main home and the first seven statements, discussed earlier under Exception, are true).

Points paid in excess of those generally charged in the area and points paid to refinance a mortgage can be deducted over the life of the mortgage. Deduct points reported to the taxpayer on Form 1098 on line 10 of Schedule A (Form 1040). Deduct points not reported to the taxpayer on Form 1098 on line 12 of Schedule A (Form 1040).

Investment Interest. Interest that is paid on money borrowed to buy or carry property held for investment is called **investment interest**. Taxpayers with investment interest expense that exceeds investment income (interest and ordinary dividend income) should see a paid professional tax preparer.

Interest that cannot be deducted. Interest that cannot be deducted includes:

- Interest on car loans where the car is used for personal use and other personal loans,
- Credit investigation fees,
- Loan fees; aid for services necessary to get a loan,
- Interest on a debt the taxpayer is not legally liable to pay, and
- Finance charges on credit card purchases of personal items.

Exercise 3

John and Shannon file a joint return. During the year, they paid the bank \$3,130 of interest on their home mortgage that was reported to them on Form 1098 (all qualified), \$500 in credit card interest, \$700 on an installment loan, and \$5,000 on a car loan. Complete the *Interest You Paid* section of Schedule A for John and Shannon.

Exhibit 7

Schedule A, lines 10 through 14

Interest You Paid (See page A-3.) Note. Personal interest is not deductible.	10	Home mortgage interest and points reported to you on Form 1098	10			
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-4 and show that person's name, identifying no., and address ▶				
	12	Points not reported to you on Form 1098. See page A-4 for special rules	11			
	13	Investment interest. Attach Form 4952 if required. (See page A-4.)	12			
	14	Add lines 10 through 13	13			14

Contributions

Taxpayers can deduct contributions to organizations that are:

- Organized and operated exclusively for religious, charitable, educational, scientific, or literary purposes,
- Organizations that work to prevent cruelty to children or animals, and
- Organizations that foster national or international amateur sports competition if they do not provide athletic facilities or equipment.

To be deductible, contributions must be made to an organization, not an individual. *Qualifying organizations* include:

- Churches, synagogues, temples, mosques, Salvation Army, Red Cross, CARE, United Way, Boy Scouts, Girl Scouts, World Wildlife Fund, etc.,
- Fraternal orders (if used for the purposes listed above),
- Nonprofit schools and hospitals,
- Nonprofit medical research organizations,
- Veterans' groups and certain cultural groups, and
- Federal, state, and local governments (if the gifts are exclusively for public purposes),
- Tsunami relief (cash contributions made January 2005 and deducted on the 2004 tax return cannot be deducted on the 2005 tax return).

Nonqualifying organizations include:

- Business organizations, such as the Chamber of Commerce,
- Civic leagues and associations,
- Political organizations and candidates,
- Social clubs,
- Foreign organizations,
- Homeowners' associations, and
- Communist organizations.

Deductible items include:

- Money gifts,
- Dues, fees, and assessments paid to qualified organizations above the value of the benefits received (not country clubs or other social organizations),
- Fair market value (FMV is the price at which the property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the necessary facts.) of used clothing, furniture, (i.e., the price paid in used clothing stores, consignment shops, and thrift stores)
- Cost and upkeep of uniforms that have no general use but must be worn while performing donated services,
- Unreimbursed transportation expenses that relate directly to the services the taxpayer gave the qualified organization, including bus fare, parking fees, tolls, and either the actual cost of gas and oil or a standard mileage charge of 14 cents per mile, and
- The part of a contribution above the fair market value for items such as merchandise and tickets to charity balls or sporting events.
- If the taxpayer donates a car to a qualified organization in 2005, the deduction is limited to the gross sales proceeds the organization received from the sale of the car. This rule applies if the value of the donated vehicle is more than \$500. If the organization makes significant use of or materially improves the car, the taxpayer can generally deduct its market value. These rules also apply to donations of boats, aircraft, and vehicles manufactured mainly for use on public streets, roads, and highways.

Beginning in 2005, Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes is used by donee organizations to report the contribution of qualified vehicles to the Internal Revenue Service. The form may also be used to provide the donor with an existing written acknowledgment of the contribution.

POTENTIAL PITFALLS 

If the taxpayer makes a contribution to a qualifying organization that is more than \$75 and is partly for goods or services, the qualifying organization must give the taxpayer a written statement. For more information, see Publication 526, *Charitable Contributions*.

Nondeductible items include:

- Cost of raffle, bingo, or lottery tickets,
- Tuition,
- Value of a person’s time or service,
- Blood donated to a blood bank or the Red Cross,
- Car depreciation, insurance, general repairs, or maintenance,
- Direct contributions to an individual,
- Sickness or burial expenses for members of a fraternal society, and
- The part of a contribution that personally benefits the taxpayer (such as the fair market value of the meal eaten at a charity dinner).

Report cash and check contributions on Schedule A, line 15. Contributions other than cash or check are entered on line 16. Taxpayers with noncash contributions exceeding \$500 should see a paid professional tax preparer.

The taxpayer must keep records to prove the amount of the cash and noncash contributions he or she makes during the year.

A taxpayer can claim a deduction for any single contribution of \$250 or more **only** if he or she has a written acknowledgment of the contribution from the qualifying organization. You do not have to see the written acknowledgement, but you should ask the taxpayer if they have one.

Exercise 4

Rose contributed \$800 to St. Martin’s Church (church gave letter verifying amount), \$25 to the Girl Scouts, and \$100 to a family whose house burned. She purchased \$100 worth of lottery tickets and spent \$200 playing bingo at her church. She donated used furniture with a fair market value of \$400 to Goodwill.

Complete the *Gifts to Charity* section of Schedule A for Rose.

Exhibit 8

Schedule A, lines 15 through 18

Gifts to Charity	15	Gifts by cash or check. If you made any gift of \$250 or more, see page A-4	15			
If you made a gift and got a benefit for it, see page A-4.	16	Other than by cash or check. If any gift of \$250 or more, see page A-4. You must attach Form 8283 if over \$500	16			
	17	Carryover from prior year	17			
	18	Add lines 15 through 17			18	

Casualty and Theft Losses

A casualty occurs when property is damaged as a result of a sudden, unexpected, or unusual event such as fire, storm, shipwreck, flood, earthquake, or automobile accident. Theft is the unlawful

taking and removing of money or property with the intent to deprive the owner of it. Theft does not include the mere disappearance of money or property.

A casualty or theft may result in a gain if the insurance proceeds or other reimbursements exceed the adjusted basis of destroyed or stolen property.

Usually, however, a casualty or theft results in a loss. Part of a casualty or theft loss may be deductible if the taxpayer can prove that the casualty or theft occurred to property that the taxpayer owned. The taxpayer must also prove the dollar amount of the loss. Taxpayers with a casualty and theft loss should seek assistance from a paid professional tax preparer.

Miscellaneous Itemized Deductions

Certain employee expenses, expenses of producing income, and other qualifying expenses are reported as miscellaneous itemized deductions on Schedule A. Miscellaneous itemized deductions that exceed 2% of adjusted gross income are deductible. There are some miscellaneous itemized deductions that are deductible, regardless of a taxpayer's adjusted gross income.

Examples of deductions that are subject to the 2% limit and that are reported on lines 20 through 22 of Schedule A are:

- Union dues and fees,
- Professional society dues,
- Uniforms not adaptable to general use,
- Small tools and supplies,
- Professional books, magazines, journals,
- Employment-related educational expenses,
- Expenses of looking for a new job,
- Investment counsel fees,
- Investment expenses,
- Tax counsel and assistance,
- Fees paid to an IRA custodian, and
- Safe deposit box rental for investment documents.

Examples of deductions that are not subject to the 2% limit and that are reported on line 27 of Schedule A are:

- Unrecovered after-tax pension contributions (see Lesson 14).
- Gambling losses to the extent of gambling winnings, and
- Work-related expenses for an individual with a disability, such as attendant-care services at the individual's place of work, that are necessary for the person to work.

Nondeductible expenses include:

- Burial or funeral expenses,
- Wedding expenses,
- Fees and licenses, such as car and marriage licenses and dog tags,

- Fines and penalties, such as parking tickets,
- Home repairs, insurance, and rent,
- Illegal bribes and kickbacks,
- Insurance premiums (except medical insurance premiums),
- Losses from the sale of a taxpayer's home, furniture, or personal car,
- Lost or misplaced cash or property,
- Personal legal expenses, and
- Commuting expenses to and from work

Exercise 5

Robert is a janitor. His adjusted gross income is \$25,000. He wants to deduct the following items on his tax return:

2004 income tax preparation fee	\$ 80
Safe deposit box rental (used to keep bonds)	50
Life insurance premiums	200
Investment expenses	50
Loss on sale of personal home	500
Investment journals and newsletters	200
Investment advisory fees	100
Attorney fees for preparation of will	150

Complete Robert's Schedule A, line 20 through 26.

Exhibit 9

Schedule A, lines 20 through 26

Job Expenses and Most Other Miscellaneous Deductions	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-6.) ▶			
	20				
	21	Tax preparation fees			
	21				
(See page A-5.)	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶			
	22				
	23	Add lines 20 through 22			
	23				
	24	Enter amount from Form 1040, line 38	24		
	24				
	25	Multiply line 24 by 2% (.02)	25		
	25				
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			26

TOTAL ITEMIZED DEDUCTIONS

Schedule A, line 28, is *Total Itemized Deductions*. It is the sum of lines 4, 9, 14, 18, 19, 26, and 27.

Compare the amount on line 28 to the standard deduction. If the taxpayer elects to itemize deductions even though they are less than the standard deductions, check the box on line 29 of the Schedule A. Otherwise, enter the larger of the standard deduction or the taxpayer's itemized deductions on Form 1040, Line 40.

Exercise 6

Seth A. and Karen Yale live in the state of Illinois and their adjusted gross income is \$40,000. Seth's social security number is xxx-xx-xxxx. They gave you a list of their itemized deductions. They received no insurance reimbursement for medical expenses. They purchased their home in 1989, and a commercial mortgage company holds the mortgage. They have not refinanced the mortgage or increased the principal balance since they bought their home. They are both under age 65 and not blind. Neither can be claimed as a dependent by another taxpayer.

Unreimbursed medical expenses:

Medical insurance premiums	\$400
Hospital	100
Doctors and dentists	2,000
Vitamins	50
Prescription drugs	500
Insulin	300

Taxes:

State income tax	\$1,500
Federal income tax	4,000
Real estate tax	700
Ad valorem	500

Interest:

Interest on mortgage (reported on Form 1098)	\$5,500
Car loan	900
Credit cards	500

Contributions:

Church (gave Yales' letter verifying this amount)	\$1,200
Bingo costs	60
American Cancer Society	200
Canned goods donated to a food drive	15
Fair market value of donated used clothing	60

Miscellaneous:

Union dues	\$50
IRA custodial fee	10
Traffic fine	100
Investment expenses	50

Complete Seth and Karen's Schedule A. Should they take the standard deduction or itemized deduction?

SCHEDULES A&B (Form 1040)		Schedule A—Itemized Deductions (Schedule B is on back)			OMB No. 1545-0074
Department of the Treasury Internal Revenue Service (99)		▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).			2005
Name(s) shown on Form 1040				Your social security number	
Medical and Dental Expenses	Caution. Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A-2)	1		
	2	Enter amount from Form 1040, line 38	2		
	3	Multiply line 2 by 7.5% (.075)	3		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4		
Taxes You Paid <small>(See page A-2.)</small>	5 State and local (check only one box):				
	a <input type="checkbox"/> Income taxes, or				5
	b <input type="checkbox"/> General sales taxes (see page A-2)				6
	6	Real estate taxes (see page A-3)	7		
	7	Personal property taxes	8		
	8	Other taxes. List type and amount ▶	8		
	9	Add lines 5 through 8	9		
Interest You Paid <small>(See page A-3.)</small>	10	Home mortgage interest and points reported to you on Form 1098	10		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-4 and show that person's name, identifying no., and address ▶	11		
	Note. Personal interest is not deductible.				
	12	Points not reported to you on Form 1098. See page A-4 for special rules	12		
	13	Investment interest. Attach Form 4952 if required. (See page A-4.)	13		
	14	Add lines 10 through 13	14		
Gifts to Charity <small>If you made a gift and got a benefit for it, see page A-4.</small>	15	Gifts by cash or check. If you made any gift of \$250 or more, see page A-4	15		
	16	Other than by cash or check. If any gift of \$250 or more, see page A-4. You must attach Form 8283 if over \$500	16		
	17	Carryover from prior year	17		
	18	Add lines 15 through 17	18		
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-5.)	19		
Job Expenses and Most Other Miscellaneous Deductions <small>(See page A-5.)</small>	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-6.) ▶	20		
	21	Tax preparation fees	21		
	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22		
	23	Add lines 20 through 22	23		
	24	Enter amount from Form 1040, line 38	24		
	25	Multiply line 24 by 2% (.02)	25		
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-	26		
Other Miscellaneous Deductions	27	Other—from list on page A-6. List type and amount ▶	27		
Total Itemized Deductions	28	Is Form 1040, line 38, over \$145,950 (over \$72,975 if married filing separately)? <input type="checkbox"/> No. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 40. <input type="checkbox"/> Yes. Your deduction may be limited. See page A-6 for the amount to enter.	28		
	29	If you elect to itemize deductions even though they are less than your standard deduction, check here <input type="checkbox"/>			

ELECTING TO ITEMIZE

Even if the taxpayer's itemized deductions are less than the amount of his or her standard deduction, he or she may want to do this, for example, if the tax benefit of being able to itemize the deductions on his or her state tax return is greater than the tax benefit he or she loses on their federal return by not taking the standard deduction. To make this election, he or she must check the box on line 29, Schedule A.

FINDING THE TAX

Taxpayers with taxable income of less than \$100,000 use the Tax Table to find their tax. However, children under 14 years of age who have more than \$1,600 of investment income (interest, dividends, etc.) might not be able to use the Tax Table. Their income might have to be taxed at the parents' tax rate. These taxpayers should be referred to a paid professional tax preparer.

The Tax Table is in Publication 678W. The tax is based on the person's filing status and taxable income. To find the tax, use the **taxable income** from the tax forms (1040EZ, line 6; 1040A, line 27; and 1040, line 43), and:

- locate the income bracket for the taxable income,
- read across that line until you reach the column for the appropriate filing status, and
- find the amount where the taxable income and filing status meet. This is the tax liability.

If the taxable income is the same as the ending amount in an income bracket, go to the next bracket to find the tax.

Qualifying widows(ers) use the married filing jointly column.

Enter the tax on Form 1040EZ, line 10, Form 1040A, line 28, or Form 1040, line 44.

Double check the amount entered. **Common errors** include:

- Using the wrong standard deduction,
- Incorrectly figuring the exemption amount,
- Using an amount other than taxable income to find the tax,
- Picking up the wrong number from the Tax Table, and
- Transposing the numbers when entering the tax amount.

TAXABLE INCOME COMPUTATION

Once you have determined the standard deduction, compare it to the total itemized deductions. In most cases, you will enter the larger of the two amounts on Form 1040, line 40. Subtract line 40 from line 38 and enter the result on line 41. Then subtract the exemption deduction (line 42) to compute the taxable income.

If the taxpayer has capital gain distributions that are reported directly on Form 1040 or Form 1040A, the taxpayer should use the Qualified Dividends and Capital Gain Tax Worksheet to determine if the tax is less.

The taxpayer should:

- Check the box next to line 13, Form 1040 and
- Use the Qualified Dividends and Capital Gain Tax Worksheet (Exhibit 11) from either the Form 1040A or 1040 instruction booklet to compute tax.

Example 5

Marjorie is a single taxpayer with taxable income of \$43,500. She files Form 1040 and does not have to file a Schedule D. In 2005, she received capital gain distributions of \$650 from XYZ Investments. Marjorie pays less tax by using the Qualified Dividends and Capital Gain Tax Worksheet (Exhibit 11).



Qualified Dividends and Capital Gain Tax Worksheet—Line 44

Keep for Your Records

Before you begin: ✓ See the instructions for line 44 on page 33 to see if you can use this worksheet to figure your tax.
 ✓ If you do not have to file Schedule D and you received capital gain distributions, be sure you checked the box on line 13 of Form 1040.

1. Enter the amount from Form 1040, line 43	1.	43,500
2. Enter the amount from Form 1040, line 9b	2.	0
3. Are you filing Schedule D?		
<input type="checkbox"/> Yes. Enter the smaller of line 15 or 16 of Schedule D, but do not enter less than -0-	}	3. 650
<input type="checkbox"/> No. Enter the amount from Form 1040, line 13		
4. Add lines 2 and 3	4.	650
5. If you are claiming investment interest expense on Form 4952, enter the amount from line 4g of that form. Otherwise, enter -0-	5.	0
6. Subtract line 5 from line 4. If zero or less, enter -0-	6.	650
7. Subtract line 6 from line 1. If zero or less, enter -0-	7.	42,850
8. Enter the smaller of:		
• The amount on line 1, or	}	8. 29,700
• \$29,700 if single or married filing separately,		
• \$59,400 if married filing jointly or qualifying widow(er), \$39,800 if head of household.		
9. Is the amount on line 7 equal to or more than the amount on line 8?		
<input type="checkbox"/> Yes. Skip lines 9 through 11; go to line 12 and check the "No" box.		
<input type="checkbox"/> No. Enter the amount from line 7	9.	
10. Subtract line 9 from line 8	10.	
11. Multiply line 10 by 5% (.05)	11.	
12. Are the amounts on lines 6 and 10 the same?		
<input type="checkbox"/> Yes. Skip lines 12 through 15; go to line 16.		
<input type="checkbox"/> No. Enter the smaller of line 1 or line 6	12.	650
13. Enter the amount from line 10 (if line 10 is blank, enter -0-)	13.	0
14. Subtract line 13 from line 12	14.	650
15. Multiply line 14 by 15% (.15)	15.	98
16. Figure the tax on the amount on line 7. Use the Tax Table or Tax Computation Worksheet, whichever applies	16.	7,384
17. Add lines 11, 15, and 16	17.	7,482
18. Figure the tax on the amount on line 1. Use the Tax Table or Tax Computation Worksheet, whichever applies	18.	7,546
19. Tax on all taxable income. Enter the smaller of line 17 or line 18. Also include this amount on Form 1040, line 44	19.	7,482

TAXWISE® HINT

If a taxpayer wants to determine whether the standard or itemized deduction is best for him or her, input Schedule A information. TaxWise® will automatically select the deduction that is more beneficial.

▶▶ SUMMING UP THIS LESSON ◀◀

Both the standard deduction (or total itemized deductions, if greater) and exemption amounts are subtracted from adjusted gross income to arrive at taxable income.

The standard deduction depends upon:

- ▶ filing status,
- ▶ age, eyesight, and
- ▶ whether the taxpayer can be claimed as a dependent on another taxpayer's return.

Determine the standard deduction by using the:

- ▶ Standard Deduction amount for the appropriate filing status from the appropriate tax form, or
- ▶ *Standard Deduction Chart for Most People*
- ▶ *Standard Deduction Chart for People Age 65 or Older or Blind, or*
- ▶ *Standard Deduction Worksheet for Dependents*

Itemized deductions are specifically allowed by law. Claim itemized deductions on Schedule A (Form 1040).

Itemized deductions include:

- ▶ Medical and dental expenses
- ▶ Taxes paid
- ▶ Home mortgage and certain investment interest paid
- ▶ Charitable contributions
- ▶ Casualty and theft losses
- ▶ Miscellaneous itemized deductions.

Medical and dental expenses that exceed 7.5 percent of adjusted gross income are deductible.

To be deductible as a charitable contribution, a donation of \$250 or more must be acknowledged in writing by the charitable organization that received the donation.

Most miscellaneous itemized deductions that exceed 2% of adjusted gross income are deductible. However, there are certain miscellaneous itemized deductions that are fully deductible, regardless of gross income.

If deducted investment interest expense exceeds investment income, refer the taxpayer to a paid professional tax preparer.

If you are uncertain whether an expense qualifies as a deduction, do not guess. Use on site reference material to determine.

**▶▶ SUMMING UP THIS LESSON ◀◀
(continued)**

Most taxpayers compare their total itemized deductions to their standard deduction and enter the larger amount on Form 1040, line 40.

Do not use the Tax Table for taxpayers with taxable income of \$100,000 or more.

Common errors include:

- ▶ Using the wrong standard deduction,
- ▶ Incorrectly figuring the exemption amount,
- ▶ Using an amount other than taxable income to find the tax,
- ▶ Picking up the wrong number from the Tax Table, and
- ▶ Transposing the numbers when entering the tax amount.

DEDUCTIONS AND TAX COMPUTATION

ANSWERS TO EXERCISES

Exercise 1

- (A) \$7,300 (Exhibit 1)
- (B) \$6,200 (Exhibit 2)
- (C) \$10,950 (Exhibit 2)
- (D) \$5,950 (Exhibit 2)
- (E) \$5,000 (Exhibit 1)
- (F) \$2,250 (Exhibit 3)

Exercise 2

Sam and Paula's Schedule A

SCHEDULES A&B (Form 1040) <small>Department of the Treasury Internal Revenue Service (99)</small>	Schedule A—Itemized Deductions (Schedule B is on back) ▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).	OMB No. 1545-0074 2005 Attachment Sequence No. 07
Name(s) shown on Form 1040 Sam & Paula Ferris		Your social security number XXX | XX | XXXX
Medical and Dental Expenses	Caution. Do not include expenses reimbursed or paid by others.	
1 Medical and dental expenses (see page A-2)	2,700	
2 Enter amount from Form 1040, line 38	45,000	
3 Multiply line 2 by 7.5% (.075)	3,375	
4 Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	0	

Exercise 3

John and Shanon's Schedule A

Interest You Paid (See page A-3.)	10 Home mortgage interest and points reported to you on Form 1098	3,130	
	11 Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-4 and show that person's name, identifying no., and address ▶		
	Note. Personal interest is not deductible.		
	12 Points not reported to you on Form 1098. See page A-4 for special rules		
	13 Investment interest. Attach Form 4952 if required. (See page A-4.)		
	14 Add lines 10 through 13	3,130	
Gifts to	15 Gifts by cash or check. If you made any gift of \$250 or		

DEDUCTIONS AND TAX COMPUTATION

ANSWERS TO EXERCISES

Exercise 4

Rose's Schedule A

Gifts to Charity If you made a gift and got a benefit for it, see page A-4.	15	Gifts by cash or check. If you made any gift of \$250 or more, see page A-4	15	825			
	16	Other than by cash or check. If any gift of \$250 or more, see page A-4. You must attach Form 8283 if over \$500	16	400			
	17	Carryover from prior year	17				
	18	Add lines 15 through 17	18			1,225	

Exercise 5

Robert's Schedule A

Job Expenses and Most Other Miscellaneous Deductions (See page A-5.)	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-6.) ▶	20				
	21	Tax preparation fees	21	80			
	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶ <i>Safe deposit box \$50; Investment expenses \$50; Investment Journal \$200; Investment advisory fees \$100</i>	22	400			
	23	Add lines 20 through 22	23	480			
	24	Enter amount from Form 1040, line 38 24 | 25,000 | . . . . .	24				
	25	Multiply line 24 by 2% (.02)	25	500			
26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-	26			0		

DEDUCTIONS AND TAX COMPUTATION

ANSWERS TO EXERCISES

Exercise 6

Schedule A

SCHEDULES A&B (Form 1040)		Schedule A—Itemized Deductions (Schedule B is on back)		OMB No. 1545-0074 2005 Attachment Sequence No. 07	
Department of the Treasury Internal Revenue Service (99)		▶ Attach to Form 1040. ▶ See instructions for Schedules A and B (Form 1040).			
Name(s) shown on Form 1040 Seth A. & Karen Yale				Your social security number XXX XX XXXX	
Medical and Dental Expenses	1	Medical and dental expenses (see page A-2)	3,300		
	2	Enter amount from Form 1040, line 38	40,000		
	3	Multiply line 2 by 7.5% (.075)	3,000		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-		300	
Taxes You Paid (See page A-2.)	5	State and local (check only one box): a <input checked="" type="checkbox"/> Income taxes, or b <input type="checkbox"/> General sales taxes (see page A-2)	1,500		
	6	Real estate taxes (see page A-3)	700		
	7	Personal property taxes			
	8	Other taxes. List type and amount ▶ <i>Ad valorem</i>	500		
	9	Add lines 5 through 8			2,700
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	5,500		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-4 and show that person's name, identifying no., and address ▶			
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-4 for special rules			
	13	Investment interest. Attach Form 4952 if required. (See page A-4.)			
	14	Add lines 10 through 13			5,500
Gifts to Charity If you made a gift and got a benefit for it, see page A-4.	15	Gifts by cash or check. If you made any gift of \$250 or more, see page A-4	1,400		
	16	Other than by cash or check. If any gift of \$250 or more, see page A-4. You must attach Form 8283 if over \$500	75		
	17	Carryover from prior year			
18	Add lines 15 through 17			1,475	
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-5.)			
Job Expenses and Most Other Miscellaneous Deductions (See page A-5.)	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-6.) ▶ <i>Union dues \$50</i>			
	21	Tax preparation fees			
	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶ <i>IRA custodial fee \$10; Investment expenses \$50</i>	60		
	23	Add lines 20 through 22	110		
	24	Enter amount from Form 1040, line 38	40,000		
	25	Multiply line 24 by 2% (.02)	800		
26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			0	
Other Miscellaneous Deductions	27	Other—from list on page A-6. List type and amount ▶			
Total Itemized Deductions	28	Is Form 1040, line 38, over \$145,950 (over \$72,975 if married filing separately)? <input type="checkbox"/> No. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 40. <input type="checkbox"/> Yes. Your deduction may be limited. See page A-6 for the amount to enter.			9,975
	29	If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ <input type="checkbox"/>			

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X Schedule A (Form 1040) 2005



Military/International students continue.

All others go to Lesson 5, page 5-1.

INTRODUCTION AND OBJECTIVES

This segment identifies and explains how to apply the rules concerning travel and transportation expenses for members of the Armed Forces.

When we have concluded this segment you will be able to identify travel and transportation expenses (including meals) deductible by Armed Forces personnel.

GENERAL INFORMATION

Fully reimbursed employee business expenses, such as travel and transportation expenses, generally are not reported on the tax return if an adequate accounting is made to the employer and any excess reimbursement is required to be returned to the employer.

Armed Forces employees must substantiate their expenses to the federal government and return any excess reimbursement.

FORM W-2

If the employee is reimbursed under a plan that requires the employee to adequately account for all business connected expenses and return any funds that are more than the substantiated expenses, the reimbursement should not be included as income in Box 1 of Form W-2. Therefore, the employee cannot deduct these expenses.

Temporary duty (TDY) and temporary additional duty (TAD) allowances for travel and transportation are not reported as income on Form W-2. If there are excess expenses on some trips and the employee wants to claim them as employee business expenses, the employee must report all TAD and TDY trip expenses incurred during the year on Form 2106 and include all TAD and TDY allowances received as reimbursements.

FORM 2106

To claim unreimbursed job related expenses, such as travel or transportation expenses, Armed Forces personnel must complete Form 2106, Employee Business Expense, and attach it to their Form 1040. Form 2106 will not have to be used if the Armed Forces member is claiming only unreimbursed employee business expenses for professional dues, subscriptions to professional journals, educational expenses, and uniform expenses. These expenses are reported on line 20 on Schedule A as miscellaneous itemized deductions subject to the 2% AGI limit.

MEALS

The cost of meals can be an employee business expense. This includes meals while on business travel away from home and for business-related entertainment. The deduction for meals is generally limited to 50% of the actual expenses. For employees subject to Department of Transportation (DOT) hours of service limits, deductible meal expenses incurred while away from home on business is 70%.

The deduction is taken on Form 2106 where the 50% limit is applied before the amount is carried to line 20 on Schedule A where it is subject to the 2% AGI limit.

If the employee is fully reimbursed for the meals under an accountable plan that excludes reimbursement from gross income, there is no amount to deduct and, therefore, no amount subject to the 50% limit.

TRAVEL EXPENSES

To be deductible, travel expenses must be ordinary and necessary expenses of traveling away from home temporarily for your job and must be greater than the total of any advances, allowances, and reimbursements you receive for such expenses. “Ordinary” expenses are customary or usual in the employee’s field, trade, business, or profession. “Necessary” expenses are appropriate or helpful in the employee’s job or business. Such expenses include airfares, the costs of operating and maintaining a car, and meals and lodging.

Deductible travel expenses are reported on Form 2106 (or Form 2106-EZ, if you qualify) and are deductible as a miscellaneous itemized deduction on Schedule A of Form 1040.

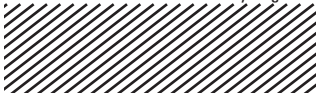
Away From Home

For costs other than local transportation to be deductible, the traveler must be away from home. The term “away from home” has a special meaning for tax purposes.

“Home,” for this purpose, generally is the taxpayer’s main place of business or post of duty. This includes the entire city or general area where his or her business or work is located, regardless of where the taxpayer or his or her family lives. For the military, “home” is the permanent duty station. A naval officer assigned to permanent duty aboard a ship that has regular eating and living facilities has a tax home aboard ship for travel expense purposes.

“Away from home” means away for a period substantially longer than an ordinary day’s work, during which taxpayers need time off for sleep or rest to meet the demands of work.

Members of the Armed Forces are away from home if they are away from their permanent duty stations long enough to require significant rest or sleep in order to be able to conduct and complete their duties.



Note: Away from home assignments that last, or are realistically expected to last more than one year are not temporary in nature. Therefore, taxpayers cannot deduct travel expenses incurred while on an assignment of more than one year.

No Deduction for Personal Expenses

For travel expenses to be deductible, there must be a work-related purpose for the travel. The taxpayer may not deduct expenses for personal travel, such as vacations, sightseeing, entertaining, or family visits.

Allowable Expenses

Common travel expenses for a member of the Armed Forces include:

- Expenses incurred while on TDY or TAD if away from home (ship, base, or station).
- Expenses of a reservist attending drills away from home overnight.
- Meals and lodging of a reservist temporarily called to active duty.
- Travel expenses, including meals and lodging, incurred in connection with deductible educational activities.
- Travel expenses incurred when carrying on official business while on “No Cost” (to the government) orders.

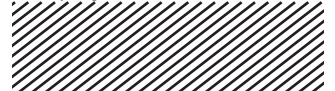
Mess bills afloat are not deductible by an officer assigned to permanent duty aboard a ship. Bills may be deductible as travel expenses by individuals and members of mobile units in a travel or TAD status while away from their permanent ships or stations.

Travel expense deductions are available to air squadron personnel when away from the squadron’s home base on TAD and to Army personnel when on field duty or maneuvers in a TDY status. Air squadron personnel and members of staffs permanently embarked on ships on extended deployments may not deduct expenses of living aboard ships as travel expenses.

Officers assigned permanent duty afloat may deduct the cost of meals and lodging incurred while on travel or TAD ashore if the ship is not berthed at the temporary duty station, or if the ship is berthed at the temporary duty station but quarters aboard are not available. No deduction is permitted for meals or lodging furnished or available in kind at the place of TAD, even if they are not used.

Example 1

Capt. Glendale traveled from his duty station in California to Washington, DC, for a conference. He was away for 5 days. The Army advanced Capt. Glendale \$700 for the trip. Capt. Glendale’s actual expenses were \$625. When he filed his travel voucher with the Army, he returned the excess of \$75. The Captain does not have to complete Form 2106.



Remember, if the Armed Forces member does not claim reimbursement for expenses that he or she is entitled to, no deduction for those expenses is allowed.

Exercise 1

- a. Sgt. Martin's permanent duty station is in Korea. His wife and children could not accompany him and have remained at their home in the United States. Can he deduct the cost of his meals and lodging?

Answer _____

- b. Can Sgt. Martin, in the circumstances above, deduct the cost of meals and lodging for his wife and children?

Answer _____

- c. Can Sgt. Martin take a deduction for the cost of returning home to visit his family?

Answer _____

Exercise 2

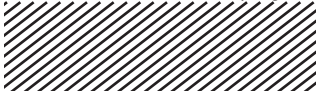
Which of the following can be taken as deductions?

- a. Travel expenses in excess of allowances and reimbursements when the taxpayer is on TAD trips.
- b. Mess bills of an officer permanently assigned to a ship.
- c. Meals that are not lavish or extravagant, but cost more than allowances or reimbursements while the taxpayer attends assigned schooling away from his or her permanent station.
- d. Laundry expenses the taxpayer incurs while traveling on TAD and for which no allowance or reimbursement is received.

Answer _____

LOCAL TRANSPORTATION EXPENSES

Local transportation expenses are generally the expenses of getting from one work place to another while not traveling away from home. Such expenses include the costs of operating and maintaining a car, but not meals and lodging. If taxpayers are required during their time on duty to go from one place to another (for example, as a courier or to attend meetings) without being away from home, their unreimbursed transportation expenses are deductible. When they must use their own vehicle, they can deduct transportation expenses. The taxpayer may be able to use the standard mileage rate to figure the deductible costs of operating his or her car for business purposes. The standard mileage rate is **40.5 cents a mile** for all business miles driven from 1/1/05 to



8/31/05 and **48.5 cents a mile** from 9/1/05 to 12/31/05. This rate is adjusted periodically for inflation. Commuting expenses are usually not deductible. However, the taxpayer may be able to deduct certain daily transportation expenses, as explained next, under *Temporary Work Location*.

TEMPORARY WORK LOCATION

A taxpayer can deduct local transportation expenses.

Local transportation expenses include the ordinary and necessary costs of all of the following.

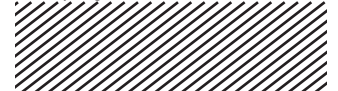
- Getting from one workplace to another in the course of the taxpayer's business or profession when he or she is traveling within the city or general area that is his or her tax home.
- Visiting clients or customers.
- Going to a business meeting away from the taxpayer's regular workplace.
- Getting from the taxpayer's home to a temporary workplace when he or she has one or more regular places of work. These temporary workplaces can be either within the area of his or her tax home or outside that area.

Local business transportation does **not** include expenses the taxpayer has while traveling away from home overnight. Those expenses are deductible as travel expenses.

If the taxpayer's employment at a work location is realistically expected to last (and does in fact last) for one year or less, the employment is temporary unless there are facts and circumstances that would indicate otherwise. If the taxpayer's employment at a work location is realistically expected to last for more than one year or if there is no realistic expectation that the employment will last for one year or less, the employment is not temporary, regardless of whether it actually lasts for more than one year. If employment at a work location initially is realistically expected to last for one year or less, but at some later date the employment is expected to last for more than one year, that employment will be treated as temporary (unless there are facts and circumstances that would indicate otherwise) until the taxpayer's expectation changes. It will not be treated as temporary after the date the taxpayer determines it will last for more than one year.

ARMED FORCES RESERVISTS

Unreimbursed travel expenses, including meals and lodging, are deductible for military reservists who, under competent orders and with or without compensation, must remain away from their main place of business to perform authorized drills and training duty.



Temporary active duty. Reservists temporarily called to active duty may deduct meals and lodging while on active duty if they kept their regular job while on active duty, returned to it after release, and were stationed away from the general area of that job or business. These expenses are deductible only if the reservists pay for meals and lodging at their official military post and only to the extent the expenses exceed BAH and BAS.

Deduction for Overnight Travel Expenses of National Guard and Reserve Members. A member of a reserve component of the Armed Forces of the United States who travels more than 100 miles away from home and stay overnight to attend drill or reserve meetings can deduct travel expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. The amount of expenses that can be deducted as an adjustment to income is limited to the regular federal per diem rate (for lodging, meals, and incidental expenses) and the standard mileage rate (for car expenses) plus any parking fees, ferry fees, and tolls. The standard mileage rate for 2005 is 40.5 cents from 1/1/05 to 8/31/05 and is 48.5 cents from 9/1/05 to 12/31/05. Any expenses in excess of these amounts and expenses that do not qualify for the adjustment to gross income deduction can be claimed only as a miscellaneous itemized deduction subject to the 2% limit.

Member of a reserve component. A member of a reserve component of the Armed Forces of the United States is a member in the Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve, the Army National Guard of the United States, the Air National Guard of the United States, or the Reserve Corps of the Public Health Service.

How to report. The member should first complete Form 2106 or Form 2106-EZ. Then include the qualified expenses for reserve travel from line 10 of Form 2106 or line 6 of Form 2106-EZ in the total on line 24 of Form 1040. Write "RC" in the space to the left of line 24 of Form 1040. Subtract this amount from the total on line 10 of Form 2106 or line 6 of Form 2106-EZ and deduct the balance as an itemized deduction on line 20 of Schedule A (Form 1040).

Example 2

Mary is an Armed Forces Reservist. She lives in a town that is 120 miles from Base A where she normally reports for a drill or meeting. During 2005 she also occasionally traveled to Base B which was only 40 miles from her home. From January through August of 2005, she made 6 trips to Base A, for a total of 1,440 miles (240 x 6). From September through December of 2005, she made 3 trips to Base A, for a total of 720 miles (240 x 3). For each of the nine trips that she made to Base A, she incurred one night of lodging cost (her meals were furnished by the government). She was not reimbursed for the \$72 per night she paid for the lodging. She does



have a receipt for the lodging expenses and they are within the per diem allowance. Mary also made 4 trips to Base B during May and June.

Mary's expenses should be reported on Form 2106. She has total vehicle expenses of \$1,062 (1760 miles @ 40.5 and 720 miles @ 48.5) on line 1. She has overnight lodging expense of \$648 (9 nights @ \$72) on line 3. Total expenses on line 6 are \$1,710. Since her trips to Base A were over 100 miles and she was gone overnight, she can deduct these expenses (\$932 mileage and \$648 lodging) on line 24 of Form 1040. She will reduce line 10, Form 2106 by the amount that she claims on line 24 of the 1040. The remaining expenses on the Form 2106 become part of the itemized deductions subject to the 2% AGI limitation.

A member cannot deduct expenses of travel that does not take him or her more than 100 miles from home as an adjustment to gross income. Instead, he or she must complete Form 2106 or 2106-EZ and deduct those expenses as an itemized deduction on line 20 of Schedule A (Form 1040).

▶▶ SUMMING UP THIS SEGMENT ◀◀

In this lesson, you have learned that:

- ▶ Travel and transportation expenses can be taken as miscellaneous itemized deductions on Schedule A, subject to the 2% AGI limit.
- ▶ Travel expenses for meals, lodging, and incidentals must be incurred while temporarily away from home on business to be deductible. Assignments that last, or are realistically expected to last more than one year are not considered temporary.
- ▶ Commuting and other personal expenses are not deductible.
- ▶ Travel costs associated with deductible educational expenses are treated like other business travel costs.
- ▶ Form 2106 and Schedule A (Form 1040) are used to figure and claim the itemized deduction for employee business expenses that exceed reimbursement.



1. a. No
b. No
c. No
2. a., c., and d.

OTHER MISCELLANEOUS DEDUCTIONS

Lesson 4
Military Segment

INTRODUCTION AND OBJECTIVE

As you learned earlier in this lesson, certain miscellaneous itemized deductions, which includes unreimbursed employee business expenses and investment expenses, are deductible only if the total itemized deductions are more than 2% of the taxpayer's adjusted gross income (AGI). All deductible miscellaneous itemized deductions discussed in this Military segment are subject to the 2% AGI limit. In this segment we will cover additional itemized deductions of special interest to members of the military. To claim these expenses, a taxpayer must itemize using Schedule A (Form 1040), Itemized Deductions.

At the end of this segment you will be able to identify other job related expenses and miscellaneous deductions, other than travel, of particular interest to the military.

UNIFORMS

Taxpayers can deduct the cost of buying and maintaining uniforms if the uniforms are specifically required as a condition of employment and they are not adaptable to general use as regular clothing.

Generally, members of the Armed Forces are required to wear uniforms when they are on duty but may be allowed to wear them when they are off duty. Because their uniforms can be worn in place of regular civilian clothing, members of the military cannot claim a deduction for uniform cost and upkeep. However, if military regulations prohibit off-duty wear of certain uniforms, the member can deduct the cost and upkeep of these uniforms. But he or she must reduce any deductible uniform costs incurred by any nontaxable uniform allowances or reimbursements received to pay for these expenses.

Active Duty & Reservist Uniforms

Members of the Armed Forces on active duty can deduct amounts spent to buy and maintain required military battle dress uniforms and utility uniforms if local military regulations prohibit their off-duty wear. The member must reduce the expense by any nontaxable uniform allowance or reimbursement received.

Articles Not Replacing Regular Clothing

A member of the Armed Forces can deduct the cost of required items that do not replace regular clothing. Such items include insignia of rank, corps devices, epaulets, aiguillettes, and swords.

Exercise 1

Indicate if the following are deductible or nondeductible by a member of the Armed Forces.

- a. The cost of an Army dress blue uniform (without shoulder boards or gold stripe on pants), including cape. Off-duty wear is not prohibited.

Answer _____

- b. The cost of a full Army green uniform (without braid) that can be worn anytime.

Answer _____

- c. The cost of gold braid for decoration of a cap and uniform.

Answer _____

- d. The cost of battle dress uniforms and utility uniforms that can be worn only while on duty or while traveling to and from duty.

Answer _____

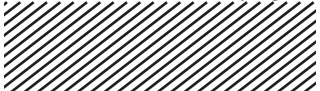
PROFESSIONAL DUES

Taxpayers, including members of the Armed Forces, can deduct dues paid to professional societies that are directly related to their trade or business. For example, Lt. Margaret Allen, an electrical engineer at Maxwell Air Force Base, can deduct professional dues paid to the American Society of Electrical Engineers.

However, members of the Armed Forces cannot deduct amounts paid to an officers' club or a noncommissioned officers' club.

EDUCATIONAL EXPENSES

Travel and transportation expenses for educational purposes are discussed in Lesson 9. In this segment, you will learn what educational expenses can be claimed as miscellaneous deductions on Schedule A. Certain rules must be met, however, for the expenses to qualify as a deduction.



Qualifications

A member of the Armed Forces can deduct expenses for education, even though the education may lead to a degree, if the education:

- Is required by the taxpayer's employer or by law or regulations for the taxpayer to keep salary, status, or job (if these requirements serve a business purpose of his or her employer); or
- Maintains or improves the skills required in the taxpayer's present work.

A taxpayer cannot deduct educational expenses, even though the above requirements are met, if the education:

- Is to meet the minimum educational requirements needed to qualify the taxpayer in his or her trade or business, or
- Is part of a program of study that will qualify the taxpayer for a new trade or business, even if he or she has no plans to enter that trade or business.

Some examples will help illustrate the various rules.

Example 1

Warrant Officer Newberry, an Army pilot, incurred educational expenses to obtain an accounting degree. He cannot deduct these expenses as a work related educational expense but he can take the lifetime learning credit if he takes the course to acquire new job skills.

Example 2

Lieutenant Commander Morris, who has a degree in financial management, is in charge of base finance at her post of duty. She incurred educational expenses when taking an advanced finance course. She can deduct educational expenses that were more than the educational allowance she received because she had already met the minimum qualifications of her job. By taking the course, she improved skills in her current position. The course did not qualify her for a new trade or business. Depending on her tax liability it may be more beneficial to take the nonrefundable credit (lifetime learning credit).

Deductible Expenses

Educational expenses and certain travel and transportation expenses related to education may be claimed on Form 2106, *Employee Business Expenses*. Expenses in excess of reimbursement are deductible only as a miscellaneous itemized deduction on Schedule A, subject to the 2% AGI limit discussed earlier.

Deductible educational expenses include amounts spent for tuition, books, supplies, laboratory fees, correspondence courses, costs of research, and typing as part of an educational program, and travel. Educational expenses of a personal nature are not deductible. For example, a taxpayer cannot deduct the cost of dinner on campus

POTENTIAL PITFALLS

Remind students that qualified educational expenses can be deducted as an adjustment to income, educational credit, or as a miscellaneous itemized deduction.

The volunteer should calculate the various ways and claim these expenses where they are most beneficial.

while he or she attends evening classes. Also, deductible educational expenses do not include items of a capital nature, such as computers or desks.

Treatment of Allowances and Reimbursements

A member of the Armed Forces must reduce deductible educational expenses by any allowance or reimbursement he or she receives. Any educational services provided in kind are not deductible. For example, base-provided transportation to or from class cannot be claimed.

Exercise 2

Sgt. Stephen Butler is a mess sergeant. On his own, he takes courses at the local university in early childhood education. Does he have deductible educational expenses? Why?

Answer _____

Exercise 3

Specialist Bates is a qualified X-ray technician. Would he have deductible educational expenses if he took a course required by the Army in new radiology techniques? Assume his expenses exceed reimbursement or allowance received.

Answer _____

Exercise 4

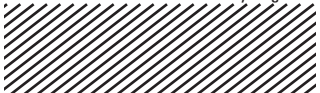
Which of the following can be claimed as miscellaneous itemized deductions by a member of the Armed Forces?

- a. Payment to an officers' club.
- b. Expenses incurred by a flight operations officer to obtain an accounting degree.
- c. Cost of epaulets.
- d. Cost and upkeep of a reservist's uniform when local military regulations prohibit off-duty wear. (No uniform allowance received.)
- e. Expenses incurred by a Navy disbursing clerk to learn television repair.

Answer _____

▶▶ SUMMING UP THIS SEGMENT ◀◀

In this segment, you learned about some of the more common itemized deductions of special interest to military members. The total of these miscellaneous deductions must be more than 2% of adjusted gross income to be deductible.



MISCELLANEOUS ITEMIZED DEDUCTIONS

ANSWERS TO EXERCISES

Lesson 4 Military Segment

1.
 - a. Nondeductible
 - b. Nondeductible
 - c. Deductible
 - d. Deductible
2. No. The courses were not required, do not improve Sgt. Baker's skills as a mess sergeant, and could lead to qualifying him for a new trade or business. However, he may be able to take the lifetime learning credit if the course is taken to acquire new job skills.
3. Yes. The course is required by Specialist Bates' employer, improves his skills in his present job, is not needed to meet the minimum educational requirements for his job, and will not lead to qualifying him for a new trade or business.
4. c. and d.

STUDENT NOTES



BUSINESS TRAVEL EXPENSES

Lesson 4
International Segment

INTRODUCTION AND OBJECTIVES

This lesson will explain how to compute business travel expenses for a U.S. citizen or resident aliens living aboard.

At the end of this segment, you will be able to:

- Determine when employee business expenses are deductible.
- Determine what expenses are deductible.
- Determine who is eligible for Home Leave expenses.
- Determine how to report the expenses.
- Complete Form 2106, *Employee Business Expenses*.
- Determine how to compute the expenses when the taxpayer elects to take the foreign earned income exclusion.

ALERT



At the time this lesson went to print the lesson content was updated reflecting the new standard mileage rates of 40.5 cents a mile from 1/1/05 to 8/31/05 and 48.5 cents a mile from 9/1/05 to 12/31/05. However, Form 2106 had not been updated to reflect the 48.5 cents a mile rate.

TRAVEL EXPENSES

Travel expenses incurred must be ordinary and necessary. Ordinary expenses are those that are customary for the type of travel being done. Necessary expenses are those that are appropriate and helpful to achieving the purpose of the travel. Treatment of the various expenses, allowances, and reimbursements depends on whether the expenses were more than allowances and reimbursements, or whether the allowances and reimbursements were more than the expenses. It also depends on whether or not the employer included these allowances and reimbursements as income on Form W-2. These situations will be discussed in this lesson.

Away from Home Overnight. For costs other than transportation the taxpayer must be “away from his tax home overnight”. “Tax Home” is defined as the taxpayer’s main place of business. “Overnight” is defined as a period substantially longer than an ordinary day’s work during which the taxpayer would need time off for sleep or rest.

Example 1

John lives with his family in Manchester, England, but works in London where he has lodging and meal expenses during the week. He travels back and forth from London to Manchester on weekends. He may not deduct any of his expenses for travel, meals, and lodging in London because that is his main place of business and the travel on weekends is not for business reasons.

DEDUCTIBLE EXPENSES

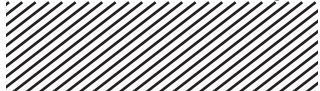
Travel expenses that are ordinary and necessary while traveling away from your home for business purposes include such things as:

1. Air, rail and bus transportation,
2. Operating and maintaining your car,
3. Taxi fares or other costs of transportation between the airport or station and hotel, from one customer to another, or from one place of business to another.
4. Transportation from the meals and lodging to the temporary work assignment,
5. Baggage and charges and transportation costs for sample and display material,
6. Meals and lodging when away from home on business.
7. Cleaning and laundry expenses,
8. Telephone and telegraph expenses,
9. Public stenographer's fees,
10. Operating and maintaining house trailers,
11. Tips that are incidental to any of these expenses, and
12. Other ordinary and necessary expenses related to travel.

Car Expenses. When using a car for business purposes the taxpayer is entitled to the actual expenses which would include such things as gas, oil, repairs, insurance and depreciation on the car or, the taxpayer can use the standard mileage rate. The standard mileage rate is **40.5 cents per mile** from 1/1/05 to 8/31/05 and **48.5 cents a mile** from 9/1/05 to 12/31/05. If the taxpayer uses the car for both business and personal mileage he or she should maintain a log book. He or she will have to allocate the expenses between business and personal use.

Meal Expense. Expenses for meals claimed on a taxpayer's return are only 50% deductible. When an employee is reimbursed for substantiated meal expenses, the reimbursement will generally be nontaxable and the expenses will not be claimed. For employees subject to Department of Transportation (DOT) hours of service limits, deductible meal expenses incurred while away from home on business is 70%.

Home-Leave. Section 903 of the Foreign Service Act of 1980 provides that the head of a Foreign Affairs Agency may order a member of the Service who is a citizen of the United States to take home leave upon completion of 18 months of continuous service abroad; and shall so order as soon as possible after completion of 3 years of continuous service abroad. Because members of the Foreign Service are required by law to take a leave of absence, they are allowed to deduct amounts paid for travel, meals, and lodging while on home leave as employee business expenses. The taxpayers who are eli-



gible for this leave will deduct these expenses on a Form 2106 just like an employee that is conducting business away from the home. As with all deductible employee business expenses, records and receipts must be maintained to support the deductions that are taken. The deductible expenses are those we discussed in the previous lesson and these expenses are subject to the same limitations. Any expenses paid for on behalf of a Foreign Service member's family are personal expenses and therefore are not deductible.

HOW TO REPORT

The following discusses how the taxpayer should report his/her allowable expenses for travel, meals & lodging. Self-employed individuals must report their expenses on the appropriate form used to report their business income and expenses by using Schedule C or Schedule C-EZ, Form 1040. Employees, including outside sales persons, must complete Form 2106, Employee Business Expenses, and attach it to their Form 1040 to claim these expenses.

Expenses paid by an employee under a "reimbursement or other expense allowance arrangement" with an employer generally do not need to be claimed and the employer will not include the reimbursement as taxable income on the employee's Form W-2. To qualify as nontaxable reimbursements, the arrangement must require that the employee substantiate the expenses to the employer and return any excess reimbursements. Per diem or other fixed allowance reimbursements that are similar to allowances specified by the Federal government will also be nontaxable to the extent that the amounts do not exceed government rates.

Form 2106 needs to be completed if:

1. The taxpayer received a reimbursement or an allowance and the employer included the amount on Form W-2, or a Form 1099 MISC as taxable income,
2. The taxpayer seeks to deduct expenses in excess of the amounts paid under a reimbursement allowance arrangement,
3. The taxpayer received no reimbursement for his or her employee business expenses, or,
4. The taxpayer received reimbursement or an allowance and did not account to his or her employer for the expenses.

If the expenses equal the reimbursements and the taxpayer accounted to his or her employer, the taxpayer does not have to complete Form 2106 unless item (1) above applies.

Example 2

George has incurred qualified employee business expenses. His company's policy is that all employees must turn in a travel voucher showing all expenses incurred and the company reimburses the employee an amount equal to the expenses. George does not have to file a Form 2106 because he reports directly to his employer and is reimbursed in full.



Example 3

Judy incurred employee business expenses of \$1,500. Her Form W-2 shows that her employer reimbursed Judy \$2,000. Judy will have to file Form 2106 and claim \$1,500 as an employee business expense on Form 2106 subject to the 50% meals limitation and 2% limitation on Schedule A. The entire \$2,000 reimbursement must be reported as income on line 7, Form 1040.

Claiming Employee Business Expenses on Form 1040.

The taxpayer can only claim employee business expenses on Form 1040 as a miscellaneous itemized deduction subject to the overall 2% limitation. Exceptions are provided for certain government officials, qualified performing artists, and individuals with a disability.

Example 4

Frank has a total of \$2,000 of unreimbursed employee business expenses (after reducing meals by 50%) and no other miscellaneous itemized deductions. His total adjusted gross income is \$52,000. Frank is entitled to a total of \$960 ($2,000 - [52,000 \times .02] = \960) as a miscellaneous itemized deduction.

COMPLETING FORM 2106

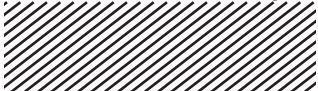
Form 2106 is divided into 2 parts. See Exhibit 1, Form 2106, pages 1 and 2. Part I deals with all the expenses and Part II deals specifically with car expenses. Part II should be completed, if applicable, before entering an amount in Line 1, Part I.

Part II, section B of Form 2106 will be used if the taxpayer owns the vehicle and chooses, or has previously chosen, to use the standard mileage rate for the same vehicle.

As mentioned previously the taxpayer is entitled to **40.5 cents per mile** from 1/1/05 to 8/31/05 and **48.5 cents a mile** from 9/1/05 to 12/31/05 for business mileage. The business standard mileage rate may not be used to compute the deductible expenses of vehicles used for hire, such as taxicabs, two or more automobiles used simultaneously (such as fleet operations), or any vehicle that is leased, rather than owned, by the taxpayer. The business standard mileage rate may not be used if the automobile has previously been depreciated using a method other than straight-line for its estimated useful life.

The front side of Form 2106 is divided into 3 steps. Let's look at each step and how it will apply to the taxpayer.

Step 1 of Form 2106 is used to summarize the employee business expenses of the taxpayer. Column A is used for all expenses except meals and entertainment. Column B is used only for meals and entertainment expenses. Step 1 must always be filled out. (Note: If the employer did not reimburse the employee for any of the expenses, skip Step 2 and go directly to Step 3 to figure the amount deductible.)



Step 2 is filled out only if the taxpayer is reimbursed by the employer and the reimbursement is not shown as income to the taxpayer on a Form W-2 or Form 1099 MISC. On line 7, only include amounts from Box 13 of Form W-2 identified as code “L”.

Many overseas employees will receive Forms W-2 reflecting only a portion of their total compensation while others will receive no Form W-2 at all.

Step 3 is used when the employer did not reimburse the employee in full. This section will show how much the taxpayer is allowed as a miscellaneous itemized deduction on the taxpayer’s Schedule A, Form 1040.



Form **2106**

Employee Business Expenses

OMB No. 1545-0139

Department of the Treasury
Internal Revenue Service (99)

▶ See separate instructions.

2005

Attachment
Sequence No. **54**

▶ Attach to Form 1040.

Your name
JOHN TAFT

Occupation in which you incurred expenses
SALES MANAGER

Social security number
XXX XX XXXX

Part I Employee Business Expenses and Reimbursements

Step 1 Enter Your Expenses

	Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1 6,597	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2 886	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment.	3 10,640	
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment.	4	
5 Meals and entertainment expenses (see instructions)		5 7,350
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6 18,123	6 7,350

Note: If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

7 Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7 8,300	0
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Step 3 Figure Expenses To Deduct on Schedule A (Form 1040)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7	8 9,823	7,350
Note: If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.		
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 70% (.70) instead of 50%. For details, see instructions.)	9 9,823	3,675
10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 20. (Reservists, qualified performing artists, fee-basis state or local government officials, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶	10	13,498

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 11700N

Form **2106** (2005)

Part II Vehicle Expenses

Section A—General Information (You must complete this section if you are claiming vehicle expenses.)

		(a) Vehicle 1	(b) Vehicle 2
11	Enter the date the vehicle was placed in service	6 / 1 / 04	/ /
12	Total miles the vehicle was driven during 2005	23 720 miles	miles
13	Business miles included on line 12	16 290 miles	miles
14	Percent of business use. Divide line 13 by line 12	69 %	%
15	Average daily roundtrip commuting distance	10 miles	miles
16	Commuting miles included on line 12	1 530 miles	miles
17	Other miles. Add lines 13 and 16 and subtract the total from line 12.	5 900 miles	miles
18	Do you (or your spouse) have another vehicle available for personal use?	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	
19	Was your vehicle available for personal use during off-duty hours?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
20	Do you have evidence to support your deduction?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
21	If "Yes," is the evidence written?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	

Section B—Standard Mileage Rate (See the instructions for Part II to find out whether to complete this section or Section C.)

22	Multiply line 13 by 40.5¢ (.405)	22	6,597
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Section C—Actual Expenses

		(a) Vehicle 1	(b) Vehicle 2
23	Gasoline, oil, repairs, vehicle insurance, etc.		
24a	Vehicle rentals		
b	Inclusion amount (see instructions)		
c	Subtract line 24b from line 24a		
25	Value of employer-provided vehicle (applies only if 100% of annual lease value was included on Form W-2—see instructions)		
26	Add lines 23, 24c, and 25		
27	Multiply line 26 by the percentage on line 14		
28	Depreciation (see instructions)		
29	Add lines 27 and 28. Enter total here and on line 1		

Section D—Depreciation of Vehicles (Use this section only if you owned the vehicle and are completing Section C for the vehicle.)

		(a) Vehicle 1	(b) Vehicle 2
30	Enter cost or other basis (see instructions)		
31	Enter section 179 deduction (see instructions)		
32	Multiply line 30 by line 14 (see instructions if you claimed the section 179 deduction or special allowance)		
33	Enter depreciation method and percentage (see instructions)		
34	Multiply line 32 by the percentage on line 33 (see instructions)		
35	Add lines 31 and 34		
36	Enter the applicable limit explained in the line 36 instructions		
37	Multiply line 36 by the percentage on line 14		
38	Enter the smaller of line 35 or line 37. If you skipped lines 36 and 37, enter the amount from line 35. Also enter this amount on line 28 above		

ALERT

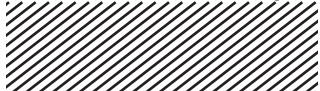


The revised Form 2106 was not available when this publication went to print. This proof does not reflect the 48.5 cents a mile rate change for travel miles driven from 9/1/05 to 12/31/05.

As you can see from the exhibit, the total expenses in Column A are reduced by the \$8,300 reimbursement not included as taxable income on John's Form W-2. He will be entitled to an itemized miscellaneous deduction of \$13,498. If John's adjusted gross income was \$60,000, John would have to reduce the \$13,498 by \$1,200 ($\$60,000 \times .02$) giving him a total of \$12,298 as a net miscellaneous deduction if John had no other miscellaneous deductions.

Exercise 1

Susan Kendall, social security number xxx-xx-xxxx, works in Manila and is temporarily assigned to her company's Tokyo, Japan office. Her round trip air fare was \$375. She also incurred lodging expenses of \$2,760 and meal expenses of \$1,420. She used mass transportation while in Tokyo and spent \$357. Her employer, who is in the retail sales trade, did not reimburse her for any of the expenses. Complete the Form 2106 for Susan Kendall.



Form **2106**
 Department of the Treasury
 Internal Revenue Service (99)

Employee Business Expenses

OMB No. 1545-0139

2005
 Attachment
 Sequence No. **54**

▶ See separate instructions.

▶ Attach to Form 1040.

Your name	Occupation in which you incurred expenses	Social security number : : :
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Part I Employee Business Expenses and Reimbursements

	Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
Step 1 Enter Your Expenses		
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment.	3	
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment.	4	
5 Meals and entertainment expenses (see instructions)		5
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6	

Note: If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

7 Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7	
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Step 3 Figure Expenses To Deduct on Schedule A (Form 1040)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7 Note: If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.	8	
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 70% (.70) instead of 50%. For details, see instructions.)	9	
10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 20. (Reservists, qualified performing artists, fee-basis state or local government officials, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶		10

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 11700N

Form **2106** (2005)

FOREIGN EARNED INCOME EXCLUSION

If the taxpayer is eligible and elects the foreign earned income exclusion he or she must adjust the amount of the business deductions related to the income excluded. The disallowed portion of the expenses is calculated by dividing the excluded foreign earned income by total foreign earned income.

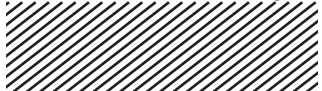
Example 6

Harold is a U.S. citizen, employed as a salesperson in a foreign country and is eligible and elects to exclude \$78,000 of his \$98,500 a year salary. His AGI is \$30,000. He had a total of \$2,000 of unreimbursed employee business expenses of which \$500 was for meals; these expenses are deductible only as miscellaneous itemized deductions on Schedule A (Form 1040). First, it is necessary to complete Form 2106. On that form Harold reduces the meal expenses by 50% of the \$500 amount spent, yielding a total of \$1,750 (\$250 & \$1,500).

Harold must reduce the \$1,750 by 79% ($78,000/98,500$) because he excluded 79% of his earned income. Thus \$1,383 of his expenses are not deductible. Harold carries the \$367 ($\$1,750 - \$1,383$) deductible amount to Schedule A.

Harold also has \$500 of other miscellaneous deductions subject to the 2% of AGI limit. He adds the \$367 from Form 2106 plus the \$500 for a total of \$867 miscellaneous expenses. 2% of Harold's AGI is \$600 ($.02 \times 30,000$). Harold's deductible miscellaneous itemized deductions are \$267 ($\$867 - \600).

If Harold did not have the other miscellaneous expenses of \$500 he would not have been able to claim any miscellaneous deductions. His remaining expenses (\$367) would have been less than 2% of his AGI (\$600).



SUMMARY EXERCISES

1. Which of the following taxpayers would be entitled to employee business expenses and if so indicate the type of expense?

Vehicle expenses

Lodging

Meals

Travel

- a. Joseph Fulton works in London and drives from and to his house every day.

Answer _____

- b. Mary Banks works in Paris and had to go to Lyon for the day to conduct business. She returns home to Paris that evening. She used her car.

Answer _____

- c. Alice Canton is a nurse working in Rome, Italy. Her employer gives her a temporary assignment for 2 months in Oslo, Norway.

Answer _____

2. What form do you use to calculate a taxpayer's employee business expenses?

Answer _____

3. When are employee business expense reimbursements not included in gross income?

Answer _____

4. When are the employee business expenses itemized miscellaneous deductions?

Answer _____

5. How are reimbursements that are more than expenses incurred treated?

Answer _____

6. Larry is a Foreign Service employee. He has been stationed in a foreign country for 3 years and comes back to the United States for 4 weeks of Home Leave. Is Larry eligible for the Home Leave deduction?

Answer _____

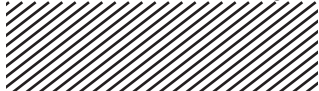


▶▶ SUMMING UP THIS SEGMENT ◀◀

Reimbursements from an accountable plan for substantiated employee business expenses are not included as income on the employee's return if the employee is required to return, and does return, any excess reimbursements.

- ▶ If the reimbursements are included as income, deductible expenses are allowed as miscellaneous itemized deductions subject of the 2% limitation.
- ▶ Travel expenses for meals, lodging and incidentals must be incurred while "away from home overnight" to be deductible.
- ▶ Form 2106 is used to calculate the amount of itemized deductions that are in excess of reimbursements.
- ▶ If reimbursements exceed expenses, the excess is income to the employee and must be reported on Form 1040. (If reimbursements exceed the expenses it is probably a nonaccountable plan, and therefore the entire reimbursement is taxable).
- ▶ If it is the company's policy for the employees to account for business expenses to the employer by supplying the employer with documented evidence and the employer reimburses the employee for the amount in full, Form 2106 is not required.
- ▶ Taxpayers who are U.S. citizens and members of the Foreign Service can deduct travel, meals and lodging expenses while on home leave.

If the taxpayer is eligible for and elects the foreign earned income exclusion, certain adjustments must be made to the gross amount deductible as employee business expenses.



BUSINESS TRAVEL EXPENSES

ANSWERS TO SUMMARY EXERCISES

Lesson 4

International Segment

Exercise 1

Kendall's Form 2106, page 1

Form 2106 Department of the Treasury Internal Revenue Service (99)	Employee Business Expenses ▶ See separate instructions. ▶ Attach to Form 1040.	OMB No. 1545-0139 2005 Attachment Sequence No. 54
Your name	Occupation in which you incurred expenses	Social security number
SUSAN KENDALL	RETAIL SALES	XXX XX XXXX
Part I Employee Business Expenses and Reimbursements		
Step 1 Enter Your Expenses		
	Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2	357
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment.	3	3,135
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment.	4	
5 Meals and entertainment expenses (see instructions)		1,420
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6	3,492
Note: If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.		
Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1		
7 Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7	0
Step 3 Figure Expenses To Deduct on Schedule A (Form 1040)		
8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7	8	3,492
Note: If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.		1,420
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 70% (.70) instead of 50%. For details, see instructions.)	9	3,492
		710
10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 20. (Reservists, qualified performing artists, fee-basis state or local government officials, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶	10	4,202
For Paperwork Reduction Act Notice, see instructions.		
Cat. No. 11700N		Form 2106 (2005)

BUSINESS TRAVEL EXPENSES

Lesson 4

International Segment *ANSWERS TO EXERCISES*

1.
 - a.) No (They are commuting expenses)
 - b.) Yes (Vehicle expenses)
 - c.) Yes (Travel, lodging, meals)
2. Form 2106
3. When the employee is required to substantiate his business expenses under a reimbursement arrangement and return any excess allowance to his employer. Also, Per Diem reimbursements that are similar to allowances specified by the Federal government will be nontaxable to the extent that the amounts do not exceed government rates.
4. When the expenses are more than the amount reimbursed. Itemized deductions are also created in the case of an employee reimbursed under a nonaccountable plan.
5. They are treated as income and shown on line 7 of Form 1040. If reimbursement in excess of expenses exists, the plan is probably a nonaccountable one, and therefore the entire reimbursement is taxable—not just the excess.
6. Yes

INTRODUCTION AND OBJECTIVES

In this lesson we will learn about the earned income credit (EIC) or earned income tax credit (EITC).

The EIC is a refundable tax credit for most people who work, but do not earn high incomes. Those who qualify can reduce their federal tax liability, potentially receiving a refund.

After completing this lesson you should be able to:

- Determine which taxpayers are eligible for the earned income credit.
- Determine when a taxpayer has a qualifying child for the EIC.
- Calculate and report the credit using the EIC worksheet.
- Explain how to request advance earned income credit (AEIC) payments.
- Report AEIC on the tax return.

GENERAL EIC REQUIREMENTS

Eligible taxpayers can receive a refund of this credit even if they owe no tax and had no income tax withheld. The taxpayer (and spouse, if filing a joint return) must meet certain eligibility rules and file a tax return, even if the taxpayer is not otherwise required to file a tax return. For tax year 2005 the maximum credit is:

Two or more qualifying children	\$4,400
One qualifying child	\$2,662
No children	\$ 399

To be eligible for a full or partial credit, the taxpayer cannot have investment income of more than \$2,700. The taxpayer must have earned income of at least \$1. Earned income and adjusted gross income must each be less than the limitation amounts discussed later.

ALERT



This lesson contains basic tax law and is required training for all volunteers.

ALERT



Use the EIC decision tree or EIC Critical Interview Questions, in Publication 4012, Volunteer Resource Guide, to determine if the taxpayer qualifies for EIC.

WHO CAN CLAIM THE EIC – GENERAL ELIGIBILITY RULES

All taxpayers claiming the EIC:

1. Earned income and adjusted gross income (AGI) must each be less than:

- \$35,263 (\$37,263 married filing jointly) with two or more qualifying children;
- \$31,030 (\$33,030 married filing jointly) with one qualifying child;
- \$11,750 (\$13,750 married filing jointly) with no qualifying children.

AGI is the amount on line 4 of Form 1040EZ, line 22 of Form 1040A, or line 38 of Form 1040.

ALERT



Confirm, by inspection, that the taxpayer (and spouse, if filing jointly) and any qualifying children have valid Social Security Cards.

2. Must have a valid Social Security Number (SSN):

SSNs are required for the taxpayer (and spouse, if filing jointly) and any qualifying children (discussed later) listed on Schedule EIC. The Social Security Administration issues SSNs to U.S. Citizens and to certain aliens.

If a Social Security card has the “**Not Valid for Employment**” imprint and the cardholder obtained the SSN to get a federally funded benefit, such as Medicaid, the SSN is not valid for EIC purposes. Similarly, if either the taxpayer(s) or the qualifying child(ren) have ITINs (individual taxpayer identification numbers), rather than SSNs, the return does not qualify for EIC.

3. Filing status cannot be married filing separately:

To qualify for the credit, the taxpayer must file as single, married filing a joint return, head of household, or qualifying widow(er) with dependent child.

4. Must be a U.S. citizen or resident alien for the entire year:

There are three types of aliens for tax purposes: nonresident, dual-status, and resident. Dual-status and resident aliens are taxed as U.S. citizens. Taxpayers claiming the EIC must be a U.S. citizen or resident alien all year, or a nonresident alien married to a U.S. citizen or resident alien and filing a joint return.

5. Must not file Form 2555 or 2555-EZ:

To qualify for the EIC, taxpayers must not exclude from gross income any income earned in foreign countries, or deduct or exclude a foreign housing amount.

6. Must meet the investment income limitation:

Investment income (such as interest from savings or tax-exempt bonds, dividends, etc.) must be \$2,700 or less for the tax year.

POTENTIAL PITFALLS



If the taxpayer's filing status is married filing separately, the taxpayer cannot claim the earned income credit.

ALERT



If the taxpayer chooses to be treated as a resident alien for the entire year, the taxpayer and spouse are taxed on their worldwide income.

7. **Must have earned income:**

Taxpayers must work full- or part-time and have earned income during the tax year. The income must be from employment or self-employment. If married and filing jointly, at least one spouse must work and have earned income. Earned income is discussed in detail later.

Combat pay election. If a taxpayer is a member of the U.S. Armed Forces he or she may elect to have his or her nontaxable combat pay included in earned income for the earned income credit.

8. **Cannot be the qualifying child of another person.** In the case of a joint return, neither the taxpayer (nor the spouse in the case of a joint return) can be a qualifying child of another person. The taxpayer is a qualifying child of another person (the taxpayer's parent, guardian, foster parent, etc.) if all the following statements are true:

- **Relationship:** The taxpayer is the other person's son, daughter, adopted child (or child lawfully placed with the other person for legal adoption), stepson, stepdaughter, or eligible foster child (placed with the other person by an authorized placement agency or by judgement, decree, or other order of any court of competent jurisdiction), brother, sister, stepbrother, stepsister, or a descendant of any of them.
- **Age:** On December 31st, the taxpayer was under age 19, or under age 24 and a full-time student, or any age and permanently and totally disabled at any time during the year.
- **Residency:** The taxpayer lived with that person in the United States for more than half of the year.

If the taxpayer (or spouse, if filing a joint return) is a qualifying child of another person, the taxpayer cannot claim the EIC.

INVESTMENT AND EARNED INCOME

Investment Income

Taxpayers whose investment income is more than \$2,700 cannot claim the EIC. Investment income includes:

1. Taxable interest
2. Tax-exempt interest
3. Ordinary dividends
4. Capital gain net income
5. Certain net income from rents and royalties. (Beyond the scope of VITA/TCE)
6. Net income from passive activities. (Beyond the scope of VITA/TCE)

Earned Income

To be eligible for a full or partial credit, the taxpayer must have earned income of at least \$1 but less than:

- \$35,263 (\$37,263 married filing jointly) with two or more qualifying children;
- \$31,030 (\$33,030 married filing jointly) with one qualifying child;
- \$11,750 (\$13,750 married filing jointly) with no qualifying children.

Earned income is wages, salaries, tips and other employee compensation, but only if the amounts are includible in gross income; plus net earnings from self-employment. Table 5-1, next page, provides examples of what to include and what not to include as earned income in computing the earned income credit.

POTENTIAL PITFALLS



Earnings while in prison are not considered earned income for EIC purposes.

Notes:

Nontaxable combat pay election. The taxpayer can elect to have his or her nontaxable combat pay included in earned income for the earned income credit. Electing to include nontaxable combat pay in earned income may increase or decrease his or her EIC. The credit should be figured with and without the nontaxable combat pay before making the election. If the taxpayer makes the election, he or she must include in earned income all nontaxable combat pay that he or she received. The amount of his or her nontaxable combat pay should be shown on the Form W-2, in box 12, with Code Q. If the taxpayer is filing a joint return, and if both taxpayer and spouse received nontaxable combat pay, both taxpayers can each make his or her own election.

Earnings while an inmate. Amounts received for work performed while an inmate in a penal institution are not considered earned income for purposes of the earned income credit. Enter “PRI” and the amount of the income earned while an inmate next to line 7 (Form 1040 or 1040A) or line 1 (Form 1040EZ). This income is still considered taxable for purposes of determining the taxpayer’s federal income tax.

Earnings while a household employee. If the taxpayer was a household employee who did not receive a Form W-2 because he or she was paid less than \$1,400, the income must still be included on line 7 (Form 1040A or 1040) or line 1 (Form 1040EZ). Enter “HSH” and the amount not reported on Form W-2 next to line 7 (Form 1040A or 1040) or Line 1 (Form 1040EZ).

Disability benefits. If a taxpayer retires on disability, benefits received under his or her employer’s disability retirement plan are considered earned income until the taxpayer reaches minimum retirement age. Minimum retirement age generally is the earliest age at which the taxpayer can receive a pension or annuity if not disabled. Taxpayers must report their taxable disability payments on line 7 of either Form 1040 or Form 1040A until they reach minimum retirement age (See Pension, Lesson 11).

ALERT



Disability payments received before a taxpayer reaches minimum retirement age are considered earned income.

Beginning on the day after a taxpayer reaches minimum retirement age, payments the taxpayer receives are taxable as a pension and are not considered earned income. Report taxable pension payments on Form 1040, lines 16a and 16b, or Form 1040A, lines 12a and 12b.

Disability Insurance Payments. Payments taxpayers receive from a disability insurance policy for which they paid the premiums are not earned income. It does not matter whether they have reached minimum retirement age. If this policy is through their employer, the amount may be shown in box 12 of their Form W-2 with code “J.”

Examples of Earned Income for the EIC

To qualify for the EIC, taxpayers must work full- or part-time and have earned income during the tax year. If married and filing jointly, at least one spouse must work and have earned income. Earned income includes all taxable income gained from working as an employee and net earnings from self-employment. Nontaxable income generally does not count as earned income. (See Table 5-1)

Table 5-1

Earned Income Table

Earned Income	
Includes	Does not include
<ul style="list-style-type: none"> ■ Taxable wages, salaries, and tips ■ Union strike benefits ■ Taxable long-term disability benefits received prior to minimum retirement age ■ Net earnings from self-employment ■ Gross income of a statutory employee ■ Household employee income ■ Nontaxable combat pay election 	<ul style="list-style-type: none"> ■ Interest and dividends ■ Social Security and railroad retirement benefits ■ Welfare benefits ■ Workfare payments ■ Pensions and annuities ■ Veteran’s benefits (including VA rehabilitation payments) ■ Workers’ compensation benefits ■ Alimony ■ Child Support ■ Nontaxable foster care payments ■ Unemployment compensation ■ Taxable scholarship or fellowship grants that are not reported on Form W-2 ■ Earnings for work performed while an inmate at a penal institution ■ Salary deferrals (for example, under a 401(k) or 403(b) plan or the Federal Thrift Savings Plan) ■ Basic housing and subsistence allowances for the U.S. Military (box 12, code Q of Form W-2) ■ The value of meals or lodging provided by an employer for the convenience of the employer ■ Housing allowance or rental value of a parsonage for the clergy ■ Excludable dependent care benefits (line 18 of either Form 2441, Form 1040, or Schedule 2, Form 1040A) ■ Salary reductions such as under a cafeteria plan ■ Excludable employer provided educational assistance benefits (may be shown in box 13 of Form W-2) ■ Anything else of value received from someone for services performed, if it is not currently taxable

The interview tips you should use when determining EIC General Eligibility Rules are shown in Exhibit 1 below.

Exhibit 1

EIC General Eligibility Rules

TIP	EIC General Eligibility Rules	
interview tips	Probe/Action: Ask the taxpayer:	
step 1	<p>Calculate the taxpayer's earned income and Adjusted Gross Income (AGI) for the tax year. Are both less than:</p> <ul style="list-style-type: none"> • \$35,263 (\$37,263 married filing jointly) with two or more qualifying children; • \$31,030 (\$33,030 married filing jointly) with one qualifying child; or • \$11,750 (\$13,750 married filing jointly) with no qualifying children? 	<p>If YES, go to Step 2. If NO, STOP. You cannot claim the EIC.</p>
step 2	<p>Do you (and your spouse, if filing jointly) have a social security number (SSN) that allows you to work?</p> <p>Caution: Answer "no" if the taxpayer's social security card has "NOT VALID FOR EMPLOYMENT" imprint. If the cardholder obtained the SSN to get a federally funded benefit, such as Medicaid, the SSN is not valid for EIC purposes.</p>	<p>If YES, go to Step 3. If NO, STOP. You cannot claim the EIC.</p>
step 3	<p>Is your filing status married filing separately?</p>	<p>If YES, STOP. You cannot claim the EIC. If NO, go to Step 4.</p>
step 4	<p>Are you (or your spouse, if married) a nonresident alien?</p> <p>Caution: Answer "no" if the taxpayer is married filing a joint return, and one spouse is a citizen or resident alien and the other is a nonresident alien.</p>	<p>If YES and you are either unmarried or married but not filing a joint return, STOP. You cannot claim the EIC. If NO, go to Step 5.</p>
step 5	<p>Are you (or your spouse, if filing jointly) filing Form 2555 or Form 2555EZ (Foreign Earned Income)?</p>	<p>If YES, STOP. You cannot claim the EIC. If NO, go to Step 6.</p>
step 6	<p>Is your investment income more than \$2,700?</p>	<p>If YES, STOP. You cannot claim the EIC. If NO, go to Step 7.</p>
step 7	<p>Are you (or your spouse, if filing jointly) an EIC qualifying child of another person?</p>	<p>If YES, STOP. You cannot claim the EIC. If NO, go to the interview tips for EIC-With A Qualifying Child (Exhibit 2) or EIC-Without A Qualifying Child (Exhibit 3).</p>

WHO CAN CLAIM THE CREDIT – WITH A QUALIFYING CHILD

If the taxpayer meets the EIC general eligibility rules (previously discussed), you must now determine if the taxpayer can claim the credit with a qualifying child or without a qualifying child.

To be a qualifying child for the EIC, a child: **Must meet relationship, age, and residency tests. Note: A child is not a qualifying child until the child meets all 3 tests.**

The following chart outlines the relationship, age, and residency tests:

Table 5-2

RELATIONSHIP	AGE	RESIDENCY
<ul style="list-style-type: none"> ■ Son, daughter, stepson, stepdaughter or a descendant of any of them* or ■ Brother, sister, stepbrother, stepsister or a descendant of any of them or ■ Eligible foster child and... 	<ul style="list-style-type: none"> ■ Under age 19 at the end of the tax year or ■ Under age 24 and a full-time student, at the end of the tax year or ■ Any age and permanently and totally disabled at any time during the year and... 	<ul style="list-style-type: none"> ■ Lived with the taxpayer in the United States for more than half the tax year (at least 183 days for 2005). This includes the time that the taxpayer and the child are temporarily apart due to a special circumstance, such as military service, school attendance, hospitalization or juvenile detention <p>Note: Child birth/death: If the child was born or died during the year, the child is considered to meet the test if the child lived with the taxpayer while the child was alive.</p>

*If the child was married at the end of the year, he or she does not meet the relationship test unless:

1. The taxpayer can claim the child's exemption, or
2. The taxpayer cannot claim the child's exemption because the taxpayer gave that right to the child's other parent.

Definitions

An **adopted child** is treated as a biological child and includes a child placed with the taxpayer for adoption by an authorized placement agency, even if the adoption is not final.

An **eligible foster child** is a child placed with the taxpayer by an authorized placement agency or by judgment, decree, or order of any court of competent jurisdiction. An authorized placement agency includes a state or local government agency or court. It also includes a tax-exempt organization licensed by a state. In addition, it includes an Indian tribal government, or an organization authorized by an Indian tribal government to place Indian children.

A child is **permanently and totally disabled** if:

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

Taxpayers may be able to claim the EIC on the basis of a **child who was kidnapped** by someone who is not a member of the taxpayer's family or the child's family. (See Publication 596, Earned Income Credit)

A taxpayer does not need a home to claim the EIC. For example, if the taxpayer and his or her child(ren) lived together for more than half the year in one or more homeless shelters, the child meets the residency test.

After you have determined that a child meets the three tests, make sure that the child has a valid SSN. (See page 5-2)

Qualifying Child of More Than One Taxpayer (Exception for Divorced or Separated Parents, below)

If the child is the qualifying child of more than one person, only one person can claim the child as a qualifying child for all of the following:

- Dependency exemption.
- Child tax credit.
- Head of household filing status.
- Credit for child and dependent care expenses.
- Earned income credit.

The other person(s) cannot take any of the five tax benefits listed above unless he or she has a different qualifying child. If the taxpayer and the other person(s) cannot agree who will claim the child as a qualifying child, the IRS will apply in the following rules (Tie-Breaker Rule) in Table 5-3 below.

Table 5-3 **EIC Tie-Breaker Rule**

IF . . .	THEN the child will be treated as the qualifying child of the . . .
only one of the persons is the child's parent	parent
both persons are the child's parent	parent with whom the child lived for the longer period of time. If the child lived with each parent for the same amount of time, then the child will be treated as the qualifying child of the parent with the highest adjusted gross income (AGI)
none of the persons are the child's parent	parent with the highest AGI

Example 1 Jane (age 30) is unmarried. In 2005, Jane lived with her four children (Al, Ben, Cam, and Dan) and her mother, Linda. Provided they each meet the eligibility and income requirements, Jane may claim the EIC based on two of the children (for example, Al and Ben), and Linda may claim the EIC based on the other two children (for, example Cam and Dan). They must be consistent, though, which means that only Jane can claim any of the other child-related benefits with respect to Al and Ben, and only Linda can claim any of the other child-related benefits with respect to Cam and Dan.

Example 2 John (age 26) is unmarried. In 2005, John and his daughter, Lynn lived, with John's father Paul, who is also unmarried. John's sole income was wages of \$19,000. Paul's sole income was wages of \$12,000. Lynn is a qualifying child of both John and Paul. John and Paul examine their tax situations and agree that Paul will claim the EIC and the other available child-related benefits on the basis of Lynn. If John later decides to claim the credit (and any other child-related benefits available to him), under the tie-breaker rule, Paul will lose the credit (and other child-related benefits) he claimed.


Divorced or Separated Parents. Special rules apply to children of divorced or separated parents. Taxpayers who are the custodial parents can treat the child as a qualifying person even if they cannot claim the child's exemption. Taxpayers who are not the custodial parents cannot treat the child as a qualifying person even if they can claim the child's exemption.

Physical custody (who the child lives with), not legal custody, determines whether or not a taxpayer is eligible to claim the EIC. It is not uncommon for physical custody to differ from legal custody.

The interview tips you should use when determining EIC With A Qualifying Child are shown in Exhibit 2 below.

Exhibit 2

EIC - With A Qualifying Child

 interview tips	<p>EIC With a Qualifying Child (Remember to apply the steps for each qualifying child) Probe/Action: Ask the taxpayer:</p>	
step 1	Does your qualifying child have an SSN that allows him or her to work? Caution: Answer “no” if the child’s social security card says “NOT VALID FOR EMPLOYMENT” and his or her SSN was obtained to get a federally funded benefit.	If YES , go to Step 2. If NO , STOP. You cannot claim the EIC on the basis of this qualifying child.
step 2	Is the child your son, daughter, stepchild, adopted child, or eligible foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them.	If YES , go to Step 3. If NO , STOP. This child is not your qualifying child. Go to interview tips for EIC—Without A Qualifying Child (Exhibit 3).
step 3	Was the child any of the following at the end of the tax year: <ul style="list-style-type: none"> • Under age 19, • Under age 24 and a full-time student, or • Any age and permanently and totally disabled? 	If YES , go to Step 4. If NO , STOP. This child is not your qualifying child. Go to interview tips for EIC-Without A Qualifying Child (Exhibit 3).
step 4	Was the child married at the end of the year?*	If NO , go to Step 5. If YES , STOP. This child is not your qualifying child (failed the relationship test). Go to interview tips for EIC-Without A Qualifying Child (Exhibit 3).
step 5	Did the child live with you in the United States for more than half (183 days for 2005) of the tax year? Caution: Answer “no” if the child was married at the end of the year and either (1) you can claim the child’s exemption, or (2) you cannot claim the child’s exemption solely because you gave that right to the child’s other parent.	If YES , go to Step 6. If NO , STOP. This child is not your qualifying child. Go to interview tips for EIC-Without A Qualifying Child (Exhibit 3).
step 6	Is the child a qualifying child of another person?	If YES , explain to the taxpayer what happens when more than one person claims the EIC using the same child (The Tie-Breaker Rule). If the taxpayer chooses to claim the credit with this child, compute the EIC using the appropriate EIC Worksheets. If NO , compute the EIC using the appropriate EIC worksheet.
*If your child was married at the end of the year, he or she does not meet the relationship test unless: You can claim the child’s exemption or you cannot claim the child’s exemption because you gave that right to the child’s other parent.		

WHO CAN CLAIM THE EIC – WITHOUT A QUALIFYING CHILD

In addition to meeting the basic eligibility requirements discussed earlier, taxpayers without a qualifying child must meet the following requirements:

1. Must have lived in the United States more than half the tax year. If filing a joint return, both spouses must have lived in the United States (includes the 50 states and the District of Columbia) for more than half the tax year.
2. Must be at least age 25 but under age 65 at the end of 2005. If filing a joint return, only one spouse must meet this requirement.
3. Cannot qualify as the dependent of another person. If filing a joint return, both spouses must meet this requirement.

The interview tips you should use when determining EIC Without A Qualifying Child are shown in Exhibit 3 below.

Exhibit 3

EIC - Without a Qualifying Child


 TIP	EIC Without a Qualifying Child	
interview tips	Probe/Action: Ask the taxpayer:	
step 1	Can you (or your spouse, if filing jointly) be claimed as a dependent by another person?	If YES , STOP. You cannot claim the EIC. If NO , go to Step 2.
step 2	Were you (or your spouse, if filing jointly) at least 25 but under age 65 on December 31 of the tax year?	If YES , go to Step 3. If NO , STOP. You cannot claim the EIC.
step 3	Did you (and your spouse, if filing jointly) live in the United States for more than half (at least 183 days for 2005) of the tax year?	If YES , compute EIC using the appropriate EIC Worksheet. If NO , STOP. You cannot claim the EIC

Table 5-4

Summary of Eligibility Requirements

<p align="center">Part A Rules for Everyone</p>	<p align="center">Part B Rules If You Have a Qualifying Child</p>	<p align="center">Part C Rules If You Do Not Have a Qualifying Child</p>
<p>Must have a valid social security number.</p>	<p>Child must meet the relationship, age, and residency tests.</p>	<p>Must be at least age 25 but under age 65.</p>
<p>Filing status cannot be "Married filing separately."</p>	<p>Qualifying child cannot be used by more than one person to claim the EIC.</p>	<p>Cannot be the dependent of another person.</p>
<p>Must be a U.S. citizen or resident alien all year.</p>		<p>Must have lived in the United States more than half the year.</p>
<p>Cannot file Form 2555 or Form 2555-EZ (relating to foreign earned income).</p>		
<p>Investment income must be \$2,700 or less.</p>		
<p>Cannot be a qualifying child of another person.</p>		
<p align="center">Part D Earned Income and AGI Limitations</p> <p>Must be less than:</p> <ul style="list-style-type: none"> ■ \$35,263 (\$37,263 for married filing jointly) if you have more than one qualifying child, ■ \$31,030 (\$33,030 for married filing jointly) if you have one qualifying child, or ■ \$11,750 (\$13,750 for married filing jointly) if you do not have a qualifying child 		

Exercise 1 – EIC Eligibility Requirements

- A.** Sharon has an eligible foster child, Eric. Eric is 12 years old and began living with Sharon in August 2005. Sharon's earned income and her adjusted gross income are \$15,525. Can Sharon claim the earned income credit? _____
- B.** Doug and Donna are married and live together. Their combined earned income is \$25,400. Doug reports adjusted gross income of \$11,432 on his separate tax return, and Donna reports adjusted gross income of \$13,968 on her separate return. Sam, their four-year-old son, lives with Doug and Donna. Can Doug and/or Donna claim the earned income credit? _____
- C.** Randy and Cara were married and lived together until August when they divorced. Randy and Cara have two children, Jimmy, age seven, and Anna, age five. The children lived with both of their parents until August, and then they lived with their mother. Randy's earned income and adjusted gross income are \$19,251. Cara's earned income is \$14,751, and her adjusted gross income is \$15,362. Can Randy and/or Cara claim the earned income credit? _____
- D.** Benjamin, age 27, lives alone, is single, and earns \$9,100. His adjusted gross income is \$9,050. Can Benjamin claim the earned income credit? _____
- E.** Melanie is 18 years old and married. Melanie's husband is overseas, and she lives with her mother, Susan. Susan's earned income is \$19,500, and her adjusted gross income is \$19,550. Susan cannot claim Melanie as a dependent. Can Susan claim the earned income credit? _____
- F.** Circle the items that are considered earned income for earned income credit purposes.
1. Wages
 2. Child Support
 3. Nontaxable combat pay election
 4. Interest income
 5. Unemployment compensation
 6. Tip income
 7. Dividend income
 8. Military subsistence allowances

POTENTIAL PITFALLS



Remember that the amount of the earned income credit depends on the taxpayer's income, number of qualifying children, and filing status. Be sure to use the correct column from the EIC Table.

DETERMINING ELIGIBILITY AND FIGURING THE CREDIT

The EIC is not for everyone. You can **minimize delays** in processing the taxpayer's current and future returns by using the EIC steps and Worksheet to **determine eligibility** and figure the credit.

Taxpayers determine their eligibility for EIC by working through the steps in the EIC instructions for 1040, 1040A, or 1040EZ. Taxpayers complete the EIC Worksheet in the instructions to figure the credit. Taxpayers should keep the steps and worksheet with their records.

Before completing line 66 of Form 1040, line 41 of Form 1040A, or line 8 of Form 1040EZ, you must complete the applicable EIC worksheet. If the taxpayer is not eligible to claim the credit but appears to be eligible based on income limitations, write "No" next to line 66 of 1040, line 41 of 1040A, or line 8 of 1040EZ.

The **Earned Income Credit Table** is used to determine the amount of the credit. The tables are found in the instructions for Forms 1040EZ, 1040A, and 1040 and also in Appendix C of this book.

Using the EIC Worksheets

The EIC steps are used to determine eligibility. The EIC worksheet is used to determine the credit. Since the 1040A EIC worksheet is the more commonly used worksheet at VITA/TCE sites, our exercise will focus on using the Form 1040A EIC steps and EIC worksheet, which together consist of 5 pages.

In most cases, all that is needed to complete EIC tax returns are the appropriate tax form and instructions booklets for Forms 1040, 1040A, & 1040EZ. Each form has its own worksheet(s) as described below.

- **Form 1040 EIC Worksheet.** If the taxpayer files Form 1040, you will use the steps in the Form 1040 package and either Worksheet A or Worksheet B. Worksheet A is for taxpayers whose earned income was received as an employee. Worksheet B is for taxpayers who have self-employment income, a member of the clergy or a church employee who files Schedule SE, or a statutory employee filing Schedule C or C-EZ. See (Exhibits 4–8)
- **Form 1040A Worksheet.** If the taxpayer files Form 1040A, you will use the steps and EIC worksheet in the Form 1040A package
- **Form 1040EZ Worksheet.** If the taxpayer files Form 1040EZ, you will use the steps and EIC worksheet in the Form 1040EZ package.

Using the EIC Table (See Appendix C)

When using the earned income credit table to determine the credit, read down the columns labeled “*At least... But less than*” and find the line that includes the amount you are instructed to look up from the EIC Worksheet. Read across to the column that includes the number of qualifying children of the taxpayer and filing status. Enter the earned income credit from that column on the EIC Worksheet.

Example 6 - Using The EIC Table

Roger’s filing status is head of household and he has two qualifying children. The amount shown on lines 1 and 3 of his Form 1040 EIC Worksheet is \$20,450.

Roger’s earned income credit from the EIC Table is \$3,114. Exhibits 4 thru 8 shows how Roger’s EIC is computed.

POTENTIAL PITFALLS

Errors are easily made when using the earned income credit table. To ensure you have entered the correct amount on the tax form, look up the credit twice—once before you enter the credit on the form and once after you enter it on the form.

Lines 66a and 66b— Earned Income Credit (EIC)

What Is the EIC?

The EIC is a credit for certain people who work. The credit may give you a refund even if you do not owe any tax.

To Take the EIC:

- Follow the steps below.
- Complete the worksheet that applies to you or let the IRS figure the credit for you.
- If you have a qualifying child, complete and attach Schedule EIC.



If you take the EIC even though you are not eligible and it is determined that your error is due to reckless or intentional disregard of the EIC rules, you will not be allowed to take the credit for 2 years even if you are otherwise eligible to do so. If you fraudulently take the EIC, you will not be allowed to take the credit for 10 years. See Form 8862, Who must file, on page 50. You may also have to pay penalties.

Step 1 All Filers

- If, in 2005:
 - 2 children lived with you, is the amount on Form 1040, line 38, less than \$35,263 (\$37,263 if married filing jointly)?
 - 1 child lived with you, is the amount on Form 1040, line 38, less than \$31,030 (\$33,030 if married filing jointly)?
 - No children lived with you, is the amount on Form 1040, line 38, less than \$11,750 (\$13,750 if married filing jointly)?

Yes. Continue **No.** You cannot take the credit.
- Do you, and your spouse if filing a joint return, have a social security number that allows you to work or is valid for EIC purposes (see page 50)?

Yes. Continue **No.** You cannot take the credit. Put "No" on the dotted line next to line 66a.
- Is your filing status married filing separately?

Yes. You cannot take the credit. **No.** Continue
- Are you filing Form 2555 or 2555-EZ (relating to foreign earned income)?

Yes. You cannot take the credit. **No.** Continue
- Were you a nonresident alien for any part of 2005?

Yes. See *Nonresident aliens* on page 50. **No.** Go to Step 2.

Step 2 Investment Income

- Add the amounts from Form 1040:

Line 8a _____
 Line 8b + _____
 Line 9a + _____
 Line 13* + _____

Investment Income =

*Do not include if line 13 is a loss.

- Is your investment income more than \$2,700?

Yes. Continue **No.** Skip question 3; go to question 4.
- Are you filing Form 4797 (relating to sales of business property)?

Yes. See *Form 4797 filers* on page 50. **No.** You cannot take the credit.
- Do any of the following apply for 2005?
 - You are filing Schedule E.
 - You are reporting income or a loss from the rental of personal property not used in a trade or business.
 - You are reporting income on Form 1040, line 21, from Form 8814 (relating to election to report child's interest and dividends).

Yes. You must use Worksheet 1 in Pub. 596 to see if you can take the credit. To get Pub. 596, see page 7. **No.** Continue
- Did a child live with you in 2005?

Yes. Go to Step 3 on page 48. **No.** Go to Step 4 on page 48.

Form 1040—Lines 66a and 66b

Continued from page 47

Step 3 Qualifying Child

A qualifying child is a child who is your...

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

AND

was ...

Under age 19 at the end of 2005

or

Under age 24 at the end of 2005 and a student (see page 50)

or

Any age and permanently and totally disabled (see page 50)

AND

who...

Lived with you in the United States for more than half of 2005.

If the child did not live with you for the required time, see *Exception to "time lived with you" condition* on page 50.



If the child was married, see page 50.

1. Look at the qualifying child conditions above. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2005?

Yes. **No.** Go to question 2.

You cannot take the credit. Put "No" on the dotted line next to line 66a.

2. Do you have at least one child who meets the conditions to be your qualifying child?

Yes. Continue **No.** Skip the next two questions; go to Step 4, question 2.

3. Does the child meet the conditions to be a qualifying child of any other person (other than your spouse if filing a joint return) for 2005?

Yes. See *Qualifying child of more than one person* on page 50. **No.** This child is your qualifying child. The child must have a valid social security number as defined on page 50 unless the child was born and died in 2005. Skip Step 4; go to Step 5 on page 49.

Step 4 Filers Without a Qualifying Child

1. Look at the qualifying child conditions in Step 3. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2005?

Yes. **No.** Continue

You cannot take the credit. Put "No" on the dotted line next to line 66a.

2. Can you, or your spouse if filing a joint return, be claimed as a dependent on someone else's 2005 tax return?

Yes. **No.** Continue

You cannot take the credit.

3. Were you, or your spouse if filing a joint return, at least age 25 but under age 65 at the end of 2005?

Yes. Continue **No.** You cannot take the credit.

4. Was your home, and your spouse's if filing a joint return, in the United States for more than half of 2005? Members of the military stationed outside the United States, see page 50 before you answer.

Yes. Go to Step 5 on page 49. **No.** You cannot take the credit. Put "No" on the dotted line next to line 66a.

Continued from page 48

Step 5 Earned Income

1. Are you filing Schedule SE because you were a member of the clergy or you had church employee income of \$108.28 or more?
 Yes. See *Clergy* or *Church employees*, whichever applies, on this page.
 No. Continue

2. Figure earned income:
 Form 1040, line 7 20,450

- Subtract, if included on line 7, any:
- Taxable scholarship or fellowship grant not reported on a Form W-2.
 - Amount received for work performed while an inmate in a penal institution (put "PRI" and the amount subtracted on the dotted line next to Form 1040, line 7).
 - Amount received as a pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan (put "DFC" and the amount subtracted on the dotted line next to Form 1040, line 7). This amount may be shown in Form W-2, box 11, or in Form W-2, box 12, with code Z. If you received such an amount but it is not reported on Form W-2, contact your employer for the amount received as a pension or annuity.

Add all of your nontaxable combat pay if you elect to include it in earned income. Also enter this amount on Form 1040, line 66b. See *Combat pay, Nontaxable* on this page. + _____



Electing to include nontaxable combat pay may increase or decrease your EIC. Figure the credit with and without your nontaxable combat pay before making the election.

Earned Income = 20,450

3. Were you self-employed, or are you filing Schedule SE because you were a member of the clergy or you had church employee income, or are you filing Schedule C or C-EZ as a statutory employee?

Yes. Skip question 4 and Step 6; go to Worksheet B on page 52.
 No. Continue

4. If you have:

- 2 or more qualifying children, is your earned income less than \$35,263 (\$37,263 if married filing jointly)?
- 1 qualifying child, is your earned income less than \$31,030 (\$33,030 if married filing jointly)?
- No qualifying children, is your earned income less than \$11,750 (\$13,750 if married filing jointly)?

Yes. Go to Step 6. **No.** You cannot take the credit.

Step 6 How To Figure the Credit

1. Do you want the IRS to figure the credit for you?
 Yes. See *Credit figured by the IRS* on page 50.
 No. Go to Worksheet A on page 51.

Definitions and Special Rules

(listed in alphabetical order)

Adopted child. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption even if the adoption is not final.

Church employees. Determine how much of the amount on Form 1040, line 7, was also reported on Schedule SE, line 5a. Subtract that amount from the amount on Form 1040, line 7, and enter the result in the first space of Step 5, line 2. Be sure to answer "Yes" to question 3 in Step 5.

Clergy. The following instructions apply to ministers, members of religious orders who have not taken a vow of poverty, and Christian Science practitioners. If you are filing Schedule SE and the amount on line 2 of that schedule includes an amount that was also reported on Form 1040, line 7:

1. Put "Clergy" on the dotted line next to Form 1040, line 66a.
2. Determine how much of the amount on Form 1040, line 7, was also reported on Schedule SE, line 2.
3. Subtract that amount from the amount on Form 1040, line 7. Enter the result in the first space of Step 5, line 2.
4. Be sure to answer "Yes" to question 3 in Step 5.

Combat pay, Nontaxable. If you were a member of the U.S. Armed Forces who served in a combat zone, certain pay is excluded from your income. See *Combat Zone Exclusion* in Pub. 3. You can elect to include this pay in your earned income when figuring the EIC. The amount of your nontaxable combat pay should be shown in Form(s) W-2, box 12, with code Q. If you are filing a joint return and both you and your spouse received nontaxable combat pay, you can each make your own election.

Form 1040—Lines 66a and 66b

Credit figured by the IRS. To have the IRS figure the credit for you:

1. Put "EIC" on the dotted line next to Form 1040, line 66a.
2. Be sure you enter the nontaxable combat pay you elect to include in earned income on Form 1040, line 66b. See *Combat pay, Nontaxable* on page 49.
3. If you have a qualifying child, complete and attach Schedule EIC. If your EIC for a year after 1996 was reduced or disallowed, see *Form 8862, Who must file* below.

Exception to "time lived with you" condition. A child is considered to have lived with you for all of 2005 if the child was born or died in 2005 and your home was this child's home for the entire time he or she was alive in 2005. Temporary absences for special circumstances, such as for school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home. Also see *Kidnapped child* on page 21, if applicable. If you were in the military stationed outside the United States, see *Members of the military* below.

Form 4797 filers. If the amount on Form 1040, line 13, includes an amount from Form 4797, you must use Worksheet 1 in Pub. 596 to see if you can take the EIC. To get Pub. 596, see page 7. Otherwise, stop; you cannot take the EIC.

Form 8862, Who must file. You must file Form 8862 if your EIC for a year after 1996 was reduced or disallowed for any reason other than a math or clerical error. But do not file Form 8862 if either of the following applies.

1. After your EIC was reduced or disallowed in an earlier year (a) you filed Form 8862 (or other documents) and your EIC was then allowed, and (b) your EIC has not been reduced or disallowed again for any reason other than a math or clerical error.
2. You are taking the EIC without a qualifying child and the only reason your EIC was reduced or disallowed in the earlier year was because it was determined that a child listed on Schedule EIC was not your qualifying child.

Also, do not file Form 8862 or take the credit for the:

- 2 years after the most recent tax year for which there was a final determination that your EIC was reduced or disallowed due to reckless or intentional disregard of the EIC rules, or
- 10 years after the most recent tax year for which there was a final determination that your EIC was reduced or disallowed due to fraud.

Married child. A child who was married at the end of 2005 is a qualifying child only if (a) you can claim him or her as your dependent on Form 1040, line 6c, or (b) this child's other parent claims him or her as a dependent under the rules for children of divorced or separated parents.

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

Members of the military. If you were on extended active duty outside the United States, your home is considered to be in the United States during that duty period. Extended active duty is military duty ordered for an indefinite period or for a period of more than 90 days. Once you begin serving extended active duty, you are considered to be on extended active duty even if you serve fewer than 90 days.

Nonresident aliens. If your filing status is married filing jointly, go to Step 2 on page 47. Otherwise, stop; you cannot take the EIC.

Permanently and totally disabled. A person who, at any time in 2005, cannot engage in any substantial gainful activity because of a physical or mental condition and a doctor has determined that this condition (a) has lasted or can be expected to last continuously for at least a year, or (b) can lead to death.

Qualifying child of more than one person. If the child meets the conditions to be a qualifying child of more than one person, only one person can take the EIC based on that child. The other person(s) cannot take the EIC for people without a qualifying child, but may be able to take the EIC based on a different qualifying child. If you and the other person(s) cannot agree who will take the EIC based on the same child, the IRS will apply the following rules.

- If only one of the persons is the child's parent, the child will be treated as the qualifying child of the parent.
- If both persons are the child's parents, the child will be treated as the qualifying child of the parent with whom the child lived for the longer period of time during 2005. If the child lived with each parent for the same amount of time, the child will be treated as the qualifying child of the parent who had the higher adjusted gross income (AGI) for 2005.
- If none of the persons is the child's parent, the child will be treated as the qualifying child of the person who had the highest AGI for 2005.

The child must have a valid social security number as defined below unless the child was born and died in 2005. If you do not have a qualifying child, stop; you cannot take the EIC. Put "No" on the dotted line next to line 66a. If you have a qualifying child, skip Step 4; go to Step 5 on page 49.

Example. You and your 5-year-old daughter moved in with your mother in April 2005. You are not a qualifying child of your mother. Your daughter meets the conditions to be a qualifying child for both you and your mother. If you and your mother cannot agree on who will treat your daughter as a qualifying child, the rules above apply. Under these rules, you are entitled to treat your daughter as a qualifying child because you are the child's parent. Your mother would not be entitled to take the EIC unless she has a different qualifying child.

Social security number (SSN). For the EIC, a valid SSN is a number issued by the Social Security Administration unless "Not Valid for Employment" is printed on the social security card and the number was issued solely to apply for or receive a federally funded benefit.

To find out how to get an SSN, see page 16. If you will not have an SSN by April 17, 2006, see *What If You Cannot File on Time?* on page 12.

Student. A child who during any 5 months of 2005:

- Was enrolled as a full-time student at a school, or
- Took a full-time, on-farm training course given by a school or a state, county, or local government agency.

A school includes a technical, trade, or mechanical school. It does not include an on-the-job training course, correspondence school, or night school.

Welfare benefits, Effect of credit on. Any refund you receive as a result of taking the EIC will not be used to determine if you are eligible for the following programs or how much you can receive from them. But if the refund you receive because of the EIC is not spent within a certain period of time, it may count as an asset (or resource) and affect your eligibility.

- Temporary Assistance for Needy Families (TANF).
- Medicaid and supplemental security income (SSI).
- Food stamps and low-income housing.

Worksheet A—Earned Income Credit (EIC)—Lines 66a and 66b

Keep for Your Records



Before you begin: ✓ Be sure you are using the correct worksheet. Do not use this worksheet if you were self-employed, or you are filing Schedule SE because you were a member of the clergy or you had church employee income, or you are filing Schedule C or C-EZ as a statutory employee. Instead, use Worksheet B that begins on page 50.

Part 1

All Filers Using Worksheet A

1. Enter your earned income from Step 5 on page 47.

1	20,450
---	--------

2. Look up the amount on line 1 above in the EIC Table on pages 52–57 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here.

2	3,114
---	-------

If line 2 is zero, You cannot take the credit. Put “No” on the dotted line next to line 66a.

3. Enter the amount from Form 1040, line 38.

3	20,450
---	--------

4. Are the amounts on lines 3 and 1 the same?
 Yes. Skip line 5; enter the amount from line 2 on line 6.
 No. Go to line 5.

Part 2

Filers Who Answered “No” on Line 4

5. If you have:
 • No qualifying children, is the amount on line 3 less than \$6,550 (\$8,550 if married filing jointly)?
 • 1 or more qualifying children, is the amount on line 3 less than \$14,400 (\$16,400 if married filing jointly)?
 Yes. Leave line 5 blank; enter the amount from line 2 on line 6.
 No. Look up the amount on line 3 in the EIC Table on pages 52–57 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here.
 Look at the amounts on lines 5 and 2. Then, enter the **smaller** amount on line 6.

5	
---	--

Part 3

Your Earned Income Credit

6. **This is your earned income credit.**

6	3,114
---	-------

Enter this amount on Form 1040, line 66a.

Reminder—

✓ If you have a qualifying child, complete and attach Schedule EIC.



If your EIC for a year after 1996 was reduced or disallowed, see page 48 to find out if you must file Form 8862 to take the credit for 2005.

Exercise 2 – Determining Eligibility and Figuring the Credit

- A.** Alex and Cheryl have two qualifying children. Their filing status is married filing jointly. The amount shown on lines 1 and 3 of their EIC Worksheet is \$21,987.

What is the earned income credit from the EIC Table? _____

- B.** Roxanne is divorced. She lives with her infant daughter. The amount shown on lines 1 and 3 of her EIC Worksheet is \$19,453.

What is the earned income credit from the EIC Table? _____

- C.** Sam U. Bell is a member of the army and served 6 months in Iraq in 2005. Sam is married to Robin O. Bell and they are filing a joint return. Sam's social security number is xxx-xx-xxxx and Robin's is xxx-xx-xxxx. Sam received \$8,000 of combat pay and is electing to include it in his earned income when figuring the EIC. Form 1040, line 7 shows \$14,950, line 8a shows \$50 of taxable interest income, and line 22 shows the Bells' adjusted gross income of \$15,000.

They have a child, Jennifer S. Bell (SSN xxx-xx-xxxx) who was born in 1996. Jennifer lived with her parents for the entire year.

Complete the Form 1040 EIC Eligibility Questions and Worksheet, Exhibits 9–13.

Lines 66a and 66b— Earned Income Credit (EIC)

Step 2 Investment Income

What Is the EIC?

The EIC is a credit for certain people who work. The credit may give you a refund even if you do not owe any tax.

To Take the EIC:

- Follow the steps below.
- Complete the worksheet that applies to you or let the IRS figure the credit for you.
- If you have a qualifying child, complete and attach Schedule EIC.



If you take the EIC even though you are not eligible and it is determined that your error is due to reckless or intentional disregard of the EIC rules, you will not be allowed to take the credit for 2 years even if you are otherwise eligible to do so. If you fraudulently take the EIC, you will not be allowed to take the credit for 10 years. See Form 8862, Who must file, on page 50. You may also have to pay penalties.

Step 1 All Filers

- If, in 2005:
 - 2 children lived with you, is the amount on Form 1040, line 38, less than \$35,263 (\$37,263 if married filing jointly)?
 - 1 child lived with you, is the amount on Form 1040, line 38, less than \$31,030 (\$33,030 if married filing jointly)?
 - No children lived with you, is the amount on Form 1040, line 38, less than \$11,750 (\$13,750 if married filing jointly)?

Yes. Continue **No.** You cannot take the credit.
- Do you, and your spouse if filing a joint return, have a social security number that allows you to work or is valid for EIC purposes (see page 50)?

Yes. Continue **No.** You cannot take the credit. Put "No" on the dotted line next to line 66a.
- Is your filing status married filing separately?

Yes. You cannot take the credit. **No.** Continue
- Are you filing Form 2555 or 2555-EZ (relating to foreign earned income)?

Yes. You cannot take the credit. **No.** Continue
- Were you a nonresident alien for any part of 2005?

Yes. See *Nonresident aliens* on page 50. **No.** Go to Step 2.

1. Add the amounts from Form 1040:

Line 8a _____
 Line 8b + _____
 Line 9a + _____
 Line 13* + _____

Investment Income =

*Do not include if line 13 is a loss.

- Is your investment income more than \$2,700?

Yes. Continue **No.** Skip question 3; go to question 4.
- Are you filing Form 4797 (relating to sales of business property)?

Yes. See Form 4797 filers on page 50. **No.** You cannot take the credit.
- Do any of the following apply for 2005?
 - You are filing Schedule E.
 - You are reporting income or a loss from the rental of personal property not used in a trade or business.
 - You are reporting income on Form 1040, line 21, from Form 8814 (relating to election to report child's interest and dividends).

Yes. You must use Worksheet 1 in Pub. 596 to see if you can take the credit. To get Pub. 596, see page 7. **No.** Continue
- Did a child live with you in 2005?

Yes. Go to Step 3 on page 48. **No.** Go to Step 4 on page 48.

Form 1040—Lines 66a and 66b

Continued from page 47

Step 3 Qualifying Child

A qualifying child is a child who is your...

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

AND

was ...

Under age 19 at the end of 2005

or

Under age 24 at the end of 2005 and a student (see page 50)

or

Any age and permanently and totally disabled (see page 50)

AND

who...

Lived with you in the United States for more than half of 2005.

If the child did not live with you for the required time, see *Exception to "time lived with you" condition* on page 50.



If the child was married, see page 50.

1. Look at the qualifying child conditions above. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2005?

- Yes.** **No.** Go to question 2.

You cannot take the credit. Put "No" on the dotted line next to line 66a.

2. Do you have at least one child who meets the conditions to be your qualifying child?

- Yes.** Continue **No.** Skip the next two questions; go to Step 4, question 2.

3. Does the child meet the conditions to be a qualifying child of any other person (other than your spouse if filing a joint return) for 2005?

- Yes.** See *Qualifying child of more than one person* on page 50. **No.** This child is your qualifying child. The child must have a valid social security number as defined on page 50 unless the child was born and died in 2005. Skip Step 4; go to Step 5 on page 49.

Step 4 Filers Without a Qualifying Child

1. Look at the qualifying child conditions in Step 3. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2005?

- Yes.** **No.** Continue
- You cannot take the credit. Put "No" on the dotted line next to line 66a.

2. Can you, or your spouse if filing a joint return, be claimed as a dependent on someone else's 2005 tax return?

- Yes.** **No.** Continue
- You cannot take the credit.

3. Were you, or your spouse if filing a joint return, at least age 25 but under age 65 at the end of 2005?

- Yes.** Continue **No.** You cannot take the credit.

4. Was your home, and your spouse's if filing a joint return, in the United States for more than half of 2005? Members of the military stationed outside the United States, see page 50 before you answer.

- Yes.** Go to Step 5 on page 49. **No.** You cannot take the credit. Put "No" on the dotted line next to line 66a.

Continued from page 48

Step 5 Earned Income

1. Are you filing Schedule SE because you were a member of the clergy or you had church employee income of \$108.28 or more?
 Yes. See *Clergy or Church employees*, whichever applies, on this page. **No.** Continue

2. Figure earned income:
 Form 1040, line 7 _____

Subtract, if included on line 7, any:

- Taxable scholarship or fellowship grant not reported on a Form W-2.
- Amount received for work performed while an inmate in a penal institution (put "PRI" and the amount subtracted on the dotted line next to Form 1040, line 7).
- Amount received as a pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan (put "DFC" and the amount subtracted on the dotted line next to Form 1040, line 7). This amount may be shown in Form W-2, box 11, or in Form W-2, box 12, with code Z. If you received such an amount but it is not reported on Form W-2, contact your employer for the amount received as a pension or annuity.

Add all of your nontaxable combat pay if you elect to include it in earned income. Also enter this amount on Form 1040, line 66b. See *Combat pay, Nontaxable* on this page.

+ _____



Electing to include nontaxable combat pay may increase or decrease your EIC. Figure the credit with and without your nontaxable combat pay before making the election.

Earned Income =

3. Were you self-employed, or are you filing Schedule SE because you were a member of the clergy or you had church employee income, or are you filing Schedule C or C-EZ as a statutory employee?
 Yes. Skip question 4 and Step 6; go to Worksheet B on page 52. **No.** Continue

4. If you have:
 • 2 or more qualifying children, is your earned income less than \$35,263 (\$37,263 if married filing jointly)?
 • 1 qualifying child, is your earned income less than \$31,030 (\$33,030 if married filing jointly)?
 • No qualifying children, is your earned income less than \$11,750 (\$13,750 if married filing jointly)?
 Yes. Go to Step 6. **No.** You cannot take the credit.

Step 6 How To Figure the Credit

1. Do you want the IRS to figure the credit for you?
 Yes. See *Credit figured by the IRS* on page 50. **No.** Go to Worksheet A on page 51.

Definitions and Special Rules

(listed in alphabetical order)

Adopted child. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption even if the adoption is not final.

Church employees. Determine how much of the amount on Form 1040, line 7, was also reported on Schedule SE, line 5a. Subtract that amount from the amount on Form 1040, line 7, and enter the result in the first space of Step 5, line 2. Be sure to answer "Yes" to question 3 in Step 5.

Clergy. The following instructions apply to ministers, members of religious orders who have not taken a vow of poverty, and Christian Science practitioners. If you are filing Schedule SE and the amount on line 2 of that schedule includes an amount that was also reported on Form 1040, line 7:

1. Put "Clergy" on the dotted line next to Form 1040, line 66a
2. Determine how much of the amount on Form 1040, line 7 was also reported on Schedule SE, line 2.
3. Subtract that amount from the amount on Form 1040, line 7. Enter the result in the first space of Step 5, line 2.
4. Be sure to answer "Yes" to question 3 in Step 5.

Combat pay, Nontaxable. If you were a member of the U.S. Armed Forces who served in a combat zone, certain pay is excluded from your income. See *Combat Zone Exclusion* in Pub. 3. You can elect to include this pay in your earned income when figuring the EIC. The amount of your nontaxable combat pay should be shown in Form(s) W-2, box 12, with code Q. If you are filing a joint return and both you and your spouse received nontaxable combat pay, you can each make your own election.

Credit figured by the IRS. To have the IRS figure the credit for you:

1. Put "EIC" on the dotted line next to Form 1040, line 66a.
2. Be sure you enter the nontaxable combat pay you elect to include in earned income on Form 1040, line 66b. See *Combat pay, Nontaxable* on page 49.
3. If you have a qualifying child, complete and attach Schedule EIC. If your EIC for a year after 1996 was reduced or disallowed, see *Form 8862, Who must file* below.

Exception to "time lived with you" condition. A child is considered to have lived with you for all of 2005 if the child was born or died in 2005 and your home was this child's home for the entire time he or she was alive in 2005. Temporary absences for special circumstances, such as for school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home. Also see *Kidnapped child* on page 21, if applicable. If you were in the military stationed outside the United States, see *Members of the military* below.

Form 4797 filers. If the amount on Form 1040, line 13, includes an amount from Form 4797, you must use Worksheet 1 in Pub. 596 to see if you can take the EIC. To get Pub. 596, see page 7. Otherwise, stop; you cannot take the EIC.

Form 8862, Who must file. You must file Form 8862 if your EIC for a year after 1996 was reduced or disallowed for any reason other than a math or clerical error. But do not file Form 8862 if either of the following applies.

1. After your EIC was reduced or disallowed in an earlier year (a) you filed Form 8862 (or other documents) and your EIC was then allowed, and (b) your EIC has not been reduced or disallowed again for any reason other than a math or clerical error.
2. You are taking the EIC without a qualifying child and the only reason your EIC was reduced or disallowed in the earlier year was because it was determined that a child listed on Schedule EIC was not your qualifying child.

Also, do not file Form 8862 or take the credit for the:

- 2 years after the most recent tax year for which there was a final determination that your EIC was reduced or disallowed due to reckless or intentional disregard of the EIC rules, or
- 10 years after the most recent tax year for which there was a final determination that your EIC was reduced or disallowed due to fraud.

Married child. A child who was married at the end of 2005 is a qualifying child only if (a) you can claim him or her as your dependent on Form 1040, line 6c, or (b) this child's other parent claims him or her as a dependent under the rules for children of divorced or separated parents.

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

Members of the military. If you were on extended active duty outside the United States, your home is considered to be in the United States during that duty period. Extended active duty is military duty ordered for an indefinite period or for a period of more than 90 days. Once you begin serving extended active duty, you are considered to be on extended active duty even if you serve fewer than 90 days.

Nonresident aliens. If your filing status is married filing jointly, go to Step 2 on page 47. Otherwise, stop; you cannot take the EIC.

Permanently and totally disabled. A person who, at any time in 2005, cannot engage in any substantial gainful activity because of a physical or mental condition and a doctor has determined that this condition (a) has lasted or can be expected to last continuously for at least a year, or (b) can lead to death.

Qualifying child of more than one person. If the child meets the conditions to be a qualifying child of more than one person, only one person can take the EIC based on that child. The other person(s) cannot take the EIC for people without a qualifying child, but may be able to take the EIC based on a different qualifying child. If you and the other person(s) cannot agree who will take the EIC based on the same child, the IRS will apply the following rules.

- If only one of the persons is the child's parent, the child will be treated as the qualifying child of the parent.
- If both persons are the child's parents, the child will be treated as the qualifying child of the parent with whom the child lived for the longer period of time during 2005. If the child lived with each parent for the same amount of time, the child will be treated as the qualifying child of the parent who had the higher adjusted gross income (AGI) for 2005.
- If none of the persons is the child's parent, the child will be treated as the qualifying child of the person who had the highest AGI for 2005.

The child must have a valid social security number as defined below unless the child was born and died in 2005. If you do not have a qualifying child, stop; you cannot take the EIC. Put "No" on the dotted line next to line 66a. If you have a qualifying child, skip Step 4; go to Step 5 on page 49.

Example. You and your 5-year-old daughter moved in with your mother in April 2005. You are not a qualifying child of your mother. Your daughter meets the conditions to be a qualifying child for both you and your mother. If you and your mother cannot agree on who will treat your daughter as a qualifying child, the rules above apply. Under these rules, you are entitled to treat your daughter as a qualifying child because you are the child's parent. Your mother would not be entitled to take the EIC unless she has a different qualifying child.

Social security number (SSN). For the EIC, a valid SSN is a number issued by the Social Security Administration unless "Not Valid for Employment" is printed on the social security card and the number was issued solely to apply for or receive a federally funded benefit.

To find out how to get an SSN, see page 16. If you will not have an SSN by April 17, 2006, see *What If You Cannot File on Time?* on page 12.

Student. A child who during any 5 months of 2005:

- Was enrolled as a full-time student at a school, or
- Took a full-time, on-farm training course given by a school or a state, county, or local government agency.

A school includes a technical, trade, or mechanical school. It does not include an on-the-job training course, correspondence school, or night school.

Welfare benefits, Effect of credit on. Any refund you receive as a result of taking the EIC will not be used to determine if you are eligible for the following programs or how much you can receive from them. But if the refund you receive because of the EIC is not spent within a certain period of time, it may count as an asset (or resource) and affect your eligibility.

- Temporary Assistance for Needy Families (TANF).
- Medicaid and supplemental security income (SSI).
- Food stamps and low-income housing.

Worksheet A—Earned Income Credit (EIC)—Lines 66a and 66b *Keep for Your Records* 


Before you begin: ✓ Be sure you are using the correct worksheet. Do not use this worksheet if you were self-employed, or you are filing Schedule SE because you were a member of the clergy or you had church employee income, or you are filing Schedule C or C-EZ as a statutory employee. Instead, use Worksheet B that begins on page 50.

Part 1

All Filers Using Worksheet A

1. Enter your earned income from Step 5 on page 47. 1

2. Look up the amount on line 1 above in the EIC Table on pages 52–57 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here. 2

If line 2 is zero,  You cannot take the credit. Put “No” on the dotted line next to line 66a.

3. Enter the amount from Form 1040, line 38. 3

4. Are the amounts on lines 3 and 1 the same?
 Yes. Skip line 5; enter the amount from line 2 on line 6.
 No. Go to line 5.

Part 2

Filers Who Answered “No” on Line 4

5. If you have:
 • No qualifying children, is the amount on line 3 less than \$6,550 (\$8,550 if married filing jointly)?
 • 1 or more qualifying children, is the amount on line 3 less than \$14,400 (\$16,400 if married filing jointly)?
 Yes. Leave line 5 blank; enter the amount from line 2 on line 6.
 No. Look up the amount on line 3 in the EIC Table on pages 52–57 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here.

Look at the amounts on lines 5 and 2. Then, enter the **smaller** amount on line 6.

5

Part 3

Your Earned Income Credit

6. This is your earned income credit. 6

Enter this amount on Form 1040, line 66a.

Reminder—

✓ If you have a qualifying child, complete and attach Schedule EIC.



If your EIC for a year after 1996 was reduced or disallowed, see page 48 to find out if you must file Form 8862 to take the credit for 2005.

SCHEDULE EIC FOR QUALIFYING CHILD(REN)

Schedule EIC contains only information about qualifying children. Only taxpayers who have a qualifying child must fill out the schedule and attach it to Form 1040A or Form 1040. Note: The taxpayer cannot use Form 1040EZ to claim the EIC with a qualifying child.

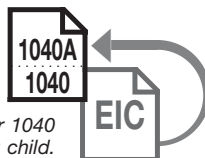
Example 7 – Completing Schedule EIC

Ronald Evans (SSNxxx-xx-xxxx) is single. His son, Harry (SSN xxx-xx-xxxx), was born in 1982. Harry lived with Ronald during all of 2005. Harry is a full-time college student. Harry is not married and is a qualifying child of only his father.

Exhibit 14 shows a completed Schedule EIC.

SCHEDULE EIC
(Form 1040A or 1040)

Earned Income Credit
Qualifying Child Information



OMB No. 1545-0074

2005

Attachment
Sequence No. **43**

Department of the Treasury
Internal Revenue Service

Complete and attach to Form 1040A or 1040
only if you have a qualifying child.

Name(s) shown on return
Ronald Evans

Your social security number
XXX | XX | XXXX

Before you begin: See the instructions for Form 1040A, lines 41a and 41b, or Form 1040, lines 66a and 66b, to make sure that (a) you can take the EIC and (b) you have a qualifying child.



- If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See back of schedule for details.
- It will take us longer to process your return and issue your refund if you do not fill in all lines that apply for each qualifying child.
- Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

Qualifying Child Information

Child 1

Child 2

1 Child's name If you have more than two qualifying children, you only have to list two to get the maximum credit.	First name Last name Harold Evans	First name Last name
2 Child's SSN The child must have an SSN as defined on page 42 of the Form 1040A instructions or page 44 of the Form 1040 instructions unless the child was born and died in 2005. If your child was born and died in 2005 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate.	XXX | XX | XXXX	
3 Child's year of birth	Year <u>1</u> <u>9</u> <u>8</u> <u>2</u> If born after 1986, skip lines 4a and 4b; go to line 5.	Year _____ If born after 1986, skip lines 4a and 4b; go to line 5.
4 If the child was born before 1987— a Was the child under age 24 at the end of 2005 and a student?	<input checked="" type="checkbox"/> Yes. Go to line 5. <input type="checkbox"/> No. Continue	<input type="checkbox"/> Yes. Go to line 5. <input type="checkbox"/> No. Continue
b Was the child permanently and totally disabled during any part of 2005?	<input type="checkbox"/> Yes. Continue <input type="checkbox"/> No. The child is not a qualifying child.	<input type="checkbox"/> Yes. Continue <input type="checkbox"/> No. The child is not a qualifying child.
5 Child's relationship to you (for example, son, daughter, grandchild, niece, nephew, foster child, etc.)	son	
6 Number of months child lived with you in the United States during 2005 • If the child lived with you for more than half of 2005 but less than 7 months, enter "7." • If the child was born or died in 2005 and your home was the child's home for the entire time he or she was alive during 2005, enter "12."	12 months Do not enter more than 12 months.	_____ months Do not enter more than 12 months.



You may also be able to take the additional child tax credit if your child (a) was under age 17 at the end of 2005, and (b) is a U.S. citizen or resident alien. For more details, see the instructions for line 42 of Form 1040A or line 68 of Form 1040.

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions.

Cat. No. 13339M

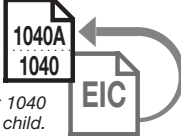


Schedule EIC (Form 1040A or 1040) 2005

Exercise 3 – Schedule EIC

Complete Schedule EIC, Exhibit 15, for Sam U. and Robin O. Bell in Exercise 2C using the information provided.

Exhibit 15

Complete Sam U. and Robin O.'s Schedule EIC, page 1

<p>SCHEDULE EIC (Form 1040A or 1040)</p> <p>Department of the Treasury Internal Revenue Service</p> <p>Name(s) shown on return</p>	<p>Earned Income Credit Qualifying Child Information</p> <p><i>Complete and attach to Form 1040A or 1040 only if you have a qualifying child.</i></p>		<p>OMB No. 1545-0074</p> <p>2005</p> <p>Attachment Sequence No. 43</p>	
		Your social security number		
<p>Before you begin: See the instructions for Form 1040A, lines 41a and 41b, or Form 1040, lines 66a and 66b, to make sure that (a) you can take the EIC and (b) you have a qualifying child.</p>				
<p> CAUTION</p> <ul style="list-style-type: none"> • If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See back of schedule for details. • It will take us longer to process your return and issue your refund if you do not fill in all lines that apply for each qualifying child. • Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213. 				
Qualifying Child Information				
	Child 1		Child 2	
1 Child's name	First name	Last name	First name	Last name
If you have more than two qualifying children, you only have to list two to get the maximum credit.				
2 Child's SSN				
The child must have an SSN as defined on page 42 of the Form 1040A instructions or page 44 of the Form 1040 instructions unless the child was born and died in 2005. If your child was born and died in 2005 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate.	: : :		: : :	
3 Child's year of birth	Year _____		Year _____	
	<i>If born after 1986, skip lines 4a and 4b; go to line 5.</i>		<i>If born after 1986, skip lines 4a and 4b; go to line 5.</i>	
4 If the child was born before 1987—				
a Was the child under age 24 at the end of 2005 and a student?	<input type="checkbox"/> Yes. <i>Go to line 5.</i>	<input type="checkbox"/> No. <i>Continue</i>	<input type="checkbox"/> Yes. <i>Go to line 5.</i>	<input type="checkbox"/> No. <i>Continue</i>
b Was the child permanently and totally disabled during any part of 2005?	<input type="checkbox"/> Yes. <i>Continue</i>	<input type="checkbox"/> No. The child is not a qualifying child.	<input type="checkbox"/> Yes. <i>Continue</i>	<input type="checkbox"/> No. The child is not a qualifying child.
5 Child's relationship to you (for example, son, daughter, grandchild, niece, nephew, foster child, etc.)				
6 Number of months child lived with you in the United States during 2005				
<ul style="list-style-type: none"> • If the child lived with you for more than half of 2005 but less than 7 months, enter "7." • If the child was born or died in 2005 and your home was the child's home for the entire time he or she was alive during 2005, enter "12." 	_____ months <i>Do not enter more than 12 months.</i>		_____ months <i>Do not enter more than 12 months.</i>	
<p> TIP You may also be able to take the additional child tax credit if your child (a) was under age 17 at the end of 2005, and (b) is a U.S. citizen or resident alien. For more details, see the instructions for line 42 of Form 1040A or line 68 of Form 1040.</p>				
For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions.		Cat. No. 13339M		Schedule EIC (Form 1040A or 1040) 2005

EIC - ELIGIBILITY TOOLS

The EIC is not for everyone. Only those taxpayers who are eligible should claim the credit. It is important to understand the eligibility requirements and claim the EIC on the returns of only those taxpayers who qualify for it. The following resources are available to navigate the complexity of the EIC.

- Publication 4012, Volunteer Resource Guide
- EIC Eligibility Questions and Worksheet (Form 1040, 1040A, 1040EZ Instructions)
- Publication 596, Earned Income Credit

COMMON EIC RETURN ERRORS

- 1. Claiming children who are not the taxpayer's EIC qualifying child.** Make sure the taxpayer's children pass the EIC qualifying child tests—relationship, age, and residency. Always verify if the child could be a qualifying child of another taxpayer.
- 2. Selecting the incorrect filing status.** Married taxpayers filing separately are not eligible for the EIC. Married taxpayers cannot use the Single filing status. Married taxpayers, who lived apart during the last 6 months of the year, may qualify as Head of Household. ***Don't guess; use Publication 4012 and the tools on filing status to make sure.***
- 3. Submitting returns with income errors.** Earned income for EIC purposes includes wages, salaries and tips (box 1, Form W-2), net earnings from self-employment, and statutory employee gross income (line 1 on Schedule C or Schedule C-EZ). Statutory employee issues are beyond the scope of VITA/TCE.
- 4. Submitting returns with incorrect Social Security numbers.** Confirm the accuracy of all names and SSN's shown on the return. The name(s) and number(s) must match official government records. Always ask to see taxpayers' and their children's social security cards.

ALERT



Remember to ask the taxpayer if the IRS disallowed the EIC in past years.

DISALLOWED EARNED INCOME CREDIT

With one exception, if a taxpayer's earned income credit was disallowed for any year after 1996 as a result of the deficiency procedures, he or she cannot claim the credit again unless Form 8862, *Information To Claim Earned Income Credit After Disallowance*, is attached to the return, and the taxpayer meets all the EIC requirements. If the credit is claimed without attaching Form 8862, it will be automatically denied, under the math error procedures.

Exception: Form 8862 is not required if the taxpayer's EIC was disallowed or reduced for any year after 2001 as a result of the deficiency procedures solely because a child listed on Schedule EIC was determined not to be the taxpayer's qualifying child, and the taxpayer is claiming the credit for the current year without a qualifying child.

A deficiency procedure occurs when the IRS questions the taxpayer's eligibility for the earned income credit for reasons other than a mathematical or clerical error. If the credit was disallowed in the earlier year because of a mathematical or clerical error, Form 8862 should not be completed.

A taxpayer who is determined to have claimed the EIC due to reckless or intentional disregard of rules or regulations is ineligible to claim the EIC for the next 2 tax years. A taxpayer who is determined to have fraudulently claimed the EIC is ineligible to claim the EIC for the next 10 tax years.

ADVANCE EARNED INCOME CREDIT PAYMENTS (AEIC)

Some taxpayers may choose to receive advance payments of the EIC. To receive advance payments, the taxpayer must be employed, must expect to have a least one qualifying child for the tax year, must expect to be eligible for the EIC, and must expect his or her earned income and adjusted gross income will be less than approximately \$30,000.

To receive advance payments, the taxpayer must give the employer a Form W-5, Earned Income Credit Advance Payment Certificate. The employer will include part of the credit regularly in the employee pay. Farm workers are excluded.

Taxpayers can receive only a portion of the credit through advance payments, so the eligibility questions and the EIC Worksheet must be completed when the tax return is prepared to determine the full amount of the credit the taxpayer is entitled to receive.

Employees who receive advance earned income credit payments must file a tax return even if they are not otherwise required to file. If the taxpayer received advance EIC payments in 2005, he or she must file a tax return to report the payments. Report the amount on line 61 (Form 1040) or line 37 (Form 1040A). Form 1040EZ cannot be used to report advance payments. The taxpayer's Form W-2 will show the advance EIC amount in box 9.

ALERT



Remember to check box 9 of Form W-2 for advance earned income credit.

Exercise 4 – Advance EIC Payment

Kyle B. Evans is a single parent. His daughter Julie lives with him and he claims her as a dependent on his tax return. Kyle's social security number is xxx-xx-xxxx. Julie was born in November 2001. Her social security number is xxx-xx-xxxx. Kyle's earned income was \$19,572, and his total income and adjusted gross income were \$21,599. His filing status is head of household and he does not itemize deductions. Kyle's child tax credit is \$788 and his earned income credit is \$1,511. He received \$550 in advance earned income credit payments.

- A. Compute Kyle's refund or balance due amount based on the information given, using the attached page 2 of Form 1040, Exhibit 16.

▶▶ SUMMING UP THIS LESSON ◀◀

- ▶ EIC is a tax break for qualified taxpayers. Eligible taxpayers must file a tax return to claim the credit.
- ▶ When the credit exceeds the amount of tax owed it can result in a tax refund.
- ▶ The taxpayer may be entitled to the credit even if he or she does not meet the income filing requirements. The taxpayer must have earned income of at least \$1.
- ▶ There are specific eligibility rules for all taxpayers, taxpayers with a qualifying child, and taxpayers without a qualifying child as shown below:

EIC Rules			
Rules for all Taxpayers		Rules for Taxpayer With a Qualifying Child	Rules for Taxpayer Without a Qualifying Child
Must have a valid Social Security number	Investment income is limited to a certain amount	Child must meet the relationship, age, and residency tests	Must be at least age 25 but under age 65
Filing status cannot be "Married filing separately"	Must have earned income	Qualifying child cannot be used by more than one person to claim the EIC	Cannot qualify as the dependent of another person
Generally must be a U.S. citizen or resident alien all year	Cannot be a qualifying child of another person		Must have lived in the United States more than half the tax year
Cannot file Form 2555 or Form 2555-EZ (relating to foreign earned income)			

- ▶ EIC is not for everyone; the taxpayer must qualify for the credit.
- ▶ Some of the most common reasons for disallowance are:
 - Claiming the credit with a child who is not the taxpayer's qualifying child.
 - Married taxpayers filing as single or head of household.
 - Reporting income incorrectly.
 - Missing or incorrect social security numbers.
- ▶ Don't guess, use Publication 4012, the EIC worksheets, Publication 596, and other tools when assisting taxpayers in claiming the EIC.

Exercise 1

- (A) No; to be a qualifying child, the child must live with the taxpayer more than half of the year.
- (B) Neither Donna nor Doug can claim the credit; in order to claim the earned income credit, married taxpayers living together must file a joint return.
- (C) Jimmy and Anna are qualifying children of both Randy and Cara. Randy and Cara can choose which of them will claim the credit and the other available child-related benefits based on each child. One can claim the credit (and other available child-related benefits) on the basis of two children, or each can claim the credit (and other available child-related benefits) on the basis of one child. If both claim the credit (and other child-related benefits) on the basis of the same child or both children, Cara will be entitled to the credit (and other available child-related benefits) because each child lived with her for the longer period of time during the year.
- (D) Yes. He is between 25 and 65; his earned income is less than \$11,490; he cannot be claimed as a dependent and he is not a qualifying child of another person.
- (E) No; to be a qualifying child, a married child must generally be eligible to be claimed as a dependent by the taxpayer.
- (F) Numbers 1, 3, and 6 should be circled.

Exercise 2

- (A) \$3,220
- (B) \$1,846

EARNED INCOME CREDIT

Lesson 5

ANSWERS TO EXERCISES

Exercise 2(C)

Sam U. and Robin O.'s Eligibility Questions, page 1

Form 1040—Lines 66a and 66b

Lines 66a and 66b— Earned Income Credit (EIC)

What Is the EIC?

The EIC is a credit for certain people who work. The credit may give you a refund even if you do not owe any tax.

To Take the EIC:

- Follow the steps below.
- Complete the worksheet that applies to you or let the IRS figure the credit for you.
- If you have a qualifying child, complete and attach Schedule EIC.



If you take the EIC even though you are not eligible and it is determined that your error is due to reckless or intentional disregard of the EIC rules, you will not be allowed to take the credit for 2 years even if you are otherwise eligible to do so. If you fraudulently take the EIC, you will not be allowed to take the credit for 10 years. See Form 8862, Who must file, on page 50. You may also have to pay penalties.

Step 1 All Filers

1. If, in 2005:
 - 2 children lived with you, is the amount on Form 1040, line 38, less than \$35,263 (\$37,263 if married filing jointly)?
 - 1 child lived with you, is the amount on Form 1040, line 38, less than \$31,030 (\$33,030 if married filing jointly)?
 - No children lived with you, is the amount on Form 1040, line 38, less than \$11,750 (\$13,750 if married filing jointly)?

Yes. Continue **No.** You cannot take the credit.
2. Do you, and your spouse if filing a joint return, have a social security number that allows you to work or is valid for EIC purposes (see page 50)?

Yes. Continue **No.** You cannot take the credit. Put "No" on the dotted line next to line 66a.
3. Is your filing status married filing separately?

Yes. **No.** Continue You cannot take the credit.
4. Are you filing Form 2555 or 2555-EZ (relating to foreign earned income)?

Yes. **No.** Continue You cannot take the credit.
5. Were you a nonresident alien for any part of 2005?

Yes. See *Nonresident aliens* on page 50. **No.** Go to Step 2.

Step 2 Investment Income

1. Add the amounts from Form 1040:

Line 8a	50.00
Line 8b	+
Line 9a	+
Line 13*	+
Investment Income	= 50.00

*Do not include if line 13 is a loss.

2. Is your investment income more than \$2,700?

Yes. Continue **No.** Skip question 3; go to question 4.
3. Are you filing Form 4797 (relating to sales of business property)?

Yes. See Form 4797 filers on page 50. **No.** You cannot take the credit.
4. Do any of the following apply for 2005?
 - You are filing Schedule E.
 - You are reporting income or a loss from the rental of personal property not used in a trade or business.
 - You are reporting income on Form 1040, line 21, from Form 8814 (relating to election to report child's interest and dividends).

Yes. You must use Worksheet 1 in Pub. 596 to see if you can take the credit. To get Pub. 596, see page 7. **No.** Continue
5. Did a child live with you in 2005?

Yes. Go to Step 3 on page 48. **No.** Go to Step 4 on page 48.

Exercise 2(C) Sam U. and Robin O.'s Eligibility Questions, page 2

Form 1040—Lines 66a and 66b

Continued from page 47

Step 3 Qualifying Child

A qualifying child is a child who is your...

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

AND

was ...

Under age 19 at the end of 2005

or

Under age 24 at the end of 2005 and a student (see page 50)

or

Any age and permanently and totally disabled (see page 50)

AND

who...

Lived with you in the United States for more than half of 2005.

If the child did not live with you for the required time, see *Exception to "time lived with you" condition* on page 50.



If the child was married, see page 50.

1. Look at the qualifying child conditions above. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2005?

Yes. **No.** Go to question 2.

You cannot take the credit. Put "No" on the dotted line next to line 66a.

2. Do you have at least one child who meets the conditions to be your qualifying child?

Yes. Continue **No.** Skip the next two questions; go to Step 4, question 2.

3. Does the child meet the conditions to be a qualifying child of any other person (other than your spouse if filing a joint return) for 2005?

Yes. See *Qualifying child of more than one person* on page 50. **No.** This child is your qualifying child. The child must have a valid social security number as defined on page 50 unless the child was born and died in 2005. Skip Step 4; go to Step 5 on page 49.

Step 4 Filers Without a Qualifying Child

1. Look at the qualifying child conditions in Step 3. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2005?

Yes. **No.** Continue

You cannot take the credit. Put "No" on the dotted line next to line 66a.

2. Can you, or your spouse if filing a joint return, be claimed as a dependent on someone else's 2005 tax return?

Yes. **No.** Continue

You cannot take the credit.

3. Were you, or your spouse if filing a joint return, at least age 25 but under age 65 at the end of 2005?

Yes. Continue **No.** You cannot take the credit.

4. Was your home, and your spouse's if filing a joint return, in the United States for more than half of 2005? Members of the military stationed outside the United States, see page 50 before you answer.

Yes. Go to Step 5 on page 49. **No.** You cannot take the credit. Put "No" on the dotted line next to line 66a.

EARNED INCOME CREDIT

Lesson 5

ANSWERS TO EXERCISES

Exercise 2(C)

Sam U. and Robin O.'s Eligibility Questions, page 3

Form 1040—Lines 66a and 66b

Continued from page 48

Step 5 Earned Income

1. Are you filing Schedule SE because you were a member of the clergy or you had church employee income of \$108.28 or more?

Yes. See *Clergy or Church employees*, whichever applies, on this page. **No.** Continue

2. Figure earned income:

Form 1040, line 7 14,950

Subtract, if included on line 7, any:

- Taxable scholarship or fellowship grant not reported on a Form W-2.
- Amount received for work performed while an inmate in a penal institution (put "PRI" and the amount subtracted on the dotted line next to Form 1040, line 7).
- Amount received as a pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan (put "DFC" and the amount subtracted on the dotted line next to Form 1040, line 7). This amount may be shown in Form W-2, box 11, or in Form W-2, box 12, with code Z. If you received such an amount but it is not reported on Form W-2, contact your employer for the amount received as a pension or annuity.

Add all of your nontaxable combat pay if you elect to include it in earned income. Also enter this amount on Form 1040, line 66b. See *Combat pay, Nontaxable* on this page.

+ 8,000



CAUTION Electing to include nontaxable combat pay may increase or decrease your EIC. Figure the credit with and without your nontaxable combat pay before making the election.

Earned Income = 22,950

3. Were you self-employed, or are you filing Schedule SE because you were a member of the clergy or you had church employee income, or are you filing Schedule C or C-EZ as a statutory employee?

Yes. Skip question 4 and Step 6; go to Worksheet B on page 52. **No.** Continue

4. If you have:

- 2 or more qualifying children, is your earned income less than \$35,263 (\$37,263 if married filing jointly)?
- 1 qualifying child, is your earned income less than \$31,030 (\$33,030 if married filing jointly)?
- No qualifying children, is your earned income less than \$11,750 (\$13,750 if married filing jointly)?

Yes. Go to Step 6. **No.**

You cannot take the credit.

Step 6 How To Figure the Credit

1. Do you want the IRS to figure the credit for you?

Yes. See *Credit figured by the IRS* on page 50. **No.** Go to Worksheet A on page 51.

Definitions and Special Rules

(listed in alphabetical order)

Adopted child. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption even if the adoption is not final.

Church employees. Determine how much of the amount on Form 1040, line 7, was also reported on Schedule SE, line 5a. Subtract that amount from the amount on Form 1040, line 7, and enter the result in the first space of Step 5, line 2. Be sure to answer "Yes" to question 3 in Step 5.

Clergy. The following instructions apply to ministers, members of religious orders who have not taken a vow of poverty, and Christian Science practitioners. If you are filing Schedule SE and the amount on line 2 of that schedule includes an amount that was also reported on Form 1040, line 7:

1. Put "Clergy" on the dotted line next to Form 1040, line 66a.
2. Determine how much of the amount on Form 1040, line 7, was also reported on Schedule SE, line 2.
3. Subtract that amount from the amount on Form 1040, line 7. Enter the result in the first space of Step 5, line 2.
4. Be sure to answer "Yes" to question 3 in Step 5.

Combat pay, Nontaxable. If you were a member of the U.S. Armed Forces who served in a combat zone, certain pay is excluded from your income. See *Combat Zone Exclusion* in Pub. 3. You can elect to include this pay in your earned income when figuring the EIC. The amount of your nontaxable combat pay should be shown in Form(s) W-2, box 12, with code Q. If you are filing a joint return and both you and your spouse received nontaxable combat pay, you can each make your own election.

Exercise 2(C)

Sam U. and Robin O.'s Eligibility Questions, page 4

Form 1040—Lines 66a and 66b

Credit figured by the IRS. To have the IRS figure the credit for you:

1. Put "EIC" on the dotted line next to Form 1040, line 66a.
2. Be sure you enter the nontaxable combat pay you elect to include in earned income on Form 1040, line 66b. See *Combat pay, Nontaxable* on page 49.
3. If you have a qualifying child, complete and attach Schedule EIC. If your EIC for a year after 1996 was reduced or disallowed, see *Form 8862, Who must file* below.

Exception to "time lived with you" condition. A child is considered to have lived with you for all of 2005 if the child was born or died in 2005 and your home was this child's home for the entire time he or she was alive in 2005. Temporary absences for special circumstances, such as for school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home. Also see *Kidnapped child* on page 21, if applicable. If you were in the military stationed outside the United States, see *Members of the military* below.

Form 4797 filers. If the amount on Form 1040, line 13, includes an amount from Form 4797, you must use Worksheet 1 in Pub. 596 to see if you can take the EIC. To get Pub. 596, see page 7. Otherwise, stop; you cannot take the EIC.

Form 8862, Who must file. You must file Form 8862 if your EIC for a year after 1996 was reduced or disallowed for any reason other than a math or clerical error. But do not file Form 8862 if either of the following applies.

1. After your EIC was reduced or disallowed in an earlier year (a) you filed Form 8862 (or other documents) and your EIC was then allowed, and (b) your EIC has not been reduced or disallowed again for any reason other than a math or clerical error.
2. You are taking the EIC without a qualifying child and the only reason your EIC was reduced or disallowed in the earlier year was because it was determined that a child listed on Schedule EIC was not your qualifying child.

Also, do not file Form 8862 or take the credit for the:

- 2 years after the most recent tax year for which there was a final determination that your EIC was reduced or disallowed due to reckless or intentional disregard of the EIC rules, or
- 10 years after the most recent tax year for which there was a final determination that your EIC was reduced or disallowed due to fraud.

Married child. A child who was married at the end of 2005 is a qualifying child only if (a) you can claim him or her as your dependent on Form 1040, line 6c, or (b) this child's other parent claims him or her as a dependent under the rules for children of divorced or separated parents.

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

Members of the military. If you were on extended active duty outside the United States, your home is considered to be in the United States during that duty period. Extended active duty is military duty ordered for an indefinite period or for a period of more than 90 days. Once you begin serving extended active duty, you are considered to be on extended active duty even if you serve fewer than 90 days.

Nonresident aliens. If your filing status is married filing jointly, go to Step 2 on page 47. Otherwise, stop; you cannot take the EIC.

Permanently and totally disabled. A person who, at any time in 2005, cannot engage in any substantial gainful activity because of a physical or mental condition and a doctor has determined that this condition (a) has lasted or can be expected to last continuously for at least a year, or (b) can lead to death.

Qualifying child of more than one person. If the child meets the conditions to be a qualifying child of more than one person, only one person can take the EIC based on that child. The other person(s) cannot take the EIC for people without a qualifying child, but may be able to take the EIC based on a different qualifying child. If you and the other person(s) cannot agree who will take the EIC based on the same child, the IRS will apply the following rules.

- If only one of the persons is the child's parent, the child will be treated as the qualifying child of the parent.
- If both persons are the child's parents, the child will be treated as the qualifying child of the parent with whom the child lived for the longer period of time during 2005. If the child lived with each parent for the same amount of time, the child will be treated as the qualifying child of the parent who had the higher adjusted gross income (AGI) for 2005.
- If none of the persons is the child's parent, the child will be treated as the qualifying child of the person who had the highest AGI for 2005.

The child must have a valid social security number as defined below unless the child was born and died in 2005. If you do not have a qualifying child, stop; you cannot take the EIC. Put "No" on the dotted line next to line 66a. If you have a qualifying child, skip Step 4; go to Step 5 on page 49.

Example. You and your 5-year-old daughter moved in with your mother in April 2005. You are not a qualifying child of your mother. Your daughter meets the conditions to be a qualifying child for both you and your mother. If you and your mother cannot agree on who will treat your daughter as a qualifying child, the rules above apply. Under these rules, you are entitled to treat your daughter as a qualifying child because you are the child's parent. Your mother would not be entitled to take the EIC unless she has a different qualifying child.

Social security number (SSN). For the EIC, a valid SSN is a number issued by the Social Security Administration unless "Not Valid for Employment" is printed on the social security card and the number was issued solely to apply for or receive a federally funded benefit.

To find out how to get an SSN, see page 16. If you will not have an SSN by April 17, 2006, see *What If You Cannot File on Time?* on page 12.

Student. A child who during any 5 months of 2005:

- Was enrolled as a full-time student at a school, or
- Took a full-time, on-farm training course given by a school or a state, county, or local government agency.

A school includes a technical, trade, or mechanical school. It does not include an on-the-job training course, correspondence school, or night school.

Welfare benefits, Effect of credit on. Any refund you receive as a result of taking the EIC will not be used to determine if you are eligible for the following programs or how much you can receive from them. But if the refund you receive because of the EIC is not spent within a certain period of time, it may count as an asset (or resource) and affect your eligibility.

- Temporary Assistance for Needy Families (TANF).
- Medicaid and supplemental security income (SSI).
- Food stamps and low-income housing.

EARNED INCOME CREDIT

Lesson 5

ANSWERS TO EXERCISES

Exercise 2(C)

Sam U. and Robin O.'s Completed EIC Worksheet

Form 1040—Lines 66a and 66b

Worksheet A—Earned Income Credit (EIC)—Lines 66a and 66b *Keep for Your Records*

Before you begin: ✓ Be sure you are using the correct worksheet. Do not use this worksheet if you were self-employed, or you are filing Schedule SE because you were a member of the clergy or you had church employee income, or you are filing Schedule C or C-EZ as a statutory employee. Instead, use Worksheet B that begins on page 50.

Part 1


All Filers Using Worksheet A

1. Enter your earned income from Step 5 on page 47.

1	22,950
---	--------

2. Look up the amount on line 1 above in the EIC Table on pages 52–57 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here.

2	1,607
---	-------

If line 2 is zero,  You cannot take the credit. Put “No” on the dotted line next to line 66a.

3. Enter the amount from Form 1040, line 38.

3	15,000
---	--------

4. Are the amounts on lines 3 and 1 the same?
 Yes. Skip line 5; enter the amount from line 2 on line 6.
 No. Go to line 5.

Part 2

Filers Who Answered “No” on Line 4

5. If you have:
• No qualifying children, is the amount on line 3 less than \$6,550 (\$8,550 if married filing jointly)?
• 1 or more qualifying children, is the amount on line 3 less than \$14,400 (\$16,400 if married filing jointly)?
 Yes. Leave line 5 blank; enter the amount from line 2 on line 6.

No. Look up the amount on line 3 in the EIC Table on pages 52–57 to find the credit. Be sure you use the correct column for your filing status and the number of children you have. Enter the credit here.
Look at the amounts on lines 5 and 2. Then, enter the **smaller** amount on line 6.

5	
---	--

Part 3

Your Earned Income Credit

6. This is your earned income credit.

6	1,607
---	-------

Enter this amount on Form 1040, line 66a.

Reminder—

✓ If you have a qualifying child, complete and attach Schedule EIC.



If your EIC for a year after 1996 was reduced or disallowed, see page 48 to find out if you must file Form 8862 to take the credit for 2005.

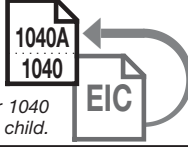


EARNED INCOME CREDIT

ANSWERS TO EXERCISES

Lesson 5

Exercise 3

Sam U. and Robin O.'s Schedule EIC

<p>SCHEDULE EIC (Form 1040A or 1040)</p> <p>Department of the Treasury Internal Revenue Service</p>	<p>Earned Income Credit Qualifying Child Information</p> <p>Complete and attach to Form 1040A or 1040 only if you have a qualifying child.</p>		<p>OMB No. 1545-0074</p> <p>2005</p> <p>Attachment Sequence No. 43</p>	
<p>Name(s) shown on return Sam U. & Robin O. Bell</p>		<p>Your social security number XXX : XX : XXXX</p>		
<p>Before you begin: See the instructions for Form 1040A, lines 41a and 41b, or Form 1040, lines 66a and 66b, to make sure that (a) you can take the EIC and (b) you have a qualifying child.</p>				
<p> CAUTION</p> <ul style="list-style-type: none"> If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See back of schedule for details. It will take us longer to process your return and issue your refund if you do not fill in all lines that apply for each qualifying child. Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213. 				
Qualifying Child Information				
	Child 1		Child 2	
1 Child's name	First name	Last name	First name	Last name
If you have more than two qualifying children, you only have to list two to get the maximum credit.	Jennifer Bell			
2 Child's SSN				
The child must have an SSN as defined on page 42 of the Form 1040A instructions or page 44 of the Form 1040 instructions unless the child was born and died in 2005. If your child was born and died in 2005 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate.	XXX : XX : XXXX			
3 Child's year of birth	Year <u>1</u> <u>9</u> <u>9</u> <u>6</u>		Year _____	
	<i>If born after 1986, skip lines 4a and 4b; go to line 5.</i>		<i>If born after 1986, skip lines 4a and 4b; go to line 5.</i>	
4 If the child was born before 1987—				
a Was the child under age 24 at the end of 2005 and a student?	<input type="checkbox"/> Yes. <i>Go to line 5.</i>	<input type="checkbox"/> No. <i>Continue</i>	<input type="checkbox"/> Yes. <i>Go to line 5.</i>	<input type="checkbox"/> No. <i>Continue</i>
b Was the child permanently and totally disabled during any part of 2005?	<input type="checkbox"/> Yes. <i>Continue</i>	<input type="checkbox"/> No. The child is not a qualifying child.	<input type="checkbox"/> Yes. <i>Continue</i>	<input type="checkbox"/> No. The child is not a qualifying child.
5 Child's relationship to you (for example, son, daughter, grandchild, niece, nephew, foster child, etc.)	daughter			
6 Number of months child lived with you in the United States during 2005				
<ul style="list-style-type: none"> If the child lived with you for more than half of 2005 but less than 7 months, enter "7." If the child was born or died in 2005 and your home was the child's home for the entire time he or she was alive during 2005, enter "12." 	<u>12</u> months <i>Do not enter more than 12 months.</i>		_____ months <i>Do not enter more than 12 months.</i>	
<p> TIP You may also be able to take the additional child tax credit if your child (a) was under age 17 at the end of 2005, and (b) is a U.S. citizen or resident alien. For more details, see the instructions for line 42 of Form 1040A or line 68 of Form 1040.</p>				
For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions.		Cat. No. 13339M	Schedule EIC (Form 1040A or 1040) 2005	

EARNED INCOME CREDIT

ANSWERS TO EXERCISES

Lesson 5

Exercise 4

Kyle B. Evans' 1040A, page 2

Form 1040 (2005)

Page 2

Tax and Credits

Standard Deduction for—

• People who checked any box on line 39a or 39b or who can be claimed as a dependent, see page 31.

• All others:
Single or Married filing separately, \$5,000

Married filing jointly or Qualifying widow(er), \$10,000

Head of household, \$7,300

38	Amount from line 37 (adjusted gross income)	38	21,599
39a	Check <input type="checkbox"/> You were born before January 2, 1941, <input type="checkbox"/> Blind. <input type="checkbox"/> Spouse was born before January 2, 1941, <input type="checkbox"/> Blind. Total boxes checked ▶ 39a		
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here ▶ 39b <input type="checkbox"/>		
40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40	7,300
41	Subtract line 40 from line 38	41	14,299
42	If line 38 is \$109,475 or less, multiply \$3,200 by the total number of exemptions claimed on line 6d. If line 38 is over \$109,475, see the worksheet on page 33	42	6,400
43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	7,899
44	Tax (see page 33). Check if any tax is from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972	44	788
45	Alternative minimum tax (see page 35). Attach Form 6251	45	
46	Add lines 44 and 45	46	788
47	Foreign tax credit. Attach Form 1116 if required	47	
48	Credit for child and dependent care expenses. Attach Form 2441	48	
49	Credit for the elderly or the disabled. Attach Schedule R	49	
50	Education credits. Attach Form 8863	50	
51	Retirement savings contributions credit. Attach Form 8880	51	
52	Child tax credit (see page 37). Attach Form 8901 if required	52	788
53	Adoption credit. Attach Form 8839	53	
54	Credits from: a <input type="checkbox"/> Form 8396 b <input type="checkbox"/> Form 8859	54	
55	Other credits. Check applicable box(es): a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8801 c <input type="checkbox"/> Specify	55	
56	Add lines 47 through 55. These are your total credits	56	788
57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0-	57	0

Other Taxes

58	Self-employment tax. Attach Schedule SE	58	
59	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	59	
60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	60	
61	Advance earned income credit payments from Form(s) W-2	61	550
62	Household employment taxes. Attach Schedule H	62	
63	Add lines 57 through 62. This is your total tax	63	550

Payments

If you have a qualifying child, attach Schedule EIC.

64	Federal income tax withheld from Forms W-2 and 1099	64	0
65	2005 estimated tax payments and amount applied from 2004 return	65	
66a	Earned income credit (EIC)	66a	1,511
b	Nontaxable combat pay election ▶ 66b		
67	Excess social security and tier 1 RRTA tax withheld (see page 54)	67	
68	Additional child tax credit. Attach Form 8812	68	
69	Amount paid with request for extension to file (see page 54)	69	
70	Payments from: a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136 c <input type="checkbox"/> Form 8885	70	
71	Add lines 64, 65, 66a, and 67 through 70. These are your total payments	71	1,511

Refund

Direct deposit? See page 54 and fill in 73b, 73c, and 73d.

72	If line 71 is more than line 63, subtract line 63 from line 71. This is the amount you overpaid	72	961
73a	Amount of line 72 you want refunded to you	73a	961
b	Routing number		
d	Account number		
c	Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings		
74	Amount of line 72 you want applied to your 2006 estimated tax ▶ 74	74	

Amount You Owe

75	Amount you owe. Subtract line 71 from line 63. For details on how to pay, see page 55 ▶	75	
76	Estimated tax penalty (see page 55)	76	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 56)? Yes. Complete the following. No

Designee's name ▶ Phone no. ▶ () Personal identification number (PIN) ▶

Sign Here

Joint return? See page 17. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed <input type="checkbox"/>	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶	EIN	Phone no. ()	

Form 1040 (2005)



INTRODUCTION AND OBJECTIVES

In this lesson you will learn about the child tax credit. This credit is unique because it can be both nonrefundable and refundable. This lesson will discuss who qualifies for the credit and how to calculate the credit.

After completing this lesson you should be able to:

- Calculate the child tax credit using the child tax credit worksheet.
- Calculate the additional child tax credit by using Form 8812, *Additional Child Tax Credit*.

Note: Additional information about the Child Tax Credit is available in Publication 972, *Child Tax Credit*.

CHILD TAX CREDIT

A taxpayer can claim a child tax credit for each of the taxpayer's qualifying children. The maximum child tax credit is \$1000 per child for 2005. The credit can be claimed on either Form 1040 or 1040A.

Qualifying child

A qualifying child (is):

- The taxpayer's child, including:
 - Son or daughter,
 - Adopted child,
 - Stepson or stepdaughter,
 - Eligible foster child (any child placed with the taxpayer by an authorized placement agency or by order of the court),
 - Brother or sister,
 - Stepbrother or stepsister,
 - Descendent of one of the above-listed relatives (including a grandchild, a niece or nephew)
- Under age 17 at the end of 2005,
- A U.S. citizen, national, or resident,
- Did not provide over half of his or her own support during 2005,
- Lived with the taxpayer for more than half of 2005.

ALERT



This lesson contains basic tax law and is required training for all volunteers.

ALERT



The requirements for a "qualifying child" for purposes of the Child Tax Credit differ from those for a "qualifying child" for purposes of the Earned Income Credit.

ALERT



A taxpayer may be able to claim the Child Tax Credit for a qualifying child who is not their dependent. When this occurs, Form 8901, *Information on Qualifying Children Who Are Not Dependents (For Child Tax Credit Only)*, will be completed and attached to Form 1040 or 1040 A.

There are some exceptions to the time-lived-with requirement. A child is considered to have lived with the taxpayer all of 2005 if:

- The child was born or died in 2005 and whose only residence was with the taxpayer.
- The child was kidnapped, under the following circumstances:
 - In the year the kidnapping occurred, the kidnapped child is presumed by law enforcement to have been taken by someone who is not a family member; and
 - The kidnapped child lived with the taxpayer for more than half of the portion of the year prior to the kidnapping.

Note: Temporary absences for special circumstances, such as school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home.

There are special rules for children of divorced or separated parents. A child will be treated as the qualifying child of the noncustodial parent if all of the following apply:

- The parents were divorced or legally separated or lived apart at all times during the last 6 months of 2005.
- The child received over half of his or her support for 2005 from the parents.
- The child was in custody of one or both of the parents for more than half of 2005.
- A decree of divorce or separate maintenance or written separation agreement that applies to 2005 provides that (a) the noncustodial parent can claim the child as a dependent, or (b) the custodial parent will sign a written declaration that he or she will not claim the child as a dependent for 2005. If the divorce or separation agreement went into effect before 1985, this requirement is met if the noncustodial parent provides at least \$600 for the support of the child for 2005.

The taxpayer must provide the name and identification number (usually a social security number) of each qualifying child on his or her tax return.

Limits on credit

The amount of a taxpayer's child tax credit depends on the taxpayer's modified adjusted gross income (modified AGI) and the taxpayer's filing status.

Modified AGI

The credit begins to phase out if the taxpayer's modified AGI is above a certain amount (**Table 1**). For most taxpayers, modified AGI is generally the same as AGI. For 2005, AGI is shown on line 21 of Form 1040A and on line 37 of Form 1040.

Table 1: Child Tax Credit Threshold Modified AGI Amounts for Claiming Child Tax Credit	
Filing Status	Amount
Married filing jointly	\$110,000
Qualifying widow(er)	75,000
Head of household	75,000
Single	75,000
Married filing separately	55,000

Before you can figure a taxpayer's credit amount for the year, you must have the taxpayer answer certain questions (**Exhibit 1**) to see if you must use the worksheet in Publication 972, *Child Tax Credit*. These questions are in the tax form instructions. If you do not need to use Publication 972, you can use the shorter *Child Tax Credit Worksheet* in the Form 1040 or 1040A instructions.

Example 1

Bill and Mary Allen are married filing a joint return and have two dependent children under age 17. The children are qualifying children for purposes of claiming the child tax credit. Bill and Mary have modified AGI of \$55,600. Their tax on Form 1040, line 46 for 2005 is \$4,194. Bill and Mary need to answer questions to determine if they must use Publication 972 (**Exhibit 1**). The completed Child Tax Credit Worksheet (**Exhibit 2**) shows that their credit is \$2,000. Their modified AGI is less than the phaseout amount for their filing status (\$110,000). They do not need to use Publication 972 to compute their child tax credit.

Line 52—Child Tax Credit

Three Steps To Take the Child Tax Credit!

- Step 1.** Make sure you have a qualifying child for the child tax credit (defined below).
- Step 2.** Make sure that for each qualifying child you either checked the box on Form 1040, line 6c, column (4), or completed Form 8901 (if the child is not your dependent).
- Step 3.** Answer the questions on this page to see if you can use the worksheet on page 44 to figure your credit or if you must use Pub. 972. If you need Pub. 972, see page 7.

A qualifying child is a child who is your...

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

AND

was ...

Under age 17 at the end of 2005

AND

who...

Did not provide over half of his or her own support for 2005

AND

who...

Lived with you for more than half of 2005. If the child did not live with you for the required time, see *Exception to "time lived with you" condition* on page 21.

AND

who...

Was a U.S. citizen, U.S. national, or a resident of the United States. If the child was adopted, see *Exception to citizen test* on page 21.



The above requirements are not the same as the requirements to be a qualifying child for the earned income credit.

Note. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption even if the adoption is not final.

Questions

Who Must Use Pub. 972



1. Is the amount on Form 1040, line 38, more than the amount shown below for your filing status?
 - Married filing jointly – \$110,000
 - Single, head of household, or qualifying widow(er) – \$75,000
 - Married filing separately – \$55,000

No. Continue **Yes.** You must use Pub. 972 to figure your credit.

2. Are you claiming any of the following credits?
 - Adoption credit, Form 8839 (see the instructions for Form 1040, line 53, on page 45).
 - Mortgage interest credit, Form 8396 (see the instructions for Form 1040, line 54, on page 45).
 - District of Columbia first-time homebuyer credit, Form 8859.

No. Continue **Yes.** You must use Pub. 972 to figure your child tax credit. You will also need the form(s) listed above for any credit(s) you are claiming.

3. Are you excluding income from Puerto Rico or are you filing any of the following forms?
 - Form 2555 or 2555-EZ (relating to foreign earned income).
 - Form 4563 (exclusion of income for residents of American Samoa).

No. Use the worksheet on page 44 to figure your credit. **Yes.** You must use Pub. 972 to figure your credit.

Child Tax Credit Worksheet—Line 52

Keep for Your Records



- To be a qualifying child for the child tax credit, the child must be **under age 17** at the end of 2005 and meet the other requirements listed on page 41.
- Do not** use this worksheet if you answered "Yes" to question 1, 2, or 3 on page 41. Instead, use Pub. 972.

1. Number of qualifying children: 2 × \$1,000. Enter the result. 1 2,000

2. Enter the amount from Form 1040, line 46. 2 4,194

3. Add the amounts from Form 1040:
 Line 47 _____
 Line 48 + _____
 Line 49 + _____
 Line 50 + _____
 Line 51 + _____ Enter the total. 3 0

4. Are the amounts on lines 2 and 3 the same?
 Yes. You cannot take this credit because there is no tax to reduce. However, you may be able to take the **additional child tax credit**. See the **TIP** below.
 No. Subtract line 3 from line 2. 4 4,194

5. Is the amount on line 1 more than the amount on line 4?
 Yes. Enter the amount from line 4. Also, you may be able to take the **additional child tax credit**. See the **TIP** below.
 No. Enter the amount from line 1. 5 2,000
 This is your child tax credit.
 Enter this amount on Form 1040, line 52.



You may be able to take the **additional child tax credit** on Form 1040, line 68, if you answered "Yes" on line 4 or line 5 above.

- First, complete your Form 1040 through line 67.
- Then, use Form 8812 to figure any additional child tax credit.



Checking your withholding

The child tax credit decreases the tax liability dollar for dollar, but not below zero. If the taxpayer is having too much tax withheld, and he or she prefers to have the money during the year, the taxpayer may be able to reduce his or her withholding. A new Form W-4, *Employee's Withholding Allowance Certificate*, should be completed and given to his or her employer.

ADDITIONAL CHILD TAX CREDIT

The child tax credit is a nonrefundable credit that gives eligible taxpayers \$1000 for each qualifying child. If a taxpayer's tax liability is less than the allowable nonrefundable child tax credit, the taxpayer may be eligible to claim the refundable **additional child tax credit**.

Before figuring additional child tax credit, figure the taxpayer's:

- Unused nonrefundable child tax credit amount,
- Total Social Security and Medicare Taxes withheld (Form W-2, *Wage and Tax Statement*, boxes 4 and 6), if the taxpayer has three or more qualifying children,
- Earned income credit amount,
- Total taxable earned income (back of Form 8812), and
- For 1040 filers, one-half of self-employment tax paid, (Form 1040, line 27).

The taxpayer will need to seek the assistance of a paid professional tax preparer if he or she has:

- Excess social security and RRTA tax withheld (more than one employer and gross income in excess of \$90,000) or
- Social Security and Medicare tax on unreported tip income.

Taxpayers must use **Form 8812**, *Additional Child Tax Credit*, to claim the additional child tax credit. This credit is based on 15% of the taxpayer's taxable earned income in excess of \$11,000.

If the taxpayer (or spouse, if married filing a joint return) received nontaxable combat pay and the taxpayer did not elect to include this pay in computing the EIC (or the taxpayer is not claiming the EIC), the taxpayer **must** include this amount in the total on line 4a and 4b of Form 8812, *Additional Child Tax Credit*.

Example 2

Maureen Langston (SSN xxx-xx-xxxx) is filing Form 1040. Her filing status is head of household for 2005. She has five dependent children, all of whom are qualifying children for purposes of the child tax credit. Maureen's earned income (and adjusted gross income) is \$27,375, her tax is \$89, Social Security/Medicare taxes are \$2,094, and the earned income credit is \$1,661. Based on this information, Maureen's child tax credit is \$89 (Exhibit 4) and her additional child tax credit was \$2,456. Exhibits 5 and 6 illustrate how Maureen's additional child tax credit was figured.

POTENTIAL PITFALLS



When figuring the additional child tax credit, you must use the back of Form 8812 to determine taxable earned income (line 4).

Line 52—Child Tax Credit

Three Steps To Take the Child Tax Credit!

- Step 1.** Make sure you have a qualifying child for the child tax credit (defined below).
- Step 2.** Make sure that for each qualifying child you either checked the box on Form 1040, line 6c, column (4), or completed Form 8901 (if the child is not your dependent).
- Step 3.** Answer the questions on this page to see if you can use the worksheet on page 44 to figure your credit or if you must use Pub. 972. If you need Pub. 972, see page 7.

A qualifying child is a child who is your...

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

AND

was ...

Under age 17 at the end of 2005

AND

who...

Did not provide over half of his or her own support for 2005

AND

who...

Lived with you for more than half of 2005. If the child did not live with you for the required time, see *Exception to "time lived with you" condition* on page 21.

AND

who...

Was a U.S. citizen, U.S. national, or a resident of the United States. If the child was adopted, see *Exception to citizen test* on page 21.



The above requirements are not the same as the requirements to be a qualifying child for the earned income credit.

Note. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption even if the adoption is not final.

Questions

Who Must Use Pub. 972



- Is the amount on Form 1040, line 38, more than the amount shown below for your filing status?
 - Married filing jointly – \$110,000
 - Single, head of household, or qualifying widow(er) – \$75,000
 - Married filing separately – \$55,000

No. Continue **Yes.** You must use Pub. 972 to figure your credit.
- Are you claiming any of the following credits?
 - Adoption credit, Form 8839 (see the instructions for Form 1040, line 53, on page 45).
 - Mortgage interest credit, Form 8396 (see the instructions for Form 1040, line 54, on page 45).
 - District of Columbia first-time homebuyer credit, Form 8859.

No. Continue **Yes.** You must use Pub. 972 to figure your child tax credit. You will also need the form(s) listed above for any credit(s) you are claiming.
- Are you excluding income from Puerto Rico or are you filing any of the following forms?
 - Form 2555 or 2555-EZ (relating to foreign earned income).
 - Form 4563 (exclusion of income for residents of American Samoa).

No. Use the worksheet on page 44 to figure your credit. **Yes.** You must use Pub. 972 to figure your credit.

Child Tax Credit Worksheet—Line 52

Keep for Your Records



- To be a qualifying child for the child tax credit, the child must be **under age 17** at the end of 2005 and meet the other requirements listed on page 41.
- Do not** use this worksheet if you answered “Yes” to question 1, 2, or 3 on page 41. Instead, use Pub. 972.

1. Number of qualifying children: 5 × \$1,000. Enter the result. 1 5,000

2. Enter the amount from Form 1040, line 46. 2 89

3. Add the amounts from Form 1040:
 Line 47 _____
 Line 48 + _____
 Line 49 + _____
 Line 50 + _____
 Line 51 + _____ Enter the total. 3 0

4. Are the amounts on lines 2 and 3 the same?
 Yes. You cannot take this credit because there is no tax to reduce. However, you may be able to take the **additional child tax credit**. See the **TIP** below.
 No. Subtract line 3 from line 2. 4 89

5. Is the amount on line 1 more than the amount on line 4?
 Yes. Enter the amount from line 4. Also, you may be able to take the **additional child tax credit**. See the **TIP** below. 5 89
 No. Enter the amount from line 1. Enter this amount on Form 1040, line 52.



You may be able to take the **additional child tax credit** on Form 1040, line 68, if you answered “Yes” on line 4 or line 5 above.

- First, complete your Form 1040 through line 67.
- Then, use Form 8812 to figure any additional child tax credit.



Form 8812 Department of the Treasury Internal Revenue Service (99)	<h2 style="margin:0;">Additional Child Tax Credit</h2> <p style="font-size: small; margin-top: 10px;">Complete and attach to Form 1040 or Form 1040A.</p>		OMB No. 1545-1620 <h1 style="margin:0;">2005</h1> Attachment Sequence No. 47
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Name(s) shown on return: Maureen Langsdon

Your social security number: XXX XX XXXX

Part I All Filers

<p>1 Enter the amount from line 1 of your Child Tax Credit Worksheet on page 38 of the Form 1040 instructions or page 37 of the Form 1040A instructions. If you used Pub. 972, enter the amount from line 8 of the worksheet on page 4 of the publication</p> <p>2 Enter the amount from Form 1040, line 52, or Form 1040A, line 33</p> <p>3 Subtract line 2 from line 1. If zero, stop; you cannot take this credit</p> <p>4a Earned income (see instructions on back)</p> <p>b Nontaxable combat pay from Form(s) W-2, box 12, with code Q. If married filing jointly, include your spouse's amounts with yours.</p> <p>4b</p> <p>5 Is the amount on line 4a more than \$11,000? <input type="checkbox"/> No. Leave line 5 blank and enter -0- on line 6. <input checked="" type="checkbox"/> Yes. Subtract \$11,000 from the amount on line 4a. Enter the result</p> <p>6 Multiply the amount on line 5 by 15% (.15) and enter the result</p> <p>Next. Do you have three or more qualifying children? <input type="checkbox"/> No. If line 6 is zero, stop; you cannot take this credit. Otherwise, skip Part II and enter the smaller of line 3 or line 6 on line 13. <input checked="" type="checkbox"/> Yes. If line 6 is equal to or more than line 3, skip Part II and enter the amount from line 3 on line 13. Otherwise, go to line 7.</p>	<p>1</p> <p>2</p> <p>3</p> <p>4a</p> <p>5</p> <p>6</p>	<p>5,000</p> <p>89</p> <p>4,911</p> <p>27,375</p> <p>16,375</p> <p>2,456</p>	
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Part II Certain Filers Who Have Three or More Qualifying Children

<p>7 Withheld social security and Medicare taxes from Form(s) W-2, boxes 4 and 6. If married filing jointly, include your spouse's amounts with yours. If you worked for a railroad, see instructions on back</p> <p>8 1040 filers: Enter the total of the amounts from Form 1040, lines 27 and 59, plus any uncollected social security and Medicare or tier 1 RRTA taxes included on line 63. } 1040A filers: Enter -0-.</p> <p>9 Add lines 7 and 8</p> <p>10 1040 filers: Enter the total of the amounts from Form 1040, lines 66a and 67. } 1040A filers: Enter the total of the amount from Form 1040A, line 41a, plus any excess social security and tier 1 RRTA taxes withheld that you entered to the left of line 43 (see instructions on back).</p> <p>11 Subtract line 10 from line 9. If zero or less, enter -0-</p> <p>12 Enter the larger of line 6 or line 11</p> <p>Next, enter the smaller of line 3 or line 12 on line 13.</p>	<p>7</p> <p>8</p> <p>9</p> <p>10</p> <p>11</p> <p>12</p>	<p>2,094</p> <p>0</p> <p>2,094</p> <p>1,661</p> <p>433</p> <p>2,456</p>	
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Part III Additional Child Tax Credit

<p>13 This is your additional child tax credit</p>	<p>13</p>	<p>2,456</p>	
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Enter this amount on Form 1040, line 68, or Form 1040A, line 42.

Instructions

Purpose of Form

Use Form 8812 to figure your additional child tax credit. The additional child tax credit may give you a refund even if you do not owe any tax.

Who Should Use Form 8812

First, complete the Child Tax Credit Worksheet that applies to you. See the instructions for Form 1040, line 52, or Form 1040A, line 33. If you meet the condition given in the *TIP* at the end of your Child Tax Credit Worksheet, use Form 8812 to see if you can take the additional child tax credit.

Effect of Credit on Welfare Benefits

Any refund you receive as a result of taking the additional child tax credit will not be used to determine if you are eligible for the following programs, or how much you can receive from them. But if the refund you receive because of the additional child tax credit is not spent within a certain period of time, it may count as an asset (or resource) and affect your eligibility.

- Temporary Assistance for Needy Families (TANF).
- Medicaid and supplemental security income (SSI).
- Food stamps and low-income housing.

Earned Income

To figure the amount to include on line 4a, answer the four questions below. Also, see *Nontaxable combat pay* next.

Nontaxable combat pay. Enter on line 4b the total amount of nontaxable combat pay that you, and your spouse if filing jointly, received in 2005. This amount should be shown in box 12 of your Form(s) W-2 with code Q.

Nontaxable combat pay received in 2005 must be included in earned income for purposes of the additional child tax credit. If you, or your spouse if filing jointly, did not elect to include nontaxable combat pay in earned income when figuring the earned income credit (EIC) on Form 1040, line 66a, or Form 1040A, line 41a, or if you are not taking the EIC, add any nontaxable combat pay not included in your earned income figured in question 2 or 4 on this page. Enter the total on Form 8812, line 4a.

1. Did you, or your spouse if filing jointly, have net earnings from self-employment and use either optional method to figure those net earnings?

- No.** Go to question 2.
- Yes.** Use Pub. 972 to figure the amount to enter on Form 8812, line 4a.

2. Are you taking the earned income credit (EIC) on Form 1040, line 66a, or Form 1040A, line 41a?

- Yes.** Use the following chart to find the amount to enter on Form 8812, line 4a.

IF you are filing Form . . .	AND you completed . . .	THEN enter on Form 8812, line 4a, the amount from . . .
1040	Worksheet B on page 46 of your 1040 instructions	Worksheet B, line 4b*, **
	Step 5 on page 43 of your 1040 instructions (but not Worksheet B)	Step 5, Earned Income **
1040A	Step 5 on page 41 of your 1040A instructions	Step 5, Earned Income **

* If you were a member of the clergy, subtract the following from the amount on line 4b: (a) the rental value of a home or the nontaxable portion of an allowance for a home furnished to you (including payments for utilities), and (b) the value of meals and lodging provided to you, your spouse, and your dependents for your employer's convenience.

** If applicable, add to this amount the amount described in *Nontaxable combat pay* above.

- No. 1040 filers:** Go to question 3.
1040A filers: Skip question 3 and go to question 4.

3. Were you, or your spouse if filing jointly, self-employed, or are you filing Schedule SE because you were a member of the clergy or you had church employee income, or are you filing Schedule C or C-EZ as a statutory employee?

- No.** Go to question 4.
- Yes.** Use Pub. 972 to figure the amount to enter on Form 8812, line 4a.

4. Does the amount on line 7 of Form 1040 or Form 1040A include any of the following amounts?

- Taxable scholarship or fellowship grants not reported on a Form W-2.
- Amounts received for work performed while an inmate in a penal institution (enter "PRI" and the amount received in the space next to line 7 of Form 1040 or 1040A).
- Amounts received as a pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan (enter "DFC" and the amount received in the space next to line 7 of Form 1040 or 1040A). This amount may be reported in box 11 of your Form W-2. If you received such an amount but box 11 is blank, contact your employer for the amount received as a pension or annuity.
- Amounts from Form 2555, line 41, or Form 2555-EZ, line 18.

No. Enter the amount from line 7 of Form 1040 or Form 1040A on Form 8812, line 4a. (If applicable, add to this amount the amount described in *Nontaxable combat pay* on this page.)

Yes. Subtract the total of those amounts from the amount on line 7 of Form 1040 or Form 1040A. (If an amount is included in more than one of the above categories, include it only once in figuring the total amount to subtract.) Enter the result on Form 8812, line 4a. (If applicable, add to this amount the amount described in *Nontaxable combat pay* on this page.)

Railroad Employees

If you worked for a railroad, include the following taxes in the total on Form 8812, line 7.

- Tier 1 tax withheld from your pay. This tax should be shown in box 14 of your Form(s) W-2 and identified as "Tier 1 tax."
- If you were an employee representative, 50% of the total tier 1 tax and tier 1 Medicare tax you paid for 2005.

1040A Filers

If you, or your spouse if filing jointly, had more than one employer for 2005 and total wages of over \$90,000, figure any excess social security and tier 1 railroad retirement (RRTA) taxes withheld. See the instructions for Form 1040A, line 43. Include any excess on Form 8812, line 10.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Internal Revenue Code section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:
Recordkeeping, 6 min.; Learning about the law or the form, 9 min.;
Preparing the form, 29 min.; Copying, assembling, and sending the form to the IRS, 20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the Instructions for Form 1040 or Form 1040A.

The interview tips you should use when determining the Child Tax Credit are shown in Exhibit 7 below.

Exhibit 7

Child Tax Credit Chart

TIP	Child Tax Credit (Remember to apply the steps for each child) Probe/Action: Ask the taxpayer:	
interview tips		
step 1	Is this child your son, daughter, adopted child, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)? A descendent is of any generation.	If YES, go to Step 2. If NO, you cannot claim the child tax credit for this child. STOP if the taxpayer has no other children.
step 2	Is this child under age 17 at end of the tax year?	If YES, go to Step 3. If NO, you cannot claim the child tax credit for this child. STOP if the taxpayer has no other children.
step 3	Did the child provide over half of his or her own support for 2005?	If NO, go to Step 4. If YES, you cannot claim the child tax credit for this child. STOP if the taxpayer has no other children.
step 4	Did the child live with you for more than half of 2005? If the child did not live with you for the required time, see <ul style="list-style-type: none"> • Exception to Time-Lived-with-You • Kidnapped Child • Children of Divorced or Separated Parents below the chart. 	If YES, go to Step 5. If NO, you cannot claim the child tax credit for this child. STOP if the taxpayer has no other children.
step 5	Is this child a citizen or resident of the United States?	If YES, go to Step 6. If NO, you cannot claim the child tax credit for this child. STOP if the taxpayer has no other children.
Questions: Who Must Use Publication 972		
step 6	Are you excluding income from Puerto Rico or are you filing Form 2555 or 2555-EZ (relating to foreign earned income) or Form 4563, <i>Exclusion of Income for Bona Fide Residents of American Samoa</i> ?	If NO, go to Step 7. If YES, you must use Publication 972 to figure the credit.
step 7	Is the amount of AGI on line 37 of your Form 1040, or line 21 of Form 1040A more than: <ul style="list-style-type: none"> • \$110,000 if you are married filing jointly, • \$75,000 if your are filing as single, head of household, or as a qualifying widow(er), or • \$55,000 if you are married filing separately? 	If NO, go to Step 8. If YES, you must use Publication 972 to figure the credit.
step 8	Are you claiming any of the following credits? <ul style="list-style-type: none"> • Adoption credit, Form 8839 • Mortgage interest credit, Form 8396 • District of Columbia first-time homebuyer credit, Form 8859 	If NO, use the Child Tax Credit Worksheet to figure the credit. If YES, you must use Publication 972 to figure the credit.
Exception to Time-Lived-with-You A child is considered to have lived with you for all of 2005 if the child was born or died in 2005 and your home was this child's home for the entire time he or she was alive. Temporary absences for special circumstances, such as for school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home.		Children of Divorced or Separated Parents A child will be treated as being the qualifying child of his or her noncustodial parent if all of the following apply. <ul style="list-style-type: none"> • The parents were divorced or legally separated or lived apart at all times during the last 6 months of 2005. • The child received over half of his or her support for 2005 from the parents. • The child was in custody of one or both of the parents for more than half of 2005. • A decree of divorce or separate maintenance or written separation agreement that applies to 2005 provides that (a) the noncustodial parent can claim the child as a dependent, or (b) the custodial parent will sign a written declaration that he or she will not claim the child as a dependent for 2005. If the divorce or separation agreement went into effect before 1985, this requirement is met if the noncustodial parent provides at least \$600 for the support of the child for 2005.
Kidnapped Child A kidnapped child is considered to have lived with you for all of 2005 if: <ul style="list-style-type: none"> • In the year the kidnapping occurred, the kidnapped child is presumed by law enforcement to have been taken by someone who is not a family member; and • The kidnapped child lived with the taxpayer for more than half of the portion of the year prior to the kidnapping. 		

Exercise 1

Victor (SSN xxx-xx-xxxx) and Emily Howard are married taxpayers with four children. Their filing status is married filing jointly for 2005 on Form 1040A. All of their children qualify for purposes of the child tax credit. They have no itemized deductions. Their adjusted gross income is \$31,467, of which \$18,467 is taxable earned income and \$13,000 is unemployment compensation. The Howards' taxable income is \$2,267, Social Security/Medicare taxes are \$1,413, and the 2005 EIC is \$1,219. They have no other credits entered in lines 29–34. Based on the facts given for the Howards:

- Figure the child tax credit.
- Complete page 2 of Form 1040A, lines 22 through 35.
- Figure the additional child tax credit.

Exhibit 8

Victor and Emily's Child Tax Credit Questions

Line 33—Child Tax Credit

Three Steps To Take the Child Tax Credit!

- Step 1. Make sure you have a qualifying child for the child tax credit (defined below).
- Step 2. Make sure that for each qualifying child you either checked the box in on Form 1040A, line 6c, column (4), or completed Form 8901 (if the child is not your dependent).
- Step 3. Answer the questions on this page to see if you may use the worksheet on page 39 to figure your credit or if you must use Pub. 972, Child Tax Credit. If you need Pub. 972, see page 7.

A qualifying child is a child who is your...

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

AND

was ...

Under age 17 at the end of 2005

AND

who...

Did not provide over half of his or her own support for 2005

AND

who...

Lived with you for more than half of 2005. If the child did not live with you for the required time, see *Exception to "time lived with you" condition* on page 23.

AND

who...

Was a U.S. citizen, U.S. national, or a resident of the United States. If the child was adopted, see *Exception to citizen test* on page 22.



The above requirements are not the same as the requirements to be a qualifying child for the earned income credit.



Note. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption even if the adoption is not final.

Questions


Who Must Use Pub. 972



- Is the amount on Form 1040A, line 22, more than the amount shown below for your filing status?
 - Married filing jointly – \$110,000
 - Single, head of household, or qualifying widow(er) – \$75,000
 - Married filing separately – \$55,000

No. Continue  **Yes.**  You must use Pub. 972 to figure your credit.
- Are you claiming the adoption credit on Form 8839 (see the instructions for Form 1040A, line 34, on page 40)?
 - No.** Use the worksheet on page 39 to figure your child tax credit.
 - Yes.** You must use Pub. 972 to figure your child tax credit. You will also need Form 8839.

Child Tax Credit Worksheet—Line 33

Keep for Your Records 



- To be a qualifying child for the child tax credit, the child must be **under age 17** at the end of 2005 and meet the other requirements listed on page 36.
- **Do not** use this worksheet if you answered “Yes” to question 1 or 2 on page 36. Instead, use Pub. 972.

1. Number of qualifying children: _____ × \$1,000. Enter the result.

1

2. Enter the amount from Form 1040A, line 28.

2

3. Add the amounts from Form 1040A:

Line 29 _____

Line 30 + _____

Line 31 + _____

Line 32 + _____

Enter the total.

3

4. Are the amounts on lines 2 and 3 the same?

Yes. 

You cannot take this credit because there is no tax to reduce. However, you may be able to take the **additional child tax credit**. See the **TIP** below.

No. Subtract line 3 from line 2.

4

5. Is the amount on line 1 more than the amount on line 4?

Yes. Enter the amount from line 4. Also, you may be able to take the **additional child tax credit**. See the **TIP** below.

No. Enter the amount from line 1.

This is your child tax credit.

5

Enter this amount on Form 1040A, line 33.



You may be able to take the **additional child tax credit** on Form 1040A, line 42, if you answered “Yes” on line 4 or line 5 above.

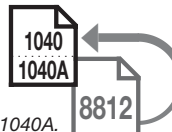
- First, complete your Form 1040A through line 41a.
- Then, use Form 8812 to figure any additional child tax credit.



Tax, credits, and payments	22 Enter the amount from line 21 (adjusted gross income).	22	
	23a Check <input type="checkbox"/> You were born before January 2, 1941, <input type="checkbox"/> Blind } Total boxes if: <input type="checkbox"/> Spouse was born before January 2, 1941, <input type="checkbox"/> Blind } checked ▶ 23a <input type="checkbox"/>		
	b If you are married filing separately and your spouse itemizes deductions, see page 30 and check here ▶ 23b <input type="checkbox"/>		
Standard Deduction for— • People who checked any box on line 23a or 23b or who can be claimed as a dependent, see page 31. • All others: Single or Married filing separately, \$5,000 Married filing jointly or Qualifying widow(er), \$10,000 Head of household, \$7,300	24 Enter your standard deduction (see left margin).	24	
	25 Subtract line 24 from line 22. If line 24 is more than line 22, enter -0-.	25	
	26 If line 22 is \$109,475 or less, multiply \$3,200 by the total number of exemptions claimed on line 6d. If line 22 is over \$109,475, see the worksheet on page 32.	26	
	27 Subtract line 26 from line 25. If line 26 is more than line 25, enter -0-. This is your taxable income .	27	
	28 Tax , including any alternative minimum tax (see page 31).	28	
	29 Credit for child and dependent care expenses. Attach Schedule 2.	29	
	30 Credit for the elderly or the disabled. Attach Schedule 3.	30	
	31 Education credits. Attach Form 8863.	31	
	32 Retirement savings contributions credit. Attach Form 8880.	32	
	33 Child tax credit (see page 36). Attach Form 8901 if required.	33	
	34 Adoption credit. Attach Form 8839.	34	
	35 Add lines 29 through 34. These are your total credits .	35	
	36 Subtract line 35 from line 28. If line 35 is more than line 28, enter -0-.	36	
	37 Advance earned income credit payments from Form(s) W-2.	37	
	38 Add lines 36 and 37. This is your total tax .	38	
If you have a qualifying child, attach Schedule EIC.	39 Federal income tax withheld from Forms W-2 and 1099.	39	
	40 2005 estimated tax payments and amount applied from 2004 return.	40	
	41a Earned income credit (EIC) .	41a	
	b Nontaxable combat pay election.	41b	
	42 Additional child tax credit. Attach Form 8812.	42	
	43 Add lines 39, 40, 41a, and 42. These are your total payments .	43	
	44 If line 43 is more than line 38, subtract line 38 from line 43. This is the amount you overpaid .	44	
	45a Amount of line 44 you want refunded to you .	45a	
	▶ b Routing number <input type="text"/> ▶ c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings		
	▶ d Account number <input type="text"/>		
46 Amount of line 44 you want applied to your 2006 estimated tax .	46		
Amount you owe	47 Amount you owe . Subtract line 43 from line 38. For details on how to pay, see page 51.	47	
	48 Estimated tax penalty (see page 51).	48	
Third party designee	Do you want to allow another person to discuss this return with the IRS (see page 52)? <input type="checkbox"/> Yes . Complete the following. <input type="checkbox"/> No		
	Designee's name ▶	Phone no. ▶ ()	Personal identification number (PIN) ▶ <input type="text"/>
Sign here	Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.		
	Your signature	Date	Your occupation
Joint return? See page 18. Keep a copy for your records.	Spouse's signature. If a joint return, both must sign.		Date
			Spouse's occupation
Paid preparer's use only	Preparer's signature ▶	Date	Preparer's SSN or PTIN
	Firm's name (or yours if self-employed), address, and ZIP code ▶	Check if self-employed <input type="checkbox"/>	EIN
			Phone no. ()

Form **8812**

Additional Child Tax Credit



OMB No. 1545-1620

2005

Attachment Sequence No. **47**

Department of the Treasury
Internal Revenue Service (99)

Complete and attach to Form 1040 or Form 1040A.

Name(s) shown on return

Your social security number

Part I All Filers

1 Enter the amount from line 1 of your Child Tax Credit Worksheet on page 38 of the Form 1040 instructions or page 37 of the Form 1040A instructions. If you used Pub. 972, enter the amount from line 8 of the worksheet on page 4 of the publication **1**

2 Enter the amount from Form 1040, line 52, or Form 1040A, line 33 **2**

3 Subtract line 2 from line 1. If zero, **stop**; you cannot take this credit **3**

4a Earned income (see instructions on back) **4a**

b Nontaxable combat pay from Form(s) W-2, box 12, with code Q. If married filing jointly, include your spouse's amounts with yours. **4b**

5 Is the amount on line 4a more than \$11,000?

No. Leave line 5 blank and enter -0- on line 6.

Yes. Subtract \$11,000 from the amount on line 4a. Enter the result **5**

6 Multiply the amount on line 5 by 15% (.15) and enter the result **6**

Next. Do you have three or more qualifying children?

No. If line 6 is zero, **stop**; you cannot take this credit. Otherwise, skip Part II and enter the **smaller** of line 3 or line 6 on line 13.

Yes. If line 6 is equal to or more than line 3, skip Part II and enter the amount from line 3 on line 13. Otherwise, go to line 7.

Part II Certain Filers Who Have Three or More Qualifying Children

7 Withheld social security and Medicare taxes from Form(s) W-2, boxes 4 and 6. If married filing jointly, include your spouse's amounts with yours. If you worked for a railroad, see instructions on back **7**

8 1040 filers: Enter the total of the amounts from Form 1040, lines 27 and 59, plus any uncollected social security and Medicare or tier 1 RRTA taxes included on line 63. **8**

1040A filers: Enter -0-.

9 Add lines 7 and 8 **9**

10 1040 filers: Enter the total of the amounts from Form 1040, lines 66a and 67. **10**

1040A filers: Enter the total of the amount from Form 1040A, line 41a, plus any excess social security and tier 1 RRTA taxes withheld that you entered to the left of line 43 (see instructions on back).

11 Subtract line 10 from line 9. If zero or less, enter -0- **11**

12 Enter the **larger** of line 6 or line 11 **12**

Next, enter the **smaller** of line 3 or line 12 on line 13.

Part III Additional Child Tax Credit

13 This is your additional child tax credit **13**



Enter this amount on Form 1040, line 68, or Form 1040A, line 42.

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 10644E

Form **8812** (2005)

Instructions

Purpose of Form

Use Form 8812 to figure your additional child tax credit. The additional child tax credit may give you a refund even if you do not owe any tax.

Who Should Use Form 8812

First, complete the Child Tax Credit Worksheet that applies to you. See the instructions for Form 1040, line 52, or Form 1040A, line 33. If you meet the condition given in the *TIP* at the end of your Child Tax Credit Worksheet, use Form 8812 to see if you can take the additional child tax credit.

Effect of Credit on Welfare Benefits

Any refund you receive as a result of taking the additional child tax credit will not be used to determine if you are eligible for the following programs, or how much you can receive from them. But if the refund you receive because of the additional child tax credit is not spent within a certain period of time, it may count as an asset (or resource) and affect your eligibility.

- Temporary Assistance for Needy Families (TANF).
- Medicaid and supplemental security income (SSI).
- Food stamps and low-income housing.

Earned Income

To figure the amount to include on line 4a, answer the four questions below. Also, see *Nontaxable combat pay* next.

Nontaxable combat pay. Enter on line 4b the total amount of nontaxable combat pay that you, and your spouse if filing jointly, received in 2005. This amount should be shown in box 12 of your Form(s) W-2 with code Q.

Nontaxable combat pay received in 2005 must be included in earned income for purposes of the additional child tax credit. If you, or your spouse if filing jointly, did not elect to include nontaxable combat pay in earned income when figuring the earned income credit (EIC) on Form 1040, line 66a, or Form 1040A, line 41a, or if you are not taking the EIC, add any nontaxable combat pay not included in your earned income figured in question 2 or 4 on this page. Enter the total on Form 8812, line 4a.

1. Did you, or your spouse if filing jointly, have net earnings from self-employment and use either optional method to figure those net earnings?

- No.** Go to question 2.
- Yes.** Use Pub. 972 to figure the amount to enter on Form 8812, line 4a.

2. Are you taking the earned income credit (EIC) on Form 1040, line 66a, or Form 1040A, line 41a?

- Yes.** Use the following chart to find the amount to enter on Form 8812, line 4a.

IF you are filing Form . . .	AND you completed . . .	THEN enter on Form 8812, line 4a, the amount from . . .
1040	Worksheet B on page 46 of your 1040 instructions	Worksheet B, line 4b*, **
	Step 5 on page 43 of your 1040 instructions (but not Worksheet B)	Step 5, Earned Income **
1040A	Step 5 on page 41 of your 1040A instructions	Step 5, Earned Income **

* If you were a member of the clergy, subtract the following from the amount on line 4b: (a) the rental value of a home or the nontaxable portion of an allowance for a home furnished to you (including payments for utilities), and (b) the value of meals and lodging provided to you, your spouse, and your dependents for your employer's convenience.

** If applicable, add to this amount the amount described in *Nontaxable combat pay* above.

- No. 1040 filers:** Go to question 3.
1040A filers: Skip question 3 and go to question 4.

3. Were you, or your spouse if filing jointly, self-employed, or are you filing Schedule SE because you were a member of the clergy or you had church employee income, or are you filing Schedule C or C-EZ as a statutory employee?

- No.** Go to question 4.
- Yes.** Use Pub. 972 to figure the amount to enter on Form 8812, line 4a.

4. Does the amount on line 7 of Form 1040 or Form 1040A include any of the following amounts?

- Taxable scholarship or fellowship grants not reported on a Form W-2.
- Amounts received for work performed while an inmate in a penal institution (enter "PRI" and the amount received in the space next to line 7 of Form 1040 or 1040A).
- Amounts received as a pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan (enter "DFC" and the amount received in the space next to line 7 of Form 1040 or 1040A). This amount may be reported in box 11 of your Form W-2. If you received such an amount but box 11 is blank, contact your employer for the amount received as a pension or annuity.
- Amounts from Form 2555, line 41, or Form 2555-EZ, line 18.

No. Enter the amount from line 7 of Form 1040 or Form 1040A on Form 8812, line 4a. (If applicable, add to this amount the amount described in *Nontaxable combat pay* on this page.)

Yes. Subtract the total of those amounts from the amount on line 7 of Form 1040 or Form 1040A. (If an amount is included in more than one of the above categories, include it only once in figuring the total amount to subtract.) Enter the result on Form 8812, line 4a. (If applicable, add to this amount the amount described in *Nontaxable combat pay* on this page.)

Railroad Employees

If you worked for a railroad, include the following taxes in the total on Form 8812, line 7.

- Tier 1 tax withheld from your pay. This tax should be shown in box 14 of your Form(s) W-2 and identified as "Tier 1 tax."
- If you were an employee representative, 50% of the total tier 1 tax and tier 1 Medicare tax you paid for 2005.

1040A Filers

If you, or your spouse if filing jointly, had more than one employer for 2005 and total wages of over \$90,000, figure any excess social security and tier 1 railroad retirement (RRTA) taxes withheld. See the instructions for Form 1040A, line 43. Include any excess on Form 8812, line 10.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Internal Revenue Code section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping, 6 min.; Learning about the law or the form, 9 min.; Preparing the form, 29 min.; Copying, assembling, and sending the form to the IRS, 20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the Instructions for Form 1040 or Form 1040A.

Exercise 1(A)

Victor and Emily's Child Tax Credit Questions

Line 33—Child Tax Credit

Three Steps To Take the Child Tax Credit!

- Step 1. Make sure you have a qualifying child for the child tax credit (defined below).
- Step 2. Make sure that for each qualifying child you either checked the box in on Form 1040A, line 6c, column (4), or completed Form 8901 (if the child is not your dependent).
- Step 3. Answer the questions on this page to see if you may use the worksheet on page 39 to figure your credit or if you must use Pub. 972, Child Tax Credit. If you need Pub. 972, see page 7.

A qualifying child is a child who is your...

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

AND

was ...

Under age 17 at the end of 2005

AND

who...

Did not provide over half of his or her own support for 2005

AND

who...

Lived with you for more than half of 2005. If the child did not live with you for the required time, see *Exception to "time lived with you" condition* on page 23.

AND

who...

Was a U.S. citizen, U.S. national, or a resident of the United States. If the child was adopted, see *Exception to citizen test* on page 22.



The above requirements are not the same as the requirements to be a qualifying child for the earned income credit.

Note. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption even if the adoption is not final.

Questions

Who Must Use Pub. 972



- Is the amount on Form 1040A, line 22, more than the amount shown below for your filing status?
 - Married filing jointly – \$110,000
 - Single, head of household, or qualifying widow(er) – \$75,000
 - Married filing separately – \$55,000

No. Continue **Yes.** You must use Pub. 972 to figure your credit.
- Are you claiming the adoption credit on Form 8839 (see the instructions for Form 1040A, line 34, on page 40)?
 - No.** Use the worksheet on page 39 to figure your child tax credit.
 - Yes.** You must use Pub. 972 to figure your child tax credit. You will also need Form 8839.

Exercise 1(A)

Victor and Emily's Child Tax Credit Worksheet

Child Tax Credit Worksheet—Line 33

Keep for Your Records



- To be a qualifying child for the child tax credit, the child must be **under age 17** at the end of 2005 and meet the other requirements listed on page 36.
- Do not** use this worksheet if you answered “Yes” to question 1 or 2 on page 36. Instead, use Pub. 972.

1. Number of qualifying children: 4 × \$1,000. Enter the result. 1 4,000

2. Enter the amount from Form 1040A, line 28. 2 226

3. Add the amounts from Form 1040A:

Line 29	_____				
Line 30	+ _____				
Line 31	+ _____				
Line 32	+ _____				
	Enter the total.			3	0

4. Are the amounts on lines 2 and 3 the same?

Yes. You cannot take this credit because there is no tax to reduce. However, you may be able to take the **additional child tax credit**. See the **TIP** below.

No. Subtract line 3 from line 2. 4 226

5. Is the amount on line 1 more than the amount on line 4?

Yes. Enter the amount from line 4. Also, you may be able to take the **additional child tax credit**. See the **TIP** below. 5 226

No. Enter the amount from line 1. } **This is your child tax credit.**

Enter this amount on Form 1040A, line 33.



You may be able to take the **additional child tax credit** on Form 1040A, line 42, if you answered “Yes” on line 4 or line 5 above.

- First, complete your Form 1040A through line 41a.
- Then, use Form 8812 to figure any additional child tax credit.

Exercise 1(B)

Victor and Emily's Form 1040 A, page 2

Form 1040A (2005)		Page 2
Tax, credits, and payments	22 Enter the amount from line 21 (adjusted gross income).	22 31,467
Standard Deduction for— ● People who checked any box on line 23a or 23b or who can be claimed as a dependent, see page 31. ● All others: Single or Married filing separately, \$5,000 Married filing jointly or Qualifying widow(er), \$10,000 Head of household, \$7,300	23a Check if: <input type="checkbox"/> You were born before January 2, 1941, <input type="checkbox"/> Blind } Total boxes checked ▶ 23a <input type="checkbox"/> <input type="checkbox"/> Spouse was born before January 2, 1941, <input type="checkbox"/> Blind }	
	b If you are married filing separately and your spouse itemizes deductions, see page 30 and check here ▶ 23b <input type="checkbox"/>	
	24 Enter your standard deduction (see left margin).	24 10,000
	25 Subtract line 24 from line 22. If line 24 is more than line 22, enter -0-.	25 21,467
	26 If line 22 is \$109,475 or less, multiply \$3,200 by the total number of exemptions claimed on line 6d. If line 22 is over \$109,475, see the worksheet on page 32.	26 19,200
	27 Subtract line 26 from line 25. If line 26 is more than line 25, enter -0-. This is your taxable income .	▶ 27 2,267
	28 Tax , including any alternative minimum tax (see page 31).	28 226
	29 Credit for child and dependent care expenses. Attach Schedule 2.	29
	30 Credit for the elderly or the disabled. Attach Schedule 3.	30
	31 Education credits. Attach Form 8863.	31
32 Retirement savings contributions credit. Attach Form 8880.	32	
33 Child tax credit (see page 36). Attach Form 8901 if required.	33 226	
34 Adoption credit. Attach Form 8839.	34	
35 Add lines 29 through 34. These are your total credits .	35 226	
36 Subtract line 35 from line 28. If line 35 is more than line 28, enter -0-.	36	
37 Advance earned income credit payments from Form(s) W-2.	37	
38 Add lines 36 and 37. This is your total tax .	▶ 38	
39 Federal income tax withheld from Forms W-2 and 1099.	39	
40 2005 estimated tax payments and amount applied from 2004 return.	40	
41a Earned income credit (EIC) .	41a 1,219	
b Nontaxable combat pay election. 41b		
42 Additional child tax credit. Attach Form 8812.	42 1,120	
43 Add lines 39, 40, 41a, and 42. These are your total payments .	▶ 43	
Refund	44 If line 43 is more than line 38, subtract line 38 from line 43. This is the amount you overpaid .	44
Direct deposit? See page 50 and fill in 45b, 45c, and 45d.	45a Amount of line 44 you want refunded to you .	▶ 45a
	▶ b Routing number <input type="text"/> ▶ c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings	
	▶ d Account number <input type="text"/>	
	46 Amount of line 44 you want applied to your 2006 estimated tax .	46
Amount you owe	47 Amount you owe . Subtract line 43 from line 38. For details on how to pay, see page 51.	▶ 47
	48 Estimated tax penalty (see page 51).	48
Third party designee	Do you want to allow another person to discuss this return with the IRS (see page 52)? <input type="checkbox"/> Yes . Complete the following. <input type="checkbox"/> No	
	Designee's name ▶	Phone no. ▶ ()
		Personal identification number (PIN) ▶ <input type="text"/>
Sign here	Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.	
Joint return? See page 18. Keep a copy for your records.	Your signature	Date
	Your occupation	Daytime phone number ()
	Spouse's signature. If a joint return, both must sign.	Date
	Spouse's occupation	
Paid preparer's use only	Preparer's signature ▶	Date
	Firm's name (or yours if self-employed), address, and ZIP code ▶	Preparer's SSN or PTIN
		Check if self-employed <input type="checkbox"/>
		EIN
		Phone no. ()

Exercise 1(C)

Victor and Emily's Form 8812, Page 1

Form 8812 Department of the Treasury Internal Revenue Service (99)	<h2 style="margin:0;">Additional Child Tax Credit</h2> <p style="font-size: small; margin: 5px 0;">Complete and attach to Form 1040 or Form 1040A.</p>		OMB No. 1545-1620 <h2 style="margin:0;">2005</h2> Attachment Sequence No. 47
Name(s) shown on return Victor and Emily Howard		Your social security number xxx xx xxxx	
Part I All Filers			
1 Enter the amount from line 1 of your Child Tax Credit Worksheet on page 38 of the Form 1040 instructions or page 37 of the Form 1040A instructions. If you used Pub. 972, enter the amount from line 8 of the worksheet on page 4 of the publication		1	4,000
2 Enter the amount from Form 1040, line 52, or Form 1040A, line 33		2	226
3 Subtract line 2 from line 1. If zero, stop ; you cannot take this credit		3	3,774
4a Earned income (see instructions on back)		4a	18,467
b Nontaxable combat pay from Form(s) W-2, box 12, with code Q. If married filing jointly, include your spouse's amounts with yours.		4b	
5 Is the amount on line 4a more than \$11,000? <input type="checkbox"/> No. Leave line 5 blank and enter -0- on line 6. <input checked="" type="checkbox"/> Yes. Subtract \$11,000 from the amount on line 4a. Enter the result		5	7,467
6 Multiply the amount on line 5 by 15% (.15) and enter the result Next, do you have three or more qualifying children? <input type="checkbox"/> No. If line 6 is zero, stop ; you cannot take this credit. Otherwise, skip Part II and enter the smaller of line 3 or line 6 on line 13. <input checked="" type="checkbox"/> Yes. If line 6 is equal to or more than line 3, skip Part II and enter the amount from line 3 on line 13. Otherwise, go to line 7.		6	1,120
Part II Certain Filers Who Have Three or More Qualifying Children			
7 Withheld social security and Medicare taxes from Form(s) W-2, boxes 4 and 6. If married filing jointly, include your spouse's amounts with yours. If you worked for a railroad, see instructions on back		7	1,413
8 1040 filers: Enter the total of the amounts from Form 1040, lines 27 and 59, plus any uncollected social security and Medicare or tier 1 RRTA taxes included on line 63. 1040A filers: Enter -0-.		8	0
9 Add lines 7 and 8		9	1,413
10 1040 filers: Enter the total of the amounts from Form 1040, lines 66a and 67. 1040A filers: Enter the total of the amount from Form 1040A, line 41a, plus any excess social security and tier 1 RRTA taxes withheld that you entered to the left of line 43 (see instructions on back).		10	1,219
11 Subtract line 10 from line 9. If zero or less, enter -0-		11	194
12 Enter the larger of line 6 or line 11 Next, enter the smaller of line 3 or line 12 on line 13.		12	1,120
Part III Additional Child Tax Credit			
13 This is your additional child tax credit		13	1,120
		Enter this amount on Form 1040, line 68, or Form 1040A, line 42.	

Exercise 1(C)

Victor and Emily's Form 8812, page 2

Instructions

Purpose of Form

Use Form 8812 to figure your additional child tax credit. The additional child tax credit may give you a refund even if you do not owe any tax.

Who Should Use Form 8812

First, complete the Child Tax Credit Worksheet that applies to you. See the instructions for Form 1040, line 52, or Form 1040A, line 33. If you meet the condition given in the *TIP* at the end of your Child Tax Credit Worksheet, use Form 8812 to see if you can take the additional child tax credit.

Effect of Credit on Welfare Benefits

Any refund you receive as a result of taking the additional child tax credit will not be used to determine if you are eligible for the following programs, or how much you can receive from them. But if the refund you receive because of the additional child tax credit is not spent within a certain period of time, it may count as an asset (or resource) and affect your eligibility.

- Temporary Assistance for Needy Families (TANF).
- Medicaid and supplemental security income (SSI).
- Food stamps and low-income housing.

Earned Income

To figure the amount to include on line 4a, answer the four questions below. Also, see *Nontaxable combat pay* next.

Nontaxable combat pay. Enter on line 4b the total amount of nontaxable combat pay that you, and your spouse if filing jointly, received in 2005. This amount should be shown in box 12 of your Form(s) W-2 with code Q.

Nontaxable combat pay received in 2005 must be included in earned income for purposes of the additional child tax credit. If you, or your spouse if filing jointly, did not elect to include nontaxable combat pay in earned income when figuring the earned income credit (EIC) on Form 1040, line 66a, or Form 1040A, line 41a, or if you are not taking the EIC, add any nontaxable combat pay not included in your earned income figured in question 2 or 4 on this page. Enter the total on Form 8812, line 4a.

1. Did you, or your spouse if filing jointly, have net earnings from self-employment and use either optional method to figure those net earnings?

- No.** Go to question 2.
- Yes.** Use Pub. 972 to figure the amount to enter on Form 8812, line 4a.

2. Are you taking the earned income credit (EIC) on Form 1040, line 66a, or Form 1040A, line 41a?

- Yes.** Use the following chart to find the amount to enter on Form 8812, line 4a.

IF you are filing Form . . .	AND you completed . . .	THEN enter on Form 8812, line 4a, the amount from . . .
1040	Worksheet B on page 46 of your 1040 instructions	Worksheet B, line 4b*, **
	Step 5 on page 43 of your 1040 instructions (but not Worksheet B)	Step 5, Earned Income **
1040A	Step 5 on page 41 of your 1040A instructions	Step 5, Earned Income **

* If you were a member of the clergy, subtract the following from the amount on line 4b: (a) the rental value of a home or the nontaxable portion of an allowance for a home furnished to you (including payments for utilities), and (b) the value of meals and lodging provided to you, your spouse, and your dependents for your employer's convenience.

** If applicable, add to this amount the amount described in *Nontaxable combat pay* above.

- No. 1040 filers:** Go to question 3.
- 1040A filers:** Skip question 3 and go to question 4.

3. Were you, or your spouse if filing jointly, self-employed, or are you filing Schedule SE because you were a member of the clergy or you had church employee income, or are you filing Schedule C or C-EZ as a statutory employee?

- No.** Go to question 4.
- Yes.** Use Pub. 972 to figure the amount to enter on Form 8812, line 4a.

4. Does the amount on line 7 of Form 1040 or Form 1040A include any of the following amounts?

- Taxable scholarship or fellowship grants not reported on a Form W-2.
- Amounts received for work performed while an inmate in a penal institution (enter "PRI" and the amount received in the space next to line 7 of Form 1040 or 1040A).
- Amounts received as a pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan (enter "DFC" and the amount received in the space next to line 7 of Form 1040 or 1040A). This amount may be reported in box 11 of your Form W-2. If you received such an amount but box 11 is blank, contact your employer for the amount received as a pension or annuity.
- Amounts from Form 2555, line 41, or Form 2555-EZ, line 18.

No. Enter the amount from line 7 of Form 1040 or Form 1040A on Form 8812, line 4a. (If applicable, add to this amount the amount described in *Nontaxable combat pay* on this page.)

Yes. Subtract the total of those amounts from the amount on line 7 of Form 1040 or Form 1040A. (If an amount is included in more than one of the above categories, include it only once in figuring the total amount to subtract.) Enter the result on Form 8812, line 4a. (If applicable, add to this amount the amount described in *Nontaxable combat pay* on this page.)

Railroad Employees

If you worked for a railroad, include the following taxes in the total on Form 8812, line 7.

- Tier 1 tax withheld from your pay. This tax should be shown in box 14 of your Form(s) W-2 and identified as "Tier 1 tax."
- If you were an employee representative, 50% of the total tier 1 tax and tier 1 Medicare tax you paid for 2005.

1040A Filers

If you, or your spouse if filing jointly, had more than one employer for 2005 and total wages of over \$90,000, figure any excess social security and tier 1 railroad retirement (RRTA) taxes withheld. See the instructions for Form 1040A, line 43. Include any excess on Form 8812, line 10.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Internal Revenue Code section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping, 6 min.; Learning about the law or the form, 9 min.; Preparing the form, 29 min.; Copying, assembling, and sending the form to the IRS, 20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the Instructions for Form 1040 or Form 1040A.

STUDENT NOTES

Lined writing area for student notes.

CREDIT FOR CHILD AND DEPENDENT CARE EXPENSES

Lesson 7

INTRODUCTION AND OBJECTIVES

In this lesson you will learn about the credit for child and dependent care expenses. This nonrefundable credit is one of the most commonly used credits. The requirements for claiming the credit are the same regardless of the form used. In fact, Form 2441 (used with Form 1040) and Schedule 2 (used with Form 1040A) are virtually identical; for the purposes of this Lesson, we will work with Form 2441. In order to qualify for this credit, the taxpayer must satisfy all five tests of eligibility.

Some taxpayers receive employer-provided dependent care benefits. Dependent care benefits include amounts the employer paid directly to the taxpayer or to the care provider. These benefits can also include the fair market value of care in a day care facility provided or sponsored by the employer. The taxpayer's salary may have been reduced to pay for these benefits. The employer-provided benefits will be reported on Form W-2, Box 10.

After completing this lesson you should be able to:

- Determine who is eligible for the credit for child and dependent care expenses.
- Calculate the credit, the exclusion and report the expenses on the correct form.

QUALIFYING PERSON TEST

A qualifying *child* must:

- Be the taxpayer's dependent child, including:
 - Son or daughter,
 - Adopted child,
 - Stepson or stepdaughter,
 - Eligible foster child (who must have been placed with the taxpayer by an authorized placement agency or an order of a court),
 - Brother or sister,
 - Stepbrother or stepsister,
 - Descendent of one of these listed relatives (including a grandchild, a niece or nephew)

ALERT



This lesson contains basic tax law and is required training for all volunteers.

ALERT



Publication 4012, *Volunteer Resource Guide*, contains a flow chart to assist you in determining whether a taxpayer can claim the credit. It also contains the definition of qualifying person and qualified expenses.

POTENTIAL PITFALLS



Normally, a qualifying person's age is defined as the age on the last day of the year. However, this credit allows a taxpayer to claim child and dependent care expenses up to the day the child turns 13.

- Be a child under the age of 13 when the care was provided, or may be any age if permanently and totally disabled.
- Be a U.S. citizen, national, or resident,
- Not have provided over half of his or her own support during 2005,
- Have lived with the taxpayer for more than half of 2005. A child who was born or died in 2005 and whose only residence was with the taxpayer meets this requirement.

Note: Temporary absences for special circumstances, such as school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home.

A qualifying *dependent*, other than a child, is:

- A dependent who was physically or mentally not able to care for himself or herself and for whom a dependency exemption can be claimed except the person had \$3,200 or more in gross income;
- A spouse who was physically or mentally not able to care for himself or herself.

Example 1

Jim paid someone to care for his wife, Janet. Janet is physically unable to care for herself. Jim also paid to have someone prepare meals for his 12-year-old daughter, Jill. Both Janet and Jill are qualifying persons for the credit.

Example 2

Bob and Rhonda paid child care expenses for their son, Ronnie. Ronnie turned 13 on July 15. Ronnie is a qualifying person until he reached the age of 13.

Children of Divorced or Separated Parents

Special rules apply to children of divorced or separated parents. Taxpayers who are the custodial parents can treat the child as a qualifying person even if they cannot claim the child's exemption.

Taxpayers who **are not** the custodial parents cannot treat the child as a qualifying person even if they can claim the child's exemption.

This exception applies only if all the following are true:

- One or both parents had custody of the child for more than half the year
- One or both parents provided more than half of the child's support for the year, and

Either:

- The custodial parent signed Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*, or similar statement, agreeing not to claim the child's exemption for the year, or

- The noncustodial parent provided at least \$600 for the child's support and can claim the child's exemption under a pre-1985 decree of divorce or separate maintenance, or written agreement.

Example 3

Amanda is divorced and has custody of her 8-year-old daughter, Carrie. Amanda signed Form 8332 to allow her ex-spouse to claim the dependency exemption for Carrie. In order to work, Amanda paid child care expenses for Carrie. Under the special rules for children of divorced or separated parents, Amanda can claim the credit for child and dependent care expenses.

EARNED INCOME TEST

The taxpayer (and spouse if married) must have earned income during the year. Earned income includes wages, salaries, tips, other taxable employee compensation, net earnings from self-employment, strike benefits, and disability pay reported as wages.

A spouse is treated as having earned income for any month he or she is a full-time student or physically or mentally not able to care for himself or herself. His or her earned income for each month is considered to be at least \$250 if there is one qualifying person in the home, or at least \$500 if there are two or more qualifying persons in the home. This applies to only one spouse for any one month. If, in the same month, both taxpayers do not work and are either full-time students or physically or mentally not able to care for themselves, only one of them can be treated as having earned income in that month.

A full-time student is defined as enrolled and attending a school for the number of hours or classes the school considers full-time. The taxpayer (or spouse) must be a student for some part of five calendar months during the year.

Example 4

Janice worked full time. Her husband, Ken, was a full-time student from January through May. Their son, Jason, was in daycare while Ken attended school. Ken's earned income for the time he attended school is considered to be \$1,250 (5 months × \$250).

WORK-RELATED EXPENSE TEST

Child and dependent care expenses must be work related to qualify for the credit. Expenses are considered work related only if both of the following are true:

1. The expenses allow the taxpayer (and spouse if married) to work or look for work (if the taxpayer or their spouse do not find a job, and have no income for the year, they cannot take the credit) and
2. The expenses are for a qualifying person's care.

POTENTIAL PITFALLS



A net loss from self-employment reduces earned income.

POTENTIAL PITFALLS



Please see Publication 503, *Child and Dependent Care Expenses*, for information about expenses prepaid in an earlier year or not paid until the following year, as well as other detailed information about this credit.

A spouse is treated as working during any month he or she is a full-time student or is physically or mentally not able to care for himself or herself.

To be work related, the expenses must be to provide care for a qualifying person. Expenses are for the care of a qualifying person only if their main purpose is the person's well being and protection.

Expenses for care do not include amounts paid for food, clothing, education, and entertainment. However, small amounts paid for these items can be included if they are incident to and cannot be separated from the cost of care.

Expenses to attend kindergarten or a higher grade are not expenses for care.

Example 5

A taxpayer takes his 3-year-old child to a nursery school that provides lunch and educational activities as a part of its preschool child-care service. The total cost can be counted to figure the credit.

Example 6

A taxpayer places her 10-year-old child in a boarding school so she can work full-time. Only the part of the boarding school expense that is for the care of the child is a work-related expense and only if it can be separated from the cost of education. The taxpayer cannot count any part of the amount paid for the child's education.

Camp. The cost of sending a child to an overnight camp is not considered a work-related expense.

Payments to relatives. Do not count amounts paid to:

1. A dependent for whom the taxpayer (or spouse if married) can claim as an exemption, or
2. The taxpayer's child who is under age 19 at the end of the year, even if he or she is not the taxpayer's dependent.

JOINT RETURN TEST

Generally, a married couple must file a joint return to take the credit. However, if the taxpayer is legally separated or living apart from his or her spouse, the taxpayer may be able to file a separate return and still take the credit.

The taxpayer is considered unmarried for purposes of the credit, if all of the following apply:

1. The taxpayer lived apart from his or her spouse during the last six months of the year, and
2. The qualifying person lived in the taxpayer's home for more than half of the year, and
3. The taxpayer provided over half the cost of keeping up their home, and
4. The taxpayer files a separate return.

PROVIDER IDENTIFICATION TEST

The taxpayer must provide the care provider's name, address, and taxpayer identification number. If the taxpayer is unable to provide this information or if the information is incorrect, he or she must show they used due diligence to obtain the information.

Due Diligence. The taxpayer can show due diligence by getting and keeping any of the following documents:

1. Form W-10, *Dependent Care Provider's Identification and Certification*.
2. Copy of the provider's social security card.
3. Copy of the provider's driver's license if it includes the social security number.
4. A copy of the provider's Form W-4 if the provider is the taxpayer's household employee.
5. A copy of the statement furnished by the taxpayer's employer if the provider is a dependent care plan.
6. A letter or invoice from the provider if it shows the name, address, and taxpayer identification number (EIN or SSN).

Provider Refusal. If the care provider refuses to give the taxpayer the identifying information, report whatever information is available, enter "see page 2" for the missing information, and provide a statement at the bottom of page 2 of Form 2441 or Schedule 2. The taxpayer will also be unable to e-file their return.

Note: If a social services agency pays someone (e.g., a grandparent) to care for a child while a parent works or goes to school and issues a Form 1099-MISC, then the parent cannot claim a credit for child and dependent care expense for that money.

LIMIT ON EXPENSES

The amount of expenses eligible for the credit is limited to the lowest of the following amounts for the year:

- The lower paid spouse's earned income (in the case of taxpayers married at the end of the year).
- The single taxpayer's earned income.
- The actual expenses paid.
- The overall limit of \$3,000 for one qualifying person or \$6,000 for two or more qualifying persons.

ALERT



During the taxpayer's screening interview, Form 13614, *Interview and Intake Sheet*, will remind you to ask the taxpayer if they paid child care expenses so they could work. It also tells the taxpayer they will need their provider's address and Taxpayer Identification Number to claim the credit.

Example 7

Mark earned \$14,000. His wife, Evelyn, earned \$5,600. Daycare expenses for their three-year-old daughter were \$2,200. The maximum amount of qualifying child care expenses is \$2,200. This is the lowest of:

- The lower paid spouse's earnings (\$5,600),
- The amount actually paid (\$2,200), and
- The overall limit for one qualifying person (\$3,000).

Some taxpayers receive dependent care benefits from their employers. If so, the overall limit of \$3,000/\$6,000 is reduced, dollar for dollar, by any reimbursement excluded from the taxpayer's income. The amount of dependent care benefits received is shown in box 10 of Form W-2.

Example 8

Geraldine has one dependent child, Donald, who is 6 years old. She paid \$2,900 in qualified expenses. Box 10 of Geraldine's Form W-2 shows she received \$1,400 during the year from her employer's dependent care assistance program. Because she received dependent care benefits, Part III of Form 2441 must be completed before completing Part II.

Exercise 1

- A. Karen earned \$18,000. She paid \$3,200 for child care expenses for her four-year-old daughter, Crystal. What is the maximum amount of child care expenses Karen can claim? _____
- B. Andrea is married to Bill. They have a seven-year-old son, Charles. Charles lived with Andrea for the entire year. Andrea paid all the expenses of keeping up the home for herself and Charles. Andrea also paid for before-school and after-school child care. Her total child care expenses were \$1,800. Bill left the home 18 months ago. He did not live with Andrea at all during 2005, but he did send \$1,200 in child support. Andrea and Bill will file separate returns. Andrea signed Form 8332 to allow Bill to claim the dependency exemption for Charles. Who can claim the credit for child and dependent care expenses?
- C. Ellen is divorced. She has custody of her 12-year-old daughter, Terri. Terri takes care of herself after school. In the summer, Ellen spends \$2,000 to send Terri to a two week long overnight camp. Are the camp expenses qualified expenses for the credit for child and dependent care credit? _____

FIGURING THE CREDIT

The credit is a percentage of qualifying expenses. For taxpayers with adjusted gross incomes of \$15,000 or less, the credit is 35 percent of qualifying expenses. As adjusted gross income increases, the percentage decreases. The lowest percentage is 20 percent for an AGI equal to or greater than \$43,000. There is no upper limitation on income for this credit. The tables on Schedule 2 (Form 1040A) and on Form 2441 (Form 1040) show the percentage for each adjusted gross income bracket. After the credit is figured using Form 2441 or Schedule 2, it is reported on Form 1040, line 48, or Form 1040A, line 29.

Example 9

David A. and Edith B. Fullerton are married and file a joint return. Last year, they paid \$3,500 for the care of their son, Jonathan. The payment was made to Karen's Kiddie Care, 456 Chapman Avenue, Your City, State, and Zip Code (EIN xx-xxxxxxx). The \$3,500 payment includes a \$1,000 dependent care benefit Edith received from her employer. This benefit was reported on Edith's Form W-2, Box 10. Edith earned \$18,979 and David earned \$20,450 last year. Their adjusted gross income is \$39,429 and their tax liability is \$2,244.

Exhibits 1 and 2 show the completed Form 2441 (Form 1040) for David and Edith.

Form 2441	Child and Dependent Care Expenses	OMB No. 1545-0068
Department of the Treasury Internal Revenue Service (99)	▶ Attach to Form 1040. ▶ See separate instructions.	2005 Attachment Sequence No. 21

Name(s) shown on Form 1040: David A. & Edith B. Fullerton

Your social security number: XXX XX XXXX

Before you begin: You need to understand the following terms. See **Definitions** on page 1 of the instructions.

- **Dependent Care Benefits**
- **Qualifying Person(s)**
- **Qualified Expenses**

Part I Persons or Organizations Who Provided the Care—You must complete this part.
(If you need more space, use the bottom of page 2.)

1 (a) Care provider's name	(b) Address <small>(number, street, apt. no., city, state, and ZIP code)</small>	(c) Identifying number <small>(SSN or EIN)</small>	(d) Amount paid <small>(see instructions)</small>
Karen's Kiddie Care	456 Chapman Avenue Your City, State Zip Code	XX-XXXXXXX	3,500

Did you receive dependent care benefits?	No	Complete only Part II below.
	Yes	Complete Part III on the back next.

Caution. If the care was provided in your home, you may owe employment taxes. See the instructions for Form 1040, line 62.

Part II Credit for Child and Dependent Care Expenses

2 Information about your **qualifying person(s)**. If you have more than two qualifying persons, see the instructions.

(a) Qualifying person's name		(b) Qualifying person's social security number	(c) Qualified expenses you incurred and paid in 2005 for the person listed in column (a)
First	Last		
Jonathan	Fullerton	XX XX XXXX	2,500

3 Add the amounts in column (c) of line 2. Do not enter more than \$3,000 for one qualifying person or \$6,000 for two or more persons. If you completed Part III, enter the amount from line 32	3	2,000																																																												
4 Enter your earned income . See instructions	4	20,450																																																												
5 If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions); all others , enter the amount from line 4	5	18,979																																																												
6 Enter the smallest of line 3, 4, or 5	6	2,000																																																												
7 Enter the amount from Form 1040, line 38	7	39,429																																																												
8 Enter on line 8 the decimal amount shown below that applies to the amount on line 7																																																														
<table style="width:100%; border-collapse: collapse;"> <tr> <th colspan="3" style="text-align: left; border-bottom: 1px solid black;">If line 7 is:</th> <th colspan="3" style="text-align: left; border-bottom: 1px solid black;">If line 7 is:</th> </tr> <tr> <th style="text-align: left; border-bottom: 1px solid black;">Over</th> <th style="text-align: left; border-bottom: 1px solid black;">But not over</th> <th style="text-align: left; border-bottom: 1px solid black;">Decimal amount is</th> <th style="text-align: left; border-bottom: 1px solid black;">Over</th> <th style="text-align: left; border-bottom: 1px solid black;">But not over</th> <th style="text-align: left; border-bottom: 1px solid black;">Decimal amount is</th> </tr> <tr> <td>\$0—15,000</td> <td></td> <td>.35</td> <td>\$29,000—31,000</td> <td></td> <td>.27</td> </tr> <tr> <td>15,000—17,000</td> <td></td> <td>.34</td> <td>31,000—33,000</td> <td></td> <td>.26</td> </tr> <tr> <td>17,000—19,000</td> <td></td> <td>.33</td> <td>33,000—35,000</td> <td></td> <td>.25</td> </tr> <tr> <td>19,000—21,000</td> <td></td> <td>.32</td> <td>35,000—37,000</td> <td></td> <td>.24</td> </tr> <tr> <td>21,000—23,000</td> <td></td> <td>.31</td> <td>37,000—39,000</td> <td></td> <td>.23</td> </tr> <tr> <td>23,000—25,000</td> <td></td> <td>.30</td> <td>39,000—41,000</td> <td></td> <td>.22</td> </tr> <tr> <td>25,000—27,000</td> <td></td> <td>.29</td> <td>41,000—43,000</td> <td></td> <td>.21</td> </tr> <tr> <td>27,000—29,000</td> <td></td> <td>.28</td> <td>43,000—No limit</td> <td></td> <td>.20</td> </tr> </table>	If line 7 is:			If line 7 is:			Over	But not over	Decimal amount is	Over	But not over	Decimal amount is	\$0—15,000		.35	\$29,000—31,000		.27	15,000—17,000		.34	31,000—33,000		.26	17,000—19,000		.33	33,000—35,000		.25	19,000—21,000		.32	35,000—37,000		.24	21,000—23,000		.31	37,000—39,000		.23	23,000—25,000		.30	39,000—41,000		.22	25,000—27,000		.29	41,000—43,000		.21	27,000—29,000		.28	43,000—No limit		.20	8	× .22
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9 Multiply line 6 by the decimal amount on line 8. If you paid 2004 expenses in 2005, see the instructions	9	440																																																												
10 Enter the amount from Form 1040, line 46, minus any amount on Form 1040, line 47	10	2,244																																																												
11 Credit for child and dependent care expenses. Enter the smaller of line 9 or line 10 here and on Form 1040, line 48	11	440																																																												

Part III Dependent Care Benefits

12	Enter the total amount of dependent care benefits you received in 2005. Amounts you received as an employee should be shown in box 10 of your Form(s) W-2. Do not include amounts reported as wages in box 1 of Form(s) W-2. If you were self-employed or a partner, include amounts you received under a dependent care assistance program from your sole proprietorship or partnership	12	1,000
13	Enter the amount forfeited, if any (see the instructions)	13	
14	Subtract line 13 from line 12	14	1,000
15	Enter the total amount of qualified expenses incurred in 2005 for the care of the qualifying person(s)	15	3,500
16	Enter the smaller of line 14 or 15	16	1,000
17	Enter your earned income . See instructions	17	20,450
18	Enter the amount shown below that applies to you. <ul style="list-style-type: none"> • If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions for line 5). • If married filing separately, see the instructions for the amount to enter. • All others, enter the amount from line 17. 	18	18,979
19	Enter the smallest of line 16, 17, or 18	19	1,000
20	Enter the amount from line 12 that you received from your sole proprietorship or partnership. If you did not receive any such amounts, enter -0-	20	0
21	Subtract line 20 from line 14	21	1,000
22	Enter \$5,000 (\$2,500 if married filing separately and you were required to enter your spouse's earned income on line 18)	22	5,000
23	Deductible benefits. Enter the smallest of line 19, 20, or 22. Also, include this amount on the appropriate line(s) of your return (see the instructions)	23	0
24	Enter the smaller of line 19 or 22	24	1,000
25	Enter the amount from line 23	25	0
26	Excluded benefits. Subtract line 25 from line 24. If zero or less, enter -0-	26	1,000
27	Taxable benefits. Subtract line 26 from line 21. If zero or less, enter -0-. Also, include this amount on Form 1040, line 7. On the dotted line next to line 7, enter "DCB"	27	0

To claim the child and dependent care credit, complete lines 28–32 below.

28	Enter \$3,000 (\$6,000 if two or more qualifying persons)	28	3,000
29	Add lines 23 and 26	29	1,000
30	Subtract line 29 from line 28. If zero or less, stop . You cannot take the credit. Exception. If you paid 2004 expenses in 2005, see the instructions for line 9	30	2,000
31	Complete line 2 on the front of this form. Do not include in column (c) any benefits shown on line 29 above. Then, add the amounts in column (c) and enter the total here	31	2,500
32	Enter the smaller of line 30 or 31. Also, enter this amount on line 3 on the front of this form and complete lines 4–11	32	2,000

Exercise 2

Sam L. (xxx-xx-xxxx) and Sue D. Windham are married and will file a joint return. They have two dependent children whom they send to day-care to allow both parents to work. Sam's earned income is \$18,500 and Sue's earned income is \$19,350. Their AGI (Form 1040, line 37) is \$37,850 and their tax liability (Form 1040, line 44) is \$1,531.

During 2005, they paid The Learning Center (496 Irvine Road, Your City, State, and Zip Code, EIN xx-xxxxxxx) \$5,450 to care for their children. The Windhams paid \$2,950 of the total and Sue's employer paid \$2,500 under a dependent care benefits program. The \$2,500 is in Box 10 of Sue's Form W-2.

The children and the amounts paid for child care are as follows:

Doug	SSN xxx-xx-xxxx	\$3,000	\$1,250 dependent care benefit
Sally	SSN xxx-xx-xxxx	\$2,450	\$1,250 dependent care benefit

Complete their Form 1040, Form 2441 (Exhibits 3 and 4).

TaxWise Hints

Use the flow charts in Publication 4012, *Volunteer Resource Guide*, to determine credit eligibility. For each qualifying child, check the "DC" box on the Main Information Sheet, Dependents/Non-dependents box. TaxWise will add a Form 2441 or Schedule 2 to the forms tree. Complete all entries annotated in red. TaxWise will then calculate any exclusion amounts, calculate the credit, complete the form and insert the credit amount on Form 1040 or Form 1040A.

▶▶ SUMMING UP THIS LESSON ◀◀

The credit for child and dependent care expenses is a nonrefundable credit which allows a taxpayer to reduce their tax liability for a portion of the expenses.

A taxpayer must satisfy the five tests to qualify for the credit. The tests are the qualifying person test; the earned income test; the work-related expense test; the joint return test; and the provider identification test.

The credit is calculated and reported on Form 2441 (Form 1040) or Schedule 2 (Form 1040A).

Part III Dependent Care Benefits

12	Enter the total amount of dependent care benefits you received in 2005. Amounts you received as an employee should be shown in box 10 of your Form(s) W-2. Do not include amounts reported as wages in box 1 of Form(s) W-2. If you were self-employed or a partner, include amounts you received under a dependent care assistance program from your sole proprietorship or partnership	12		
13	Enter the amount forfeited, if any (see the instructions)	13		
14	Subtract line 13 from line 12	14		
15	Enter the total amount of qualified expenses incurred in 2005 for the care of the qualifying person(s)	15		
16	Enter the smaller of line 14 or 15	16		
17	Enter your earned income . See instructions	17		
18	Enter the amount shown below that applies to you. <ul style="list-style-type: none"> • If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions for line 5). • If married filing separately, see the instructions for the amount to enter. • All others, enter the amount from line 17. 	18		
19	Enter the smallest of line 16, 17, or 18	19		
20	Enter the amount from line 12 that you received from your sole proprietorship or partnership. If you did not receive any such amounts, enter -0-	20		
21	Subtract line 20 from line 14	21		
22	Enter \$5,000 (\$2,500 if married filing separately and you were required to enter your spouse's earned income on line 18)	22		
23	Deductible benefits. Enter the smallest of line 19, 20, or 22. Also, include this amount on the appropriate line(s) of your return (see the instructions)	23		
24	Enter the smaller of line 19 or 22	24		
25	Enter the amount from line 23	25		
26	Excluded benefits. Subtract line 25 from line 24. If zero or less, enter -0-	26		
27	Taxable benefits. Subtract line 26 from line 21. If zero or less, enter -0-. Also, include this amount on Form 1040, line 7. On the dotted line next to line 7, enter "DCB"	27		

To claim the child and dependent care credit, complete lines 28–32 below.

28	Enter \$3,000 (\$6,000 if two or more qualifying persons)	28		
29	Add lines 23 and 26	29		
30	Subtract line 29 from line 28. If zero or less, stop . You cannot take the credit. Exception. If you paid 2004 expenses in 2005, see the instructions for line 9	30		
31	Complete line 2 on the front of this form. Do not include in column (c) any benefits shown on line 29 above. Then, add the amounts in column (c) and enter the total here	31		
32	Enter the smaller of line 30 or 31. Also, enter this amount on line 3 on the front of this form and complete lines 4–11	32		

Exercise 1

- (A) \$3,000, which is the lowest of: earned income (\$18,000); the amount actually paid (\$3,200); and the limit of one qualifying person (\$3,000).
- (B) Andrea. Although Andrea does not claim Charles as a dependent, under the special rules for divorced or separated parents, Andrea can claim the child and dependent care credit because she is the custodial parent. Bill cannot claim the credit because he is not the custodial parent.
- (C) No.

CREDIT FOR CHILD AND DEPENDENT CARE EXPENSES

Exhibit 5 Exercise 2

The Windham's Form 2441, page 1


Form 2441 Department of the Treasury Internal Revenue Service (99)	Child and Dependent Care Expenses ▶ Attach to Form 1040. ▶ See separate instructions.	OMB No. 1545-0068 2005 Attachment Sequence No. 21																																																																									
Name(s) shown on Form 1040 Sam L. & Sue D. Windham		Your social security number XXX : XX : XXXX																																																																									
Before you begin: You need to understand the following terms. See Definitions on page 1 of the instructions.																																																																											
• Dependent Care Benefits • Qualifying Person(s) • Qualified Expenses																																																																											
Part I Persons or Organizations Who Provided the Care—You must complete this part. (If you need more space, use the bottom of page 2.)																																																																											
1	(a) Care provider's name The Learning Center	(b) Address (number, street, apt. no., city, state, and ZIP code) 496 Irvine Road Your City, State Zip Code	(c) Identifying number (SSN or EIN) XX-XXXXXXX	(d) Amount paid (see instructions) 5,450																																																																							
Did you receive dependent care benefits?			No → Complete only Part II below. Yes → Complete Part III on the back next.																																																																								
Caution. If the care was provided in your home, you may owe employment taxes. See the instructions for Form 1040, line 62.																																																																											
Part II Credit for Child and Dependent Care Expenses																																																																											
2 Information about your qualifying person(s) . If you have more than two qualifying persons, see the instructions.																																																																											
	(a) Qualifying person's name First Last Doug Windham Sally Windham	(b) Qualifying person's social security number XXX : XX : XXXX XXX : XX : XXXX	(c) Qualified expenses you incurred and paid in 2005 for the person listed in column (a) 1,750 1,200																																																																								
3	Add the amounts in column (c) of line 2. Do not enter more than \$3,000 for one qualifying person or \$6,000 for two or more persons. If you completed Part III, enter the amount from line 32		2,950																																																																								
4	Enter your earned income . See instructions		18,500																																																																								
5	If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions); all others , enter the amount from line 4		19,350																																																																								
6	Enter the smallest of line 3, 4, or 5		2,950																																																																								
7	Enter the amount from Form 1040, line 38		37,850																																																																								
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CREDIT FOR CHILD AND DEPENDENT CARE EXPENSES

ANSWERS TO EXERCISES Lesson 7

Exhibit 6 Exercise 2

The Windham's Form 2441, page 2

Form 2441 (2005)		Page 2
Part III Dependent Care Benefits		
12 Enter the total amount of dependent care benefits you received in 2005. Amounts you received as an employee should be shown in box 10 of your Form(s) W-2. Do not include amounts reported as wages in box 1 of Form(s) W-2. If you were self-employed or a partner, include amounts you received under a dependent care assistance program from your sole proprietorship or partnership	12	2,500
13 Enter the amount forfeited, if any (see the instructions)	13	
14 Subtract line 13 from line 12	14	2,500
15 Enter the total amount of qualified expenses incurred in 2005 for the care of the qualifying person(s)	15	5,450
16 Enter the smaller of line 14 or 15	16	2,500
17 Enter your earned income . See instructions	17	18,500
18 Enter the amount shown below that applies to you. <ul style="list-style-type: none"> • If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions for line 5). • If married filing separately, see the instructions for the amount to enter. • All others, enter the amount from line 17. 	18	19,350
19 Enter the smallest of line 16, 17, or 18	19	2,500
20 Enter the amount from line 12 that you received from your sole proprietorship or partnership. If you did not receive any such amounts, enter -0-	20	0
21 Subtract line 20 from line 14	21	2,500
22 Enter \$5,000 (\$2,500 if married filing separately and you were required to enter your spouse's earned income on line 18)	22	5,000
23 Deductible benefits. Enter the smallest of line 19, 20, or 22. Also, include this amount on the appropriate line(s) of your return (see the instructions)	23	0
24 Enter the smaller of line 19 or 22	24	2,500
25 Enter the amount from line 23	25	0
26 Excluded benefits. Subtract line 25 from line 24. If zero or less, enter -0-	26	2,500
27 Taxable benefits. Subtract line 26 from line 21. If zero or less, enter -0-. Also, include this amount on Form 1040, line 7. On the dotted line next to line 7, enter "DCB"	27	0
To claim the child and dependent care credit, complete lines 28–32 below.		
28 Enter \$3,000 (\$6,000 if two or more qualifying persons)	28	6,000
29 Add lines 23 and 26	29	2,500
30 Subtract line 29 from line 28. If zero or less, stop . You cannot take the credit. Exception. If you paid 2004 expenses in 2005, see the instructions for line 9	30	3,500
31 Complete line 2 on the front of this form. Do not include in column (c) any benefits shown on line 29 above. Then, add the amounts in column (c) and enter the total here	31	2,950
32 Enter the smaller of line 30 or 31. Also, enter this amount on line 3 on the front of this form and complete lines 4–11	32	2,950
 Printed on recycled paper		Form 2441 (2005)

STUDENT NOTES

INTRODUCTION AND OBJECTIVES

For tax year 2005, there are nine different tax benefits for higher education. Some of these benefits are not taxed (i.e., Coverdell education savings account, qualified tuition program, early IRA withdrawals, employer provided educational assistance and education savings bond programs). The student loan interest deduction and tuition and fees deduction were covered in Lesson 10, Adjustments to Income. In this lesson you will learn about the two education credits: Hope credit and the Lifetime Learning credit.

After completing this lesson, you should be able to:

- Calculate the Hope credit on Form 8863.
- Calculate the Lifetime Learning credit on Form 8863.

GENERAL REQUIREMENTS

Taxpayers can claim the **Hope Scholarship Credit** (Hope credit) and the **Lifetime Learning Credit** for higher education expenses paid in 2005 for an eligible student. Both credits are **nonrefundable** and can be claimed on either Form 1040 or Form 1040A. These two credits are also called **education credits**.

To claim either of the education credits the taxpayer must:

- File using any filing status other than married filing separately,
- Meet all of the general requirements,
- Meet all of the specific requirements for the individual credit, and
- Meet the income limits.

The general requirements provide that the taxpayer must have incurred **qualified expenses** for an **eligible student** to attend **an eligible educational institution** during the tax year.

ALERT



This lesson contains basic tax law and is required training for all volunteers.

ALERT



Publication 4012, Volunteer Resource Guide, contains an Education Credits table to assist you in determining eligibility for the credits.

Qualified Education Expenses

The Hope credit and the Lifetime Learning credit are based on qualified tuition and related expenses the taxpayer pays for himself or herself, the taxpayer's spouse, or dependents the taxpayer claims on his or her tax return.

Eligible Educational Institution

An eligible educational institution is generally any accredited public, nonprofit, or proprietary (private) postsecondary institution eligible to participate in the student aid programs administered by the Department of Education. Most universities and colleges, including community colleges, meet these requirements.

Qualified tuition and related expenses are tuition and fees required for enrollment or attendance at an eligible educational institution and generally **include fees for**:

- Course-related books, supplies and equipment, and
- Student activities.

Note: It is rare for books to meet this test because all such fees must be paid **to the institution** as a condition of enrollment or attendance.

Qualified tuition and related expenses **do not include** the cost of:

- Insurance,
- Medical expenses (including student health fees),
- Room and board,
- Transportation or similar personal, living, or family expenses, **even if** the fees must be paid to the institution as a condition of enrollment or attendance.

When considering qualified tuition and related expenses for the Hope credit, the cost of courses for athletics, sports, games, hobbies or noncredit courses are not used unless the course is part of the student's degree program. However, when computing the qualified tuition and related expenses for the Lifetime Learning credit, these types of expenses are includible if the course was taken to acquire or improve the job skills of the student.

If a taxpayer **prepaid** qualified tuition and related expenses for an academic period that begins in the first three months of the following year, he or she can use the prepaid amount in figuring the credit.

Form 1098-T, Tuition Statement

Form 1098-T is used to report Qualified Tuition and related expenses. These expenses are tuition and fees a student must pay to be enrolled at or attend an eligible educational institution.

To help figure the taxpayer's education credit, the taxpayer should receive Form 1098-T. Generally, an eligible educational institution (such as a college or university) must send Form 1098-T (or acceptable substitute) to each enrolled student by January 31, 2006. See Example 1 below.

Example 1

Thomas Gordon pays \$1,500 in December 2005 for qualified tuition for the winter semester that begins in January 2006. He can use the \$1,500 paid in December of 2005 to compute his credit for 2005.

Thomas' Form 1098-T is shown in Exhibit 1.

Exhibit 1

<input type="checkbox"/> CORRECTED		OMB No. 1545-1574		2005 Form 1098-T	Tuition Statement
FILER'S name, street address, city, state, ZIP code, and telephone number State University 555 Elon Drive Your City, State, Zip Code		1 Payments received for qualified tuition and related expenses \$ 1,500	2 Amounts billed for qualified tuition and related expenses \$		
FILER'S Federal identification no. XX-XXXXXXX	STUDENT'S social security number XXX-XX-XXXX	3 Adjustments made for a prior year \$	4 Scholarships or grants \$	Copy B For Student	
STUDENT'S name Thomas Gordon Street address (including apt. no.) 25 Caldwell Lane City, state, and ZIP code Your City, State, Zip		5 Adjustments to scholarships or grants for a prior year \$	6 The amount in box 1 or 2 includes amounts for an academic period beginning January- March 2006 (if checked) <input type="checkbox"/>	7 Reimbursements or refunds of qualified tuition and related expenses from an insurance contract \$	This is important tax information and is being furnished to the Internal Revenue Service.
Service Provider/Acct. No. (see instructions)		8 Check if at least half-time student <input checked="" type="checkbox"/>	9 Check if a graduate student . . . <input type="checkbox"/>		
Form 1098-T		(keep for your records)		Department of the Treasury - Internal Revenue Service	

Payments with borrowed funds.

Taxpayers can claim the Hope credit and the Lifetime Learning credit for qualified tuition and related expenses paid with the proceeds of a loan. Use the expenses to figure the credit for the year in which the expenses are paid, not the year in which the loan is repaid.

Eligible Student

The taxpayer, the taxpayer's spouse, or the taxpayer's dependent(s) (for whom the taxpayer claims a dependency exemption) can be an eligible student.

In addition, for the Hope credit, the student must be:

- Enrolled in a program that leads to a degree, certificate or other recognized educational credential.
- Taking at least one-half of the normal full-time workload for his or her course of study for at least one academic period beginning during the calendar year.
- Enrolled for one of the first two years of his or her postsecondary education.
- Free of any felony conviction for possessing or distributing a controlled substance.

WHO CAN CLAIM EXPENSES?

The taxpayer must claim a dependent exemption for the eligible student in order to claim an education credit. Either the taxpayer or the dependent, but not both, can claim an education credit for that dependent's higher education expenses.

If the taxpayer...	Then only...
Claims an exemption on the tax return for a dependent who is an eligible student	The taxpayer can claim the Hope or lifetime learning credit based on that student's expenses. The student cannot claim the credit.
Does not claim an exemption for a dependent who is an eligible student (even if entitled to the exemption)	The student can claim the Hope or lifetime learning credit. The taxpayer cannot claim the student's expenses.

If someone other than the taxpayer, the taxpayer's spouse, or the dependent (such as a relative or former spouse) makes a payment directly to the eligible educational institution to pay for an eligible student's tuition and related expenses, the student is treated as receiving the payment from the other person. In this case, the student is considered to have paid the qualified tuition and related expenses to the eligible institution. If the taxpayer claims an exemption for the student, the taxpayer is considered to have paid the expenses.

Example 2

Mary Birch paid her grandson's, Todd, tuition for 2005 directly to the university. For purposes of claiming the Hope credit, Todd is treated as receiving the money as a gift and in turn paying his qualified expenses himself. If Todd's parents claim his exemption, they may be able to use the expenses to claim the Hope credit. If anyone else claims an exemption for Todd, Todd cannot claim a Hope credit.

Income Requirements

The Hope credit and the Lifetime Learning credit are phased out (gradually reduced) if the taxpayer's modified adjusted gross income (MAGI) is between \$43,000 and \$53,000 (\$87,000 and \$107,000) if married filing jointly. The taxpayer cannot claim an education credit if his or her MAGI exceeds \$53,000 or \$107,000 if married filing jointly. In addition, education credits are not allowed to taxpayers who file as married filing separately.

Modified Adjusted Gross Income (MAGI)

For most taxpayers, MAGI is adjusted gross income (AGI) as figured on their federal income tax return. MAGI when using Form 1040A is the AGI on line 22 of that form. MAGI when using Form 1040 is the AGI on line 38 of that form, modified by adding back any:

- 1) Foreign earned income exclusion
- 2) Foreign housing exclusion
- 3) Exclusion of income for *bona fide* residents of American Samoa, and
- 4) Exclusion of income from Puerto Rico.

A Hope credit can be claimed for *each* eligible student that is claimed on the taxpayer's return.

Credit Amounts

The Hope credit is figured on Form 8863, *Education Credits (Hope and Lifetime Learning Credits)*. The maximum Hope credit is \$1,500 *per student* for each of the first two taxable years of his or her postsecondary education. For each eligible student who qualifies for the Hope credit:

- If the expenses are \$1,000 or less, the credit is the amount of the expenses,
- If the expenses are between \$1,000 and \$2,000, the credit is \$1,000 plus one-half of the expenses over \$1,000. For example, if the expenses are \$1,500, the credit is \$1,250 (\$1,000 plus one-half of \$500), and
- If the expenses are \$2,000 or more, the credit is \$1,500.

Example 3

Sue and Ted Marshall paid \$7,000 in qualified tuition and fees for their daughter, Mary, to attend the local university. They determined it would be more beneficial for them to take the Hope Credit rather than the Tuition and Fees Deduction. Their AGI and MAGI is \$40,000 and their tax liability on Form 1040, Line 46, is \$2,634. Their Form 8863 is shown in Exhibit 2.

Form 8863 Department of the Treasury Internal Revenue Service (99)	Education Credits (Hope and Lifetime Learning Credits) ▶ See instructions. ▶ Attach to Form 1040 or Form 1040A.	OMB No. 1545-1618 2005 Attachment Sequence No. 50					
Name(s) shown on return Ted & Sue Marshall		Your social security number XXX XX XXXX					
Caution: You cannot take both an education credit and the tuition and fees deduction (Form 1040, line 34, or Form 1040A, line 19) for the same student in the same year.							
Part I Hope Credit. Caution: You cannot take the Hope credit for more than 2 tax years for the same student .							
1	(a) Student's name (as shown on page 1 of your tax return) First name Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions). Do not enter more than \$2,000 for each student.	(d) Enter the smaller of the amount in column (c) or \$1,000	(e) Add column (c) and column (d)	(f) Enter one-half of the amount in column (e)	
	Mary Marshall	XXX XX XXXX	2,000	1,000	3,000	1,500	
2	Tentative Hope credit. Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III . . . ▶					2	1,500
Part II Lifetime Learning Credit							
3	Caution: You cannot take the Hope credit and the lifetime learning credit for the same student in the same year.		(a) Student's name (as shown on page 1 of your tax return) First name Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions)		
4	Add the amounts on line 3, column (c), and enter the total					4	
5	Enter the smaller of line 4 or \$10,000					5	
6	Tentative lifetime learning credit. Multiply line 5 by 20% (.20) and go to Part III . . . ▶					6	
Part III Allowable Education Credits							
7	Tentative education credits. Add lines 2 and 6					7	1,500
8	Enter: \$107,000 if married filing jointly; \$53,000 if single, head of household, or qualifying widow(er)					8	107,000
9	Enter the amount from Form 1040, line 38*, or Form 1040A, line 22					9	40,000
10	Subtract line 9 from line 8. If zero or less, stop ; you cannot take any education credits					10	67,000
11	Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)					11	20,000
12	If line 10 is equal to or more than line 11, enter the amount from line 7 on line 13 and go to line 14. If line 10 is less than line 11, divide line 10 by line 11. Enter the result as a decimal (rounded to at least three places)					12	×
13	Multiply line 7 by line 12 ▶					13	1,500
14	Enter the amount from Form 1040, line 46, or Form 1040A, line 28					14	2,634
15	Enter the total, if any, of your credits from Form 1040, lines 47 through 49, or Form 1040A, lines 29 and 30					15	0
16	Subtract line 15 from line 14. If zero or less, stop ; you cannot take any education credits ▶					16	2,634
17	Education credits. Enter the smaller of line 13 or line 16 here and on Form 1040, line 50, or Form 1040A, line 31 ▶					17	1,500
			* If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see Pub. 970 for the amount to enter.				
For Paperwork Reduction Act Notice, see page 3.			Cat. No. 25379M			Form 8863 (2005)	

The Lifetime Learning credit is based on the total qualified education expenses paid by the taxpayer and not on the number of eligible students. Education expenses are qualified for the Lifetime Learning credit if they are:

- For courses taken as part of a postsecondary degree program, or
- For courses that are not part of a postsecondary degree program, but that are taken to improve or acquire job skills.

Example 4

Samantha, a professional photographer, enrolls in an advanced photography course at a local community college. Although the course is not part of a degree program, she enrolls in it to improve her job skills. The course fee paid by Samantha is considered qualified tuition for the purpose of claiming the Lifetime Learning credit.

Example 5

Cleve, an engineer, plans to vacation in Europe next year. In preparation for the trip, he enrolls in a noncredit photography class at a local community college. Because Cleve is not taking the course as part of a degree program or to acquire or improve his job skills, the cost of the course is not a qualifying expense for claiming the Lifetime Learning credit.

Credit amounts

The Lifetime Learning credit is also figured on Form 8863. The maximum amount of the credit is \$2,000 per taxpayer for all eligible students. The credit amount is figured by multiplying total qualified educational expenses, up to \$10,000, by 20%. This number may be further reduced based on your MAGI.

Example 6

Judy Hood is single and took a course at the local college to recertify her to teach in public schools. Her qualified tuition expenses were \$800. She chooses to take the Lifetime Learning credit rather than the Tuition and Fees Deduction. Her AGI and MAGI is \$30,000 and her tax liability on Form 1040, Line 46, is \$2,909. Her completed Form 8863 is shown in Exhibit 3.

No DOUBLE BENEFITS

A taxpayer cannot:

- Deduct higher education expenses and claim a credit based on those same expenses (as, for example, a business expense),
- Claim an education credit in the same year as a tuition and fees deduction is claimed for the same student,
- Claim a Hope credit and a Lifetime Learning credit based on the same qualified education expenses,
- Claim an education credit based on the expenses used to figure the tax-free portion of a distribution from a Coverdell ESA or qualified tuition program (QTP),
- Claim a credit based on qualified education expenses paid with a tax-free scholarship, grant, or employer-provided educational assistance.

However, a taxpayer can claim a credit based on expenses paid with the eligible student's earnings, loans, gifts, inheritances, or personal savings.

An eligible student cannot claim an education credit if he or she is claimed as a dependent on another taxpayer's tax return. Any amounts paid by the student are considered paid by the taxpayer who claims the student as a dependent.

The following table summarizes the differences between the credits.

Table: Comparison of Education Credits

Hope Credit	Lifetime Learning Credit
Up to \$1,500 credit per eligible student	Up to \$2,000 credit per return
Available only until the first 2 years of postsecondary education are completed	Available for all years of postsecondary education and for courses to acquire or improve job skills
Available only for 2 tax years per eligible student	Available for an unlimited number of years
Student must be pursuing an undergraduate degree or other recognized education credential	Student does not need to be pursuing a degree or other recognized education credential
Student must be enrolled at least half time for at least one academic period during the year	Available for one or more courses
No felony drug conviction on student's record	Felony drug conviction rule does not apply

Adjustments to Qualified Expenses

Tax-free educational assistance can include the following:

- Scholarships and fellowships,
- Pell grants,

- Employer-provided educational assistance,
- Veteran's educational assistance, and
- Any other nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses.

If the taxpayer paid qualified tuition expenses with these tax-free funds, a credit cannot be claimed for these amounts. Qualified expenses must be reduced by the amount of any tax-free educational assistance received.

Example 7

In 2005, Jackie paid \$3,000 for tuition and \$5,000 for room and board at her local university. To help pay these costs, she was awarded a \$2,000 scholarship and a \$4,000 student loan.

The scholarship is a qualified scholarship that is excludable from Jackie's income. For purposes of the education credit, she must first use the scholarship to reduce her tuition (her only qualified expense). The student loan is not considered tax-free educational assistance so she does not use it to reduce the qualified expenses. Therefore, Jackie is treated as having paid only \$1,000 in qualified expenses (\$3,000 tuition - \$2,000 scholarship).

Refunds

Qualified tuition and related expenses do not include expenses for which the taxpayer received a refund. If the refund or tax-free assistance is received in the same year in which the expenses were paid or in the following year before the tax return is filed, reduce the qualified expenses by the amount received and figure the education credits using the reduced amount of qualified expenses.

If the refund or tax-free assistance is received after the tax return is filed for the year in which the expenses were paid, figure the amount by which the education credits would have been reduced if the refund or tax-free assistance had been received in the year for which the education credits were claimed. Include that amount as an additional tax for the year the refund or tax-free assistance was received. For 2005, enter the amount and "ECR" (Education Credit Repayment) on line 44.

Example 8

Sally paid \$2,250 tuition on December 26, 2004, for her daughter who began college on January 17, 2005. She filed her 2004 tax return on February 14, 2005, and claimed a Hope credit of \$1,500. After Sally filed her return, her daughter dropped two courses but maintained one-half of a full-time workload. Sally received a refund of \$750. She must refigure her 2004 Hope credit using \$1,500 of qualified expenses instead of \$2,250. The refigured credit is \$1,250. She must include the difference of \$250 on line 44 of her 2005 Form 1040 and annotate next to the line: \$250 ECR.

Exercise 1

Frank (SSN xxx-xx-xxxx) and Janet (SSN xxx-xx-xxxx) Averett are married and file a joint return. For 2005, their modified AGI (\$51,500) is the same as their AGI. They completed Form 1040 through line 46. Their tax amount on Line 44 is \$4,059. Janet is attending the local community college part-time to earn credits toward an associate degree in nursing. She paid \$3,000 in tuition and fees. Their daughter, Nicole (SSN xxx-xx-xxxx), is a full-time freshman at the state university. Frank and Janet paid \$8,800 in tuition and fees for Nicole in 2005. They choose to take the lifetime learning credit for Janet and the Hope credit for Nicole. They will claim no other credits. Complete their Form 8863 at Exhibit 4.

TaxWise HINTS

To input qualified tuition expenses and prepare a Form 8863 using TaxWise, link from Form 1040, line 50, to select Form 8863, enter the student's name in either the Hope credit section or the lifetime learning credit section and complete all the entries annotated in red. TaxWise will automatically complete the form and carry the mathematical calculations to the Form 1040.

▶▶ SUMMING UP THIS LESSON ◀◀

The Hope and lifetime learning credits are nonrefundable credits that allow a taxpayer to claim all or a portion of qualified tuition and related expenses paid for postsecondary education.

Generally, taxpayers can claim the Hope or lifetime learning credit if they pay qualified tuition and related expenses to an eligible higher education institution for an eligible student who is either the taxpayer, the taxpayer's spouse, or a dependent whom the taxpayer can claim an exemption on his or her tax return.

A taxpayer cannot:

- ▶ Deduct higher education expenses on his or her tax return and also claim a Hope or lifetime learning credit based on those same expenses,
- ▶ Claim a Hope credit and a lifetime learning credit based on the same qualified education expenses, or
- ▶ Claim a credit based on expenses paid with tax-free scholarship, grant, or employer-provided educational assistance.

The Hope and lifetime learning credits are claimed on Form 8863 which can be filed with either Form 1040 or Form 1040A.

Form 8863 Department of the Treasury Internal Revenue Service (99)	Education Credits (Hope and Lifetime Learning Credits) ▶ See instructions. ▶ Attach to Form 1040 or Form 1040A.	OMB No. 1545-1618 2005 Attachment Sequence No. 50				
Name(s) shown on return		Your social security number				
Caution: You cannot take both an education credit and the tuition and fees deduction (Form 1040, line 34, or Form 1040A, line 19) for the same student in the same year.						
Part I Hope Credit. Caution: You cannot take the Hope credit for more than 2 tax years for the same student .						
1	(a) Student's name (as shown on page 1 of your tax return) First name _____ Last name _____	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions). Do not enter more than \$2,000 for each student.	(d) Enter the smaller of the amount in column (c) or \$1,000	(e) Add column (c) and column (d)	(f) Enter one-half of the amount in column (e)
2	Tentative Hope credit. Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III ▶					2
Part II Lifetime Learning Credit						
3	Caution: You cannot take the Hope credit and the lifetime learning credit for the same student in the same year.		(a) Student's name (as shown on page 1 of your tax return) First name _____ Last name _____		(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions)
4	Add the amounts on line 3, column (c), and enter the total					4
5	Enter the smaller of line 4 or \$10,000					5
6	Tentative lifetime learning credit. Multiply line 5 by 20% (.20) and go to Part III . . . ▶					6
Part III Allowable Education Credits						
7	Tentative education credits. Add lines 2 and 6					7
8	Enter: \$107,000 if married filing jointly; \$53,000 if single, head of household, or qualifying widow(er)					8
9	Enter the amount from Form 1040, line 38*, or Form 1040A, line 22					9
10	Subtract line 9 from line 8. If zero or less, stop ; you cannot take any education credits					10
11	Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)					11
12	If line 10 is equal to or more than line 11, enter the amount from line 7 on line 13 and go to line 14. If line 10 is less than line 11, divide line 10 by line 11. Enter the result as a decimal (rounded to at least three places)					12 × .
13	Multiply line 7 by line 12 ▶					13
14	Enter the amount from Form 1040, line 46, or Form 1040A, line 28					14
15	Enter the total, if any, of your credits from Form 1040, lines 47 through 49, or Form 1040A, lines 29 and 30					15
16	Subtract line 15 from line 14. If zero or less, stop ; you cannot take any education credits ▶					16
17	Education credits. Enter the smaller of line 13 or line 16 here and on Form 1040, line 50, or Form 1040A, line 31 ▶					17
* If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see Pub. 970 for the amount to enter.						
For Paperwork Reduction Act Notice, see page 3.			Cat. No. 25379M		Form 8863 (2005)	

Exercise 1

Frank and Janet's Form 8863

Form 8863 Department of the Treasury Internal Revenue Service (99)	Education Credits (Hope and Lifetime Learning Credits) ▶ See instructions. ▶ Attach to Form 1040 or Form 1040A.	OMB No. 1545-1618 2005 Attachment Sequence No. 50			
Name(s) shown on return Frank & Janet Averett		Your social security number XXX XX XXXX			
Caution: You cannot take both an education credit and the tuition and fees deduction (Form 1040, line 34, or Form 1040A, line 19) for the same student in the same year.					
Part I Hope Credit. Caution: You cannot take the Hope credit for more than 2 tax years for the same student .					
1 (a) Student's name (as shown on page 1 of your tax return) First name Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions). Do not enter more than \$2,000 for each student.	(d) Enter the smaller of the amount in column (c) or \$1,000	(e) Add column (c) and column (d)	(f) Enter one-half of the amount in column (e)
Nicole Averett	XXX XX XXXX	2,000	1,000	3,000	1,500
2 Tentative Hope credit. Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III ▶					2 1,500
Part II Lifetime Learning Credit					
3 Caution: You cannot take the Hope credit and the lifetime learning credit for the same student in the same year.	(a) Student's name (as shown on page 1 of your tax return) First name Last name Janet Averett	(b) Student's social security number (as shown on page 1 of your tax return) XXX XX XXXX	(c) Qualified expenses (see instructions) 3,000		
4 Add the amounts on line 3, column (c), and enter the total					4 3,000
5 Enter the smaller of line 4 or \$10,000					5 3,000
6 Tentative lifetime learning credit. Multiply line 5 by 20% (.20) and go to Part III . . . ▶					6 600
Part III Allowable Education Credits					
7 Tentative education credits. Add lines 2 and 6					7 2,100
8 Enter: \$107,000 if married filing jointly; \$53,000 if single, head of household, or qualifying widow(er)					8 107,000
9 Enter the amount from Form 1040, line 38*, or Form 1040A, line 22					9 51,500
10 Subtract line 9 from line 8. If zero or less, stop ; you cannot take any education credits					10 55,500
11 Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)					11 20,000
12 If line 10 is equal to or more than line 11, enter the amount from line 7 on line 13 and go to line 14. If line 10 is less than line 11, divide line 10 by line 11. Enter the result as a decimal (rounded to at least three places)					12 × .
13 Multiply line 7 by line 12 ▶					13 2,100
14 Enter the amount from Form 1040, line 46, or Form 1040A, line 28					14 4,059
15 Enter the total, if any, of your credits from Form 1040, lines 47 through 49, or Form 1040A, lines 29 and 30					15 0
16 Subtract line 15 from line 14. If zero or less, stop ; you cannot take any education credits ▶					16 4,059
17 Education credits. Enter the smaller of line 13 or line 16 here and on Form 1040, line 50, or Form 1040A, line 31 ▶					17 2,100
* If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see Pub. 970 for the amount to enter.					

INTRODUCTION AND OBJECTIVES

In this lesson you will learn about four “miscellaneous credits”. The credit for the elderly or the disabled, the mortgage interest credit, the foreign tax credit and the credit for qualified retirement savings are covered in this lesson.

After completing this lesson you should be able to:

- Determine who is a qualified individual for the credit for the elderly or disabled and apply the income limits.
- Calculate the credit for the elderly or the disabled.
- Calculate the credit for qualified retirement savings contributions by using Form 8880.
- Accurately report the foreign tax credit if Form 1116 is not required.
- Be aware of the mortgage interest credit.

CREDITS

A credit is a dollar-for-dollar reduction of the taxpayer’s tax liability. A **refundable** credit can be greater than the tax. Taxpayers not only can have their tax reduced to zero; they can also receive a “refund” of excess credit. A **nonrefundable credit** can also be greater than the tax, but the nonrefundable credit can only reduce the tax to zero. Therefore, taxpayers will not receive a refund for any excess nonrefundable credit. All of the credits discussed in this lesson are nonrefundable credits.

ALERT



This lesson contains basic tax law and is required training for all volunteers.

CREDIT FOR THE ELDERLY OR THE DISABLED

Elderly individuals and individuals who are permanently and totally disabled may be able to claim a special credit on their tax returns if they are a U.S. citizen or resident.

To be eligible for the credit, an individual must be:

- At least 65 years old by the end of the year, or
- Under age 65, retired on permanent and total disability by the end of the year and did not reach mandatory retirement age before this year. They must also have received taxable disability income for this year.

Although physician statements are no longer required to be attached to the return, they must be completed and kept with the taxpayer's records.

Certain work offered at qualified locations to persons with disabilities or with mental retardation is considered sheltered employment. Because a person has accepted sheltered employment is not proof of the person's ability to engage in substantial gainful activity.

Exhibit 1 helps to determine if the taxpayer is a qualified individual for this credit.

Income Limits

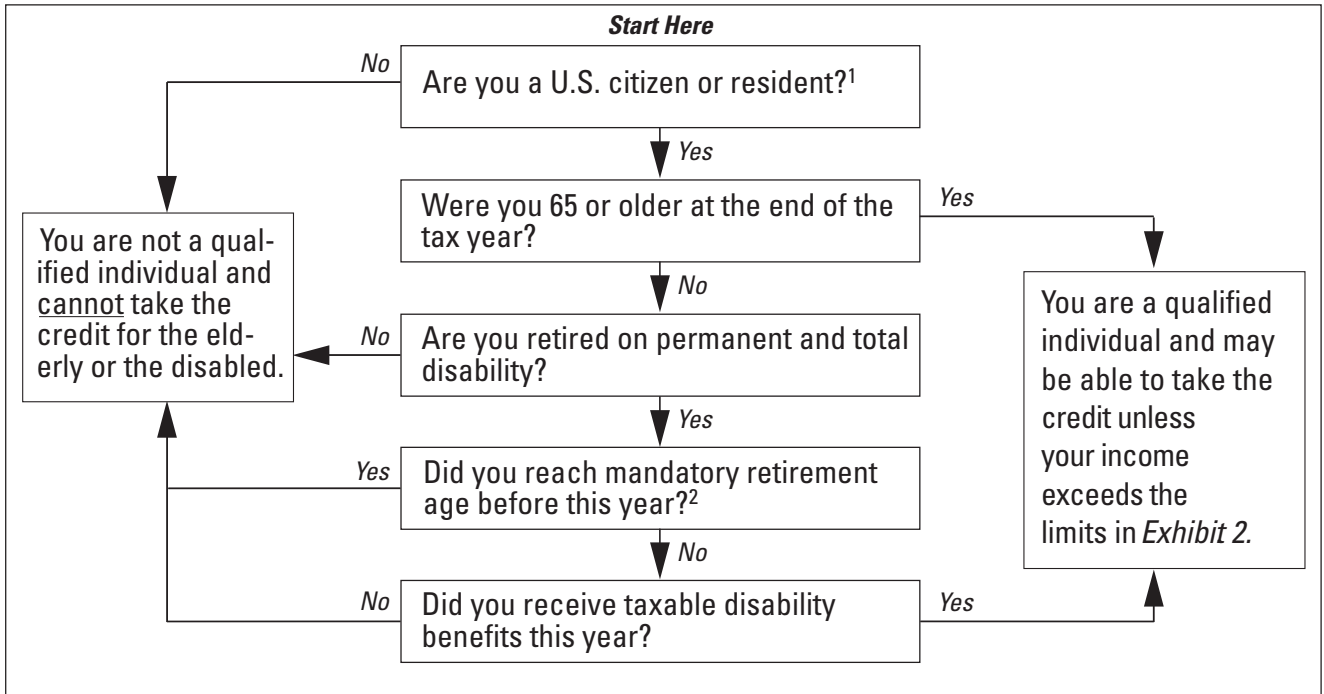
Taxpayers cannot exceed the income limits for their filing status (see **Exhibit 2**).

CALCULATE THE CREDIT

If the taxpayer is a qualified individual and meets the income limits, complete a Schedule 3 for 1040A filers or a Schedule R for 1040 filers. Schedule R (Form 1040) and Schedule 3 (Form 1040A) are nearly identical.

Example 1

John (000-00-9850) and Sarah Hillsdale are married and file a joint return. Their respective ages are 66 and 68. They received nontaxable social security benefits of \$4,500 in 2005. They had adjusted gross income (line 37, Form 1040) of \$13,000. Parts I and III of the Schedule R will be completed and the schedule attached to their Form 1040 for 2005. (Part II need not be completed since both are age 65 or older.) See Exhibits 3 and 4.



¹ If you were a nonresident alien at any time during the tax year and were married to a U.S. citizen or resident at the end of the tax year, see U.S. citizen or resident under *Qualified individual*. If you and your spouse both choose to be treated as U.S. residents, answer yes to this question.

² Mandatory retirement age is the age set by your employer at which you would have been required to retire, had you not become disabled.

Exhibit 2

Income Limits

Even if you qualify, you CANNOT take the credit if:		
Your filing status is	AND your adjusted gross income (AGI) is equal to or more than	OR your nontaxable social security or other nontaxable pension(s) is equal to or more than
Single, Head of household, or Qualifying widow(er) with dependent child	\$17,500	\$5,000
Married filing a joint return and both spouses qualify in <i>Exhibit 1</i>	\$25,000	\$7,500
Married filing a joint return and only one spouse qualifies in <i>Exhibit 1</i>	\$20,000	\$5,000
Married filing a separate return and you did not live with your spouse at any time during the year	\$12,500	\$3,750

Part III Figure Your Credit

10 If you checked (in Part I):		Enter:			
Box 1, 2, 4, or 7	.....	\$5,000	}	10	7,500
Box 3, 5, or 6	.....	\$7,500			
Box 8 or 9	.....	\$3,750			
Did you check box 2, 4, 5, 6, or 9 in Part I?		Yes →	You must complete line 11.		
		No →	Enter the amount from line 10 on line 12 and go to line 13.		
11 If you checked (in Part I):				11	
<ul style="list-style-type: none"> • Box 6, add \$5,000 to the taxable disability income of the spouse who was under age 65. Enter the total. • Box 2, 4, or 9, enter your taxable disability income. • Box 5, add your taxable disability income to your spouse's taxable disability income. Enter the total. 					
TIP For more details on what to include on line 11, see page R-3.					
12 If you completed line 11, enter the smaller of line 10 or line 11; all others , enter the amount from line 10				12	7,500
13 Enter the following pensions, annuities, or disability income that you (and your spouse if filing a joint return) received in 2005.					
a Nontaxable part of social security benefits and Nontaxable part of railroad retirement benefits treated as social security (see page R-3).	.....	13a	4,500		
b Nontaxable veterans' pensions and Any other pension, annuity, or disability benefit that is excluded from income under any other provision of law (see page R-3).	.....	13b			
c Add lines 13a and 13b. (Even though these income items are not taxable, they must be included here to figure your credit.) If you did not receive any of the types of nontaxable income listed on line 13a or 13b, enter -0- on line 13c	.....	13c	4,500		
14 Enter the amount from Form 1040, line 38	.....	14	13,000		
15 If you checked (in Part I):		Enter:			
Box 1 or 2	.....	\$7,500	}	15	10,000
Box 3, 4, 5, 6, or 7	.....	\$10,000			
Box 8 or 9	.....	\$5,000			
16 Subtract line 15 from line 14. If zero or less, enter -0-	.....	16	3,000		
17 Enter one-half of line 16	.....	17	1,500		
18 Add lines 13c and 17	.....	18			6,000
19 Subtract line 18 from line 12. If zero or less, stop ; you cannot take the credit. Otherwise, go to line 20	.....	19			1,500
20 Multiply line 19 by 15% (.15)	.....	20			225
21 Enter the amount from Form 1040, line 46	.....	21	0		
22 Add the amounts from Form 1040, lines 47 and 48, and enter the total	.....	22	0		
23 Subtract line 22 from line 21	.....	23			0
24 Credit for the elderly or the disabled. Enter the smaller of line 20 or line 23 here and on Form 1040, line 49	.....	24			0

The credit for the elderly will be calculated automatically by the tax software. The software will check age, income, and filing status to determine eligibility. However, it is extremely important to input Social Security Benefit income even if you know it is not taxable. Without this information the software may incorrectly calculate the credit.

CREDIT FOR QUALIFIED RETIREMENT SAVINGS CONTRIBUTIONS

If the taxpayer contributed to a retirement plan or an IRA, he or she may be eligible for the credit for qualified retirement savings contributions credit. The amount of the saver's credit is determined by the taxpayer's filing status, adjusted gross income, and his or her qualified contributions.

The credit is reported on line 51 of Form 1040, or line 32 of Form 1040A.

To be eligible for the saver's credit, the taxpayer:

- Must be age 18 or older by the end of the tax year,
- Cannot be claimed on another person's tax return, and
- Cannot be a full-time student.

A **full-time student** is anyone who attends school full-time for some part of each of five calendar months of the year. The five months need not be consecutive. An individual is a full-time student if he or she is enrolled for the number of hours or courses the school considers as full-time attendance.

If using TaxWise® software, the credit for qualified retirement savings contributions will be calculated automatically for contributions reported on a Form W-2. The software picks up the information from the codes and dollar amounts entered on the Form W-2. If manually preparing a return, be sure to carefully review the Form W-2 for these contributions.

FIGURING THE CREDIT

The credit for qualified retirement savings contributions is figured by multiplying the **credit rate** by the lesser of the:

- Maximum allowable contribution (\$2,000) or
- Eligible contributions.

The credit rate is determined by using the following table.

IF your filing status is...	AND your adjusted gross income is...	THEN your credit rate is...
Married filing jointly	Less than \$30,001	50%
	Between \$30,001 and \$32,500	20%
	Between \$32,501 and \$50,000	10%
	Over \$50,000	0
Head of Household	Less than \$22,501	50%
	Between \$22,501 and \$24,375	20%
	Between \$24,376 and \$37,500	10%
	Over \$37,500	0
Single, Married filing separately, or qualifying widow(er)	Less than \$15,001	50%
	Between \$15,001 and \$16,250	20%
	Between \$16,251 and \$25,000	10%
	Over \$25,000	0

Adjusted gross income is determined without regard to:

- The foreign income exclusion
- The foreign housing exclusion or deduction
- Income from sources within Guam, American Samoa, and the Northern Mariana Islands
- Income from Puerto Rico

Eligible contributions are determined by reducing the taxpayer's **qualified retirement savings contributions** by the following distributions that were received during the **testing period**.

- Any distribution that is included in the taxpayer's gross income from a qualified retirement plan or from an eligible deferred compensation plan.
- Any distribution from a Roth IRA that is not a qualified rollover contribution.

If the distributions received by the taxpayer are for loans or for excess IRA contributions returned before the due date of the return, they are not used to reduce the taxpayer's qualified retirement savings contributions.

Qualified retirement savings contributions are contributions made to a traditional or Roth IRA and salary reduction contributions to a 401(k) plan (including a SIMPLE 401(k)), a tax-sheltered annuity (403(b)) plan, an eligible deferred compensation plan of a state or local government (457(b)) plan), a SIMPLE IRA plan, or a salary reduction SEP.

Qualified retirement savings contributions also include voluntary after-tax employee contributions to a tax-qualified retirement plan or a tax-sheltered annuity (403(b)) plan. For purposes of the credit, an employee contribution will be voluntary as long as it is not required as a condition of employment.

The **testing period** includes:

- The tax year,
- The two preceding tax years, and
- The period between the end of the tax year and the due date of the return (including extensions).

Example 1

Terry contributes \$3,000 to a 401(k) plan during 2005. In 2004, Terry withdrew \$500 from his IRA. In 2005, he withdrew \$900 from his IRA. Neither of these withdrawals were rolled over. In 2005, Terry's adjusted gross income was \$23,000 and his filing status was head of household. Based on these facts, Terry would figure his saver's credit as follows:

(Qualified retirement contributions – withdrawals) x credit rate
(per table)

$$(\$3,000 - \$1,400) \times .20$$

$$\$1,600 \times .20 = \$320 \text{ saver's credit}$$

The credit is figured on **Form 8880**, *Credit for Qualified Retirement Savings Contributions*.

Married filing jointly. If the taxpayer is married filing a joint return, he or she and his or her spouse may both use the credit. Both the taxpayer and spouse are eligible for a credit of the maximum annual contribution amount of \$2,000.

If the taxpayers file a joint return, the qualified contribution is reduced by the taxable distributions received by the taxpayer or the taxpayer's spouse if the taxpayers filed jointly for both:

- the year a distribution was made, and
- the year the credit is claimed.

Exercise 1

Jason is 22 and earned \$30,000 in 2005. He is single and contributed \$3,000 to his 401(k) plan at work. Is Jason eligible for the credit for qualified retirement savings contributions?

Exercise 2

Martha Barnard (000-00-0088) is 32 and files as Head of Household. Her only income is wages of \$26,819. This year, she was able to contribute \$1,000 to her employer's 401(k) plan. She did not put any money in an IRA. Use Exhibit 5 to complete Martha's Form 8880 through line 10.

Form **8880**
Department of the Treasury
Internal Revenue Service

Credit for Qualified Retirement Savings Contributions

▶ Attach to Form 1040 or Form 1040A.
▶ See instructions on back.

OMB No. 1545-1805
2005
Attachment
Sequence No. 129

Name(s) shown on return

Your social security number



You **cannot** take this credit if **either** of the following applies.

- The amount on Form 1040, line 38, or Form 1040A, line 22, is more than \$25,000 (\$37,500 if head of household; \$50,000 if married filing jointly).
- The person(s) who made the qualified contribution or elective deferral **(a)** was born after January 1, 1988, **(b)** is claimed as a dependent on someone else's 2005 tax return, or **(c)** was a **student** (see instructions).

	(a) You	(b) Your spouse
1 Traditional and Roth IRA contributions for 2005. Do not include rollover contributions	1	
2 Elective deferrals to a 401(k) or other qualified employer plan, voluntary employee contributions, and 501(c)(18)(D) plan contributions for 2005 (see instructions)	2	
3 Add lines 1 and 2	3	
4 Certain distributions received after 2002 and before the due date (including extensions) of your 2005 tax return (see instructions). If married filing jointly, include both spouses' amounts in both columns. See instructions for an exception	4	
5 Subtract line 4 from line 3. If zero or less, enter -0-	5	
6 In each column, enter the smaller of line 5 or \$2,000	6	
7 Add the amounts on line 6. If zero, stop ; you cannot take this credit		7
8 Enter the amount from Form 1040, line 38*, or Form 1040A, line 22	8	
9 Enter the applicable decimal amount shown below:		

If line 8 is—		And your filing status is—		
Over—	But not over—	Married filing jointly	Head of household	Single, Married filing separately, or Qualifying widow(er)
Enter on line 9—				
---	\$15,000	.5	.5	.5
\$15,000	\$16,250	.5	.5	.2
\$16,250	\$22,500	.5	.5	.1
\$22,500	\$24,375	.5	.2	.1
\$24,375	\$25,000	.5	.1	.1
\$25,000	\$30,000	.5	.1	.0
\$30,000	\$32,500	.2	.1	.0
\$32,500	\$37,500	.1	.1	.0
\$37,500	\$50,000	.1	.0	.0
\$50,000	---	.0	.0	.0

Note: If line 9 is zero, **stop**; you cannot take this credit.

10 Multiply line 7 by line 9	10	
11 Enter the amount from Form 1040, line 46, or Form 1040A, line 28	11	
12 Enter the total of your credits from Form 1040, lines 47 through 50, or Form 1040A, lines 29 through 31	12	
13 Subtract line 12 from line 11. If zero, stop ; you cannot take this credit	13	
14 Credit for qualified retirement savings contributions. Enter the smaller of line 10 or line 13 here and on Form 1040, line 51, or Form 1040A, line 32	14	

*See Pub. 590 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 33394D

Form **8880** (2005)

MORTGAGE INTEREST CREDIT

Taxpayers who hold qualified mortgage credit certificates under a qualified state or local government program may claim a credit for mortgage interest paid. The certificate must be for the taxpayer's main home. If the interest is paid to certain related parties (such as relatives), the credit cannot be claimed.

The credit is figured on Form 8396, *Mortgage Interest Credit*. Include the amount of the credit on Form 1040, Line 54. Also, check box a on Line 54 for Form 8396.

Any mortgage interest credit that the taxpayer cannot use in 2005 can be carried forward for up to three tax years. Figure the carry-forward credit in Part II of Form 8396.

Reduce the mortgage interest deduction claimed on Schedule A, Form 1040, by the amount shown on Line 3 of Form 8396.

Caution: If the taxpayer was issued (and used) a qualified mortgage credit certificate after 1990 for a home, the taxpayer may have to recapture (repay) all or part of the benefit if the taxpayer sells that home within 9 years. The recapture is figured on Form 8828, *Recapture of Federal Mortgage Subsidy*.

FOREIGN TAX CREDIT

If the taxpayer paid income, war profits, or excess profits taxes to any:

- Foreign country,
- U.S. possession, or
- Any political subdivision, or agency or instrumentality of the country or possession, he or she may be able to take a **Foreign Tax Credit** (FTC) for taxes paid.

To determine if the tax paid is eligible for the foreign tax credit, the taxpayer **may** need to consult a paid tax preparer.

Generally, to claim the FTC, a taxpayer is required to file Form 1116, *Foreign Tax Credit (Individual, Estate, Trust, or Nonresident Alien Individual)*; however, the taxpayer does not have to file Form 1116 to take the credit if he or she meets all of the following requirements.

- All of the taxpayer's gross foreign source income is from interest and dividends that are reported on Form 1099-INT, or Form 1099-DIV (or substitute statement)
- If the taxpayer has dividend income from shares of stock, he or she held those shares for at least 16 days.
- The taxpayer is not filing Form 4563, *Exclusion of Income for Bona Fide Residents of American Samoa*, or excluding income from sources within Puerto Rico.
- The total of the taxpayer's foreign taxes is less than or equal to \$300 (\$600 if married filing jointly).

- All of the taxpayer's foreign taxes were:
 - Legally owed and not eligible for a refund, and
 - Paid to countries that are recognized by the United States and do not support terrorism.

For additional information, *see the Instructions for Form 1116*.

If the taxpayer meets all of the requirements listed above, enter the foreign tax credit on line 47 of Form 1040. Form 1116 is not required.

Example 2

Tabitha received a 1099-DIV that shows \$219 of foreign taxes (box 6) in 2005. According to Tabitha she paid no other foreign taxes. She can claim the \$219 on line 47 of Form 1040.

Exercise 3

Clyde comes to your site seeking help with his foreign tax credit. He is single and his 1099-DIVs show a total of \$423 of foreign tax. Does Clyde need Form 1116 to claim his credit?

HEALTH COVERAGE TAX CREDIT

The Health Coverage Tax Credit (HCTC) is a federal tax credit established by the Trade Act of 2002 to assist

1. Workers who lose their jobs due to the effects of international trade and/or
2. People who receive benefits from the Pension Benefit Guaranty Corporation (PBGC) and are at least 55 years old.

The HCTC is beyond the scope of the Volunteer Return Preparation Program. Taxpayers who are potentially eligible should be referred to a paid preparer or to www.irs.gov for more information.

▶▶ SUMMING UP THIS LESSON ◀◀

- ▶ Due to the income limitations, very few taxpayers are eligible to receive the credit for the elderly or disabled.
- ▶ The credit for the elderly or the disabled is based on filing status, age, and income.
- ▶ The credit is calculated and reported on Form 1040, Schedule R, or Form 1040A, Schedule 3.
- ▶ If the taxpayer contributed to a retirement plan or an IRA, he or she may be eligible for the Qualified Retirement Savings Contribution Credit.

Exercise 1

No; Jason is not eligible for the credit because his income exceeds the threshold limit.

Exercise 2

See the completed Form 8880 on the next page.

Exercise 3

Yes, Clyde needs to complete a Form 1116 since his foreign taxes exceed \$300. Clyde will need to seek the assistance of a paid professional preparer.

Answer to Exercise 2

Form **8880**

Credit for Qualified Retirement Savings Contributions

OMB No. 1545-1805

2005

Attachment Sequence No. **129**

Department of the Treasury
Internal Revenue Service

▶ Attach to Form 1040 or Form 1040A.

▶ See instructions on back.

Name(s) shown on return

Martha Barnard

Your social security number

000:00:0088



You **cannot** take this credit if **either** of the following applies.

- The amount on Form 1040, line 38, or Form 1040A, line 22, is more than \$25,000 (\$37,500 if head of household; \$50,000 if married filing jointly).
- The person(s) who made the qualified contribution or elective deferral **(a)** was born after January 1, 1988, **(b)** is claimed as a dependent on someone else's 2005 tax return, or **(c)** was a **student** (see instructions).

	(a) You	(b) Your spouse																																																																	
1 Traditional and Roth IRA contributions for 2005. Do not include rollover contributions	1																																																																		
2 Elective deferrals to a 401(k) or other qualified employer plan, voluntary employee contributions, and 501(c)(18)(D) plan contributions for 2005 (see instructions)	2 1,000																																																																		
3 Add lines 1 and 2	3 1,000																																																																		
4 Certain distributions received after 2002 and before the due date (including extensions) of your 2005 tax return (see instructions). If married filing jointly, include both spouses' amounts in both columns. See instructions for an exception	4																																																																		
5 Subtract line 4 from line 3. If zero or less, enter -0-	5 1,000																																																																		
6 In each column, enter the smaller of line 5 or \$2,000	6 1,000																																																																		
7 Add the amounts on line 6. If zero, stop ; you cannot take this credit	7	1,000																																																																	
8 Enter the amount from Form 1040, line 38*, or Form 1040A, line 22	8 26,819																																																																		
9 Enter the applicable decimal amount shown below:																																																																			
<table border="1"> <thead> <tr> <th colspan="2">If line 8 is—</th> <th colspan="3">And your filing status is—</th> </tr> <tr> <th>Over—</th> <th>But not over—</th> <th>Married filing jointly</th> <th>Head of household</th> <th>Single, Married filing separately, or Qualifying widow(er)</th> </tr> <tr> <th colspan="5">Enter on line 9—</th> </tr> </thead> <tbody> <tr> <td>---</td> <td>\$15,000</td> <td>.5</td> <td>.5</td> <td>.5</td> </tr> <tr> <td>\$15,000</td> <td>\$16,250</td> <td>.5</td> <td>.5</td> <td>.2</td> </tr> <tr> <td>\$16,250</td> <td>\$22,500</td> <td>.5</td> <td>.5</td> <td>.1</td> </tr> <tr> <td>\$22,500</td> <td>\$24,375</td> <td>.5</td> <td>.2</td> <td>.1</td> </tr> <tr> <td>\$24,375</td> <td>\$25,000</td> <td>.5</td> <td>.1</td> <td>.1</td> </tr> <tr> <td>\$25,000</td> <td>\$30,000</td> <td>.5</td> <td>.1</td> <td>.0</td> </tr> <tr> <td>\$30,000</td> <td>\$32,500</td> <td>.2</td> <td>.1</td> <td>.0</td> </tr> <tr> <td>\$32,500</td> <td>\$37,500</td> <td>.1</td> <td>.1</td> <td>.0</td> </tr> <tr> <td>\$37,500</td> <td>\$50,000</td> <td>.1</td> <td>.0</td> <td>.0</td> </tr> <tr> <td>\$50,000</td> <td>---</td> <td>.0</td> <td>.0</td> <td>.0</td> </tr> </tbody> </table>			If line 8 is—		And your filing status is—			Over—	But not over—	Married filing jointly	Head of household	Single, Married filing separately, or Qualifying widow(er)	Enter on line 9—					---	\$15,000	.5	.5	.5	\$15,000	\$16,250	.5	.5	.2	\$16,250	\$22,500	.5	.5	.1	\$22,500	\$24,375	.5	.2	.1	\$24,375	\$25,000	.5	.1	.1	\$25,000	\$30,000	.5	.1	.0	\$30,000	\$32,500	.2	.1	.0	\$32,500	\$37,500	.1	.1	.0	\$37,500	\$50,000	.1	.0	.0	\$50,000	---	.0	.0	.0
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For Paperwork Reduction Act Notice, see back of form.

Cat. No. 33394D

Form **8880** (2005)



Military/International students continue.

Basic Course students go to lesson 14, others go to Lesson 10.

STUDENT NOTES

INTRODUCTION AND OBJECTIVES

This lesson will discuss how to compute the foreign tax credit in situations where a U.S. citizen could pay taxes twice on the same income—once to the government of the foreign country where the income was sourced and once to the U.S. Government. This segment will address the foreign tax credit only as it applies to U.S. citizens and residents.

In the International segment of the income lesson, the topic of worldwide income was discussed. U.S. citizens and residents compute their U.S. taxes based on their worldwide income. This sometimes leads to a situation when a U.S. citizen may be paying tax twice on the same income. In order to avoid double taxation, a foreign tax credit was created. This allows an individual to take a tax credit for those taxes paid to a foreign government on income from sources in a foreign country.

Like other tax credits, the foreign tax credit is a dollar-for-dollar reduction in the amount of tax. However, in some cases, not all taxes paid to a foreign government can be used in the computation of the foreign tax credit.

After completing this lesson, you should be able to supplement the information you learned in the basic text and:

- Determine which taxes are eligible for the foreign tax credit.
- Apply the criteria for claiming the foreign tax credit
- Accurately compute the foreign tax credit using Form 1116 or tax preparation software
- Assist taxpayer in compiling the documents necessary for a paid professional to complete the return.

WHAT TAXES QUALIFY FOR THE CREDIT

There are several factors to consider when determining if a tax paid to a foreign government is eligible for the foreign tax credit. They include:

1. Was the income foreign source?
2. What type of tax was paid to the foreign government?
3. Will the taxpayer receive some kind of specific economic benefit from the payment of this tax?

In this part of the lesson, we'll study the criteria for claiming the foreign tax credit.

The taxpayer must have income from a foreign country on which he/she is taxed by a foreign country. The tax imposed on the income must be similar to the income tax imposed in the U.S. This simply means that the income must be from a country other than the U.S. and that the tax paid must be similar to U.S. income tax. Let's look at some examples.

Example 1

Robb and Betty Grant are U.S. citizens who reside in France. The schedule B on their U.S. tax return contains the following:

\$500, Lee County National Bank (U.S.)

\$600, Banque National de Paris (French)

They paid income taxes on both types of interest to both countries. On their U.S. tax return, they can compute a foreign tax credit against the taxes that they pay to the U.S. on the interest received from the French bank. They would need to check with the French taxing authorities to determine if they can claim a similar tax credit on their French tax return for the interest income from the U.S. bank.

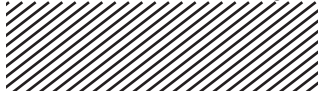
Example 2

Marie Elliott is a U.S. citizen who lives in Hong Kong. She owns a house in Hong Kong and paid \$2,000 in real estate taxes for her home and \$1,000 in personal property taxes. She also paid \$300 in income taxes to the government of Hong Kong. She is not able to claim a foreign tax credit for either the real estate taxes paid or the personal property taxes paid since these two taxes are not income taxes. She can, however, use the \$300 in income taxes paid to Hong Kong to compute a foreign tax credit. (Note—she can take the real estate taxes that she paid and deduct them as itemized deductions if she itemizes on her U.S. tax return. Foreign personal property taxes are only deductible if they relate to the production of income or a trade/business.)

Exercise 1

The following is a list of the income on Anne's U.S. income tax return. She is a U.S. citizen living in Canada. She also had to pay taxes on each of these types of income to Canada. Indicate on which of the following a foreign tax credit may be computed.

- _____ a. Wages from her job in the U.S.
- _____ b. Interest income from a U.S. bank.
- _____ c. Interest income from a Canadian bank.
- _____ d. Dividend income from a U.S. corporation.
- _____ e. Dividend income from a Canadian corporation.



Exercise 2

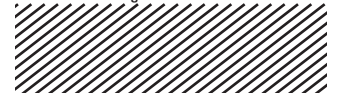
Determine if the following taxes paid to a foreign government can be used to compute the foreign tax credit. All taxpayers are U.S. citizens.

- a. Martha pays \$1,200 a year in taxes. This tax is based on the number and types of appliances which she owns and uses in her home.
- b. Jean pays an inheritance tax to the Spanish government. It is based on an inheritance she received upon the death of an uncle.
- c. Dorothy lives in Jamaica. She paid \$1,500 to the Jamaican government for her salaried income which she earned in Jamaica.
- d. Henry lives in Haiti. He paid \$100 in taxes to the Haitian government. This tax was based on his type of living accommodations, the location of his residence and the size of this family.

In addition to the requirements that the tax be paid to the foreign country on income derived from a foreign country and the tax be an income tax similar to the income tax as defined under U.S. law, the tax must also not be payment for a specific economic benefit. Simply put, the “tax” cannot actually be a “payment” that results in an individual receiving goods, services or the right to use certain properties which are not available to others who are subject to the income tax that is generally imposed by the foreign country. A taxpayer cannot receive any specific benefit, directly or indirectly from paying a tax.

Example 3

Bob lives in Country X. He owns and operates his own business in this country. This country has a two tier income tax system. Everyone pays income tax at graduated rates depending upon their income. Bob also pays income tax based upon the profits of his business. This second level of income tax gives Bob the right to reduced fees for telephones, utilities and rents for his business. The government of Country X calls it an income tax because it is based upon the profits of the business. If Bob did not pay this tax, he could not rent a government-owned building and he would pay significantly more for the utilities and his business telephone usage. Since Bob receives a specific economic benefit for the second tier of income tax that he pays, he cannot use those tax payments to compute a foreign tax credit on his U.S. tax return. However, the first tier of income taxes are similar to U.S. income taxes and can be used to figure his foreign tax credit.



Country Restrictions. Aside from the restrictions that we have already discussed, there are also certain countries to which a taxpayer may pay foreign income taxes but cannot claim a foreign tax credit. Generally the reason a credit may not be claimed for tax paid to one of these countries is because the Secretary of State has designated the country as one that repeatedly provides support for acts of international terrorism.

The credit can also be denied to countries with which the United States has no diplomatic relations, or countries whose government the United States does not recognize. At the time of this writing, income taxes paid to the following countries are not eligible for the foreign tax credit.

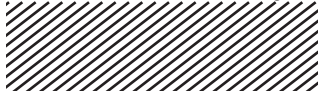
CUBA
IRAN
IRAQ
LIBYA
NORTH KOREA
SYRIA
SUDAN

Example 4

Ralph is a U.S. citizen who has investments in both Belgium and Iran. On these investments Ralph pays income tax to these two countries by withholding tax from his dividend checks. Ralph can claim the taxes paid to Belgium when computing the foreign tax credit. The income taxes paid to Iran do not qualify for a foreign tax credit.

TYPES OF INCOME

A separate Form 1116 must be completed for each different type of income. We will only be studying three income categories: passive income, high withholding tax, interest and general limitation income. Remember that you can only check one income category per form and separate Forms 1116 must be submitted for each category. Your tax preparation software will do this for you.



Form 1116 Department of the Treasury Internal Revenue Service (99)	Foreign Tax Credit (Individual, Estate, or Trust) ▶ Attach to Form 1040, 1040NR, 1041, or 990-T. ▶ See separate instructions.	OMB No. 1545-0121 <div style="font-size: 2em; font-weight: bold; margin: 5px 0;">2005</div> Attachment Sequence No. 19												
Name _____		Identifying number as shown on page 1 of your tax return _____												
Use a separate Form 1116 for each category of income listed below. See Categories of Income on page 3 of the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.														
<table style="width: 100%; border: none;"> <tr> <td style="width: 33%;"><input type="checkbox"/> a Passive income</td> <td style="width: 33%;"><input type="checkbox"/> d Shipping income</td> <td style="width: 33%;"><input type="checkbox"/> g Lump-sum distributions</td> </tr> <tr> <td><input type="checkbox"/> b High withholding tax interest</td> <td><input type="checkbox"/> e Dividends from a DISC or former DISC</td> <td><input type="checkbox"/> h Section 901(j) income</td> </tr> <tr> <td><input type="checkbox"/> c Financial services income</td> <td><input type="checkbox"/> f Certain distributions from a foreign sales corporation (FSC) or former FSC</td> <td><input type="checkbox"/> i Certain income re-sourced by treaty</td> </tr> <tr> <td></td> <td></td> <td><input type="checkbox"/> j General limitation income</td> </tr> </table>			<input type="checkbox"/> a Passive income	<input type="checkbox"/> d Shipping income	<input type="checkbox"/> g Lump-sum distributions	<input type="checkbox"/> b High withholding tax interest	<input type="checkbox"/> e Dividends from a DISC or former DISC	<input type="checkbox"/> h Section 901(j) income	<input type="checkbox"/> c Financial services income	<input type="checkbox"/> f Certain distributions from a foreign sales corporation (FSC) or former FSC	<input type="checkbox"/> i Certain income re-sourced by treaty			<input type="checkbox"/> j General limitation income
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		<input type="checkbox"/> j General limitation income												

Passive Income. Passive income generally includes the following types of income: dividends, interest, royalties, rents and annuities. If you are assisting a person who has one of these types of passive income from a foreign country, and he or she paid income taxes to a foreign country, you can use your tax software to compute a foreign tax credit.

Example 5

Darlene is a U.S. citizen living in Venezuela. She keeps a bank account in the Banco Nacional de Venezuela. In 2005, she received \$380 in interest income from the Venezuelan bank. She also paid Venezuelan income taxes on this interest income. On her U.S. return, she would claim a foreign tax credit for the taxes paid to Venezuela on her interest income. She would check the box for the “Passive income” category on Form 1116.

High Withholding Tax Interest. Certain interest income is not included in the passive income category. If the taxpayer you are helping had interest income on which at least 5% foreign gross income tax was withheld, then this income is classified as high withholding tax interest and not passive income.

Example 6

Michael is a U.S. citizen who lives in the United Kingdom. He maintains a bank account in a London bank. According to local law, the bank withholds a mandatory 27.5% of interest income as income tax. Since the withholding rate is at least 5%, the high withholding tax interest category would be checked on his Form 1116.

Example 7

Regina lives in Singapore and is a U.S. citizen. She has both dividend income and interest income from countries outside the United States. Her foreign bank withholds 15% of her interest income for income taxes. She also pays foreign income taxes on her dividend income. Regina must complete two Forms 1116. Her foreign dividend income is “passive income” and indicated as such on one Form 1116. Her foreign interest income is in the “high withholding

tax interest” category and is on another Form 1116. The credits on these separate Forms 1116 will eventually be combined. This will be studied later in this lesson.

General Limitation Income. The final income category on Form 1116 is the “general limitation income” category. If the person you are helping has foreign income that does not come under any of the other categories on Form 1116, then that foreign income comes under the general limitation income category. Most often, this would be wages earned in a foreign country that an individual does not exclude, or excludes only part of, under the foreign earned income exclusion.

Example 8

Siegfried lives in Switzerland and is a U.S. citizen. He works in Switzerland and pays income taxes to Switzerland on his earnings. He does not elect to claim a foreign earned income exclusion. He can claim a foreign tax credit for the taxes paid on his earnings to the Swiss government. He checks the box for the general limitation income category on his Form 1116.

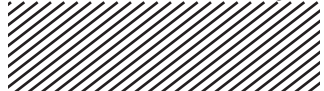
High Taxed Income. If the individual you are assisting has passive income which is taxed by a foreign government at a rate that is higher than the highest U.S. income tax rate, then the foreign tax credit for that income would be computed under the general limitation category. (Passive income was discussed earlier in this lesson.) In 2005, the highest U.S. income tax rate is 35%. Therefore, if the person pays more than 35% on the foreign source passive income for which he or she claimed the credit, then the credit is computed under the “general limitation” category.

Example 9

Maria lives in Brazil and is a U.S. citizen. She has a bank account in Brazil and pays 45% income tax on her interest income. Even though interest income is normally passive income for purposes of the foreign tax credit, this income would be listed under the “general limitation” category on Form 1116 since the rate of income tax she pays on this passive income is higher than the highest U.S. income tax rate.

Example 10

Bernard is a resident of Barbados and a U.S. citizen. He keeps a bank account in Barbados. In 2005 he paid 17% income tax on his interest income from his bank account in Barbados. Since 17% (the tax rate he paid) is not more than 35% (the highest U.S. income tax rate) and since the 17% that Bernard paid was not paid by withholding, this income fails into the “passive income” category of Form 1116.



OTHER FOREIGN TAX CREDIT CONCEPTS

We have already discussed the income categories that are listed on separate sections of the Form 1116. In addition, the top of Form 1116 has a line to indicate the name of the country of residence of the taxpayer. This will need to be entered for tax software to correctly figure the tax credit.

Part I is used to figure the taxable income from foreign sources in each income category. If the person you are helping has one type of foreign income that comes from several foreign countries, you use one Form 1116. You will note that there is room on Form 1116 for up to 3 countries.

Example 11

George is both a U.S. citizen and resident. He has interest income from both Canada and Mexico, as well as the U.S. His software will print only one Form 1116 since all the interest income is in the passive income category.

On Line 1, list all foreign income that fits under the category checked at the top of Form 1116. You will list that income separately for each foreign country.

Example 12

George had \$300 in interest income from his Canadian bank and \$200 in interest income from his Mexican bank. See the completed Form 1116, Line 1 for his income in Exhibit 2 which follows.

Exhibit 2

Form 1116, Line 1

Part I Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)				
	Foreign Country or U.S. Possession			Total
	A	B	C	(Add cols. A, B, and C.)
I Enter the name of the foreign country or U.S. possession ▶	Mexico	Canada		
1 Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions):				
	200	300		1 500

Note: If the taxpayer you are assisting has claimed the foreign earned income exclusion, enter on Line 1 of Form 1116 for general limitation income only the amount of earned income not excluded.



Example 13

Monique lives in France and is a U.S. citizen. She earned \$84,000 in 2005 in France. Monique claimed the foreign earned income exclusion of \$80,000 (discussed in an earlier lesson). As illustrated in Exhibit 3 below, she would only enter \$4,000 on Line 1 of her Form 1116 (\$84,000 earned Income – \$80,000 exclusion).

Exhibit 3

Form 1116, Line 1

Part I Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)				
Foreign Country or U.S. Possession				Total
				(Add cols. A, B, and C.)
A	B	C		
1 Enter the name of the foreign country or U.S. possession ▶ France				
1 Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions):				
4,000			1	4,000

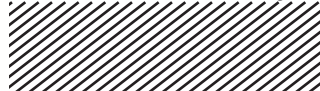
Lines 2–5 are probably the hardest and most confusing lines to complete on the Form 1116. Let's review the situations that we will not be studying.

- 1. Expenses directly allocable to the income.** If the person you are assisting has expenses that are related directly to the income claimed on Line 1 such as employee business expenses, and the income claimed on Line 1 was earned income, then you may recommend that this person seek professional assistance or contact the IRS.
- 2. Investment Interest Expense.** If a person borrowed money in order to purchase investment property such as stock, then some special allocations may need to be done. They may wish to contact the IRS or seek a professional preparer.
- 3. Foreign Losses.** If the person you are helping had any type of foreign losses such as net losses from selling capital assets or a net loss from being a limited partner, they may wish to hire a professional preparer or contact the IRS if they wish to prepare their own return.

Now that we have discussed what areas are beyond the scope of VITA, let's continue with the completion of Part I.

Line 3. The tax software will complete Line 3a if you completed a Schedule A for the person you are assisting to itemize his or her deductions. The total of the itemized deductions not directly related to foreign or U.S. income are medical expenses, real estate taxes and gifts to charity.

If the person you are assisting does not itemize deductions, then the standard deduction claimed on Line 40 of the Form 1040 would be entered on Line 3a.



Example 14

Betty is claiming a foreign tax credit. She is single and had itemized deductions of \$6,900 for 2005. Her Schedule A includes \$6,200 of real estate taxes and \$700 of charitable contributions. (See Exhibit 4.)

Exhibit 4

Form 1116, Line 3

3	Pro rata share of other deductions not definitely related:			
a	Certain itemized deductions or standard deduction (see instructions)	6,900		
b	Other deductions (attach statement)			
c	Add lines 3a and 3b	6,900		
d	Gross foreign source income (see instructions)			
e	Gross income from all sources (see instructions)			
f	Divide line 3d by line 3e (see instructions)			
g	Multiply line 3c by line 3f.			

Example 15

Rebecca wishes to claim a foreign tax credit. She is single and had itemized deductions of \$2,500. Since the standard deduction for a single person for 2005 is \$5,000, it is more advantageous to take the standard deduction. Rebecca's Form 1116 would therefore have a \$5,000 entry on Line 3a. (See Exhibit 5.)

Exhibit 5

Form 1116, Line 3

3	Pro rata share of other deductions not definitely related:			
a	Certain itemized deductions or standard deduction (see instructions)	5,000		
b	Other deductions (attach statement)			
c	Add lines 3a and 3b	5,000		
d	Gross foreign source income (see instructions)			
e	Gross income from all sources (see instructions)			
f	Divide line 3d by line 3e (see instructions)			
g	Multiply line 3c by line 3f.			

All income from foreign sources in the category checked at the top of Form 1116 is listed on Line 3d. If the foreign earned income exclusion was claimed on Form 2555 and if the Form 1116 is for the general limitation category, then the amount of the claimed exclusion is included here as well. For example, on Line 3d for Monique from one of our prior examples the entry would be \$84,000. That's the sum of \$4,000 from Line 1 plus the \$80,000 exclusion she claimed. Under most circumstances, Line 3d and Line 1 will be the same.

Line 3e is gross income from all sources. Usually, this line will be the same as Line 22 of the Form 1040. If a Form 2555 was completed and the Foreign Earned Income Exclusion was claimed, then the amount of the exclusion must be added back to the gross income amount on Line 22.

The software's next step is to determine the percentage of foreign source income to total income. This is done by dividing Line 3d by Line 3e and it will enter the answer on Line 3f. Then it takes Line 3c and multiplies it by the percentage determined on Line 3f and then enters this answer on Line 3g. For our purposes Line 6 will then be the same as Line 3g. This number represents the amount of your deductions allocated to foreign income in the category.

Your software will compute the rest of Part I and has begun to enter figures on Part III.

Part II. Foreign Taxes Paid or Accrued. Part II of Form 1116 deals with the amount of foreign taxes paid or that may be owed (accrued). Since the foreign tax credit is allowed when a U.S. taxpayer either pays or accrues taxes to a foreign government, the amount paid or owed to a foreign government must be indicated on the tax return in this section.

Before we can discuss how to complete Part II, we need to discuss cash basis and accrual basis taxpayers. A cash basis taxpayer is one who reports income when actually or constructively received, and expenses when they are paid. The majority of people who file individual income tax returns are cash basis taxpayers. If the person is a cash basis taxpayer, he or she has a choice to take foreign tax credit using the cash or accrual method.

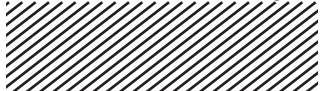
Example 16

Marie is a U.S. citizen who resides in Argentina, where she is currently employed. She is paid every week on Thursday. Her last payday for 2005 is December 30th. She is paid based upon the time she worked in the previous week Sunday through Saturday. Since she is a cash basis taxpayer, she claims on her 2005 tax return the income that she was paid from January 1, 2005 through December 31, 2005 no matter when she earned it or when she may have been entitled to it. She also claims as deductions, expenses for which she actually paid in 2005 even though she may have incurred the debt prior to 2005.

An accrual basis taxpayer computes income and deductions differently. A person who is on the accrual basis computes income when he or she actually earned it or became entitled to it. Therefore, his or her deductions are computed based on when those debts were incurred, but not necessarily paid.

Example 17

If Marie was an accrual basis taxpayer instead of a cash basis taxpayer, then she would declare as her 2005 income the money she had earned from her employer through December 31, even though she would not have been paid for her last week's work until early 2006.



When computing the amount of foreign taxes for Part II of Form 1116, you will need to know if the taxpayer is on a cash basis or an accrual basis. If the person you are helping does not know, then he or she is probably on a cash basis. Taxpayers on the accrual basis should be referred to professional tax preparers for assistance.

A taxpayer on the cash basis may choose to use the accrual method to determine the foreign tax credit. However, once this choice has been made the taxpayer must use the accrual method for the foreign tax credit on all future tax returns.

In the U.S., we have a pay-as-you-go system. That means that we pay taxes on taxable income as we make it. When a wage-earner gets a paycheck, an amount has already been withheld by his or her employer for federal income tax. If there has not been withholding on taxable income, then estimated tax payments must be made.

Many foreign countries have a different system. In some cases, the individual simply reports his or her taxable income and the government involved computes the tax and bills the taxpayer. In other instances, taxpayers make payments in one year for income made the previous year. In these instances, a cash basis taxpayer may wish to use the accrual basis for computing the foreign tax credit since his or her U.S. tax would be based on the income made in 2005 but they would not actually pay the taxes or know the actual tax amount until after the end of the tax year. But remember that once the choice to use the accrual method has been made, it must be used on all future tax returns in computing the foreign tax credit.

On Part II of Form 1116, you must indicate if the credit is being claimed for foreign taxes actually paid in 2005 or if it is being claimed for foreign taxes accrued during 2005. Just as there is space in Part I of the form to claim income from 3 different countries, there is space in Part II for claiming payments to these 3 different countries.

Part II also has two separate sections in which you indicate the amounts withheld, paid, or accrued in the foreign currency and then convert these amounts into U.S. dollars.

FOREIGN EXCHANGE RATE

One of the questions that frequently arise is what currency exchange rate should be used. If you are using the cash basis, then the exchange rate that is the most accurate for the date of the payment should be used.

If the person you are helping had tax withheld throughout the year, then you can use the annual average exchange rate. If the person you are assisting is using the accrual method to claim his or her foreign taxes paid, you must generally use the average exchange rate for the tax year.

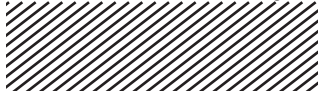


Column (x) of the Form 1116 Part II is a summary (in U.S. dollars) of all the foreign taxes paid or accrued on income in the category checked at the top of Form 1116.

Line 8 of Part II is the total of foreign taxes paid or accrued to all foreign countries. If the foreign taxes are paid or accrued on foreign income that falls into more than one separate category of income, but the tax is not specifically allocable to any one of the items of income, an allocation of the tax to each separate category must be made. This allocation is made by multiplying the total foreign income by a fraction. The numerator of the fraction is the net income of each of the separate categories. The denominator is total net foreign income.

Exercise 3

Charles is a U.S. citizen who lives and works in the United Kingdom. He takes the foreign earned income exclusion for his wages. His only other foreign income is interest income from his London bank. British income taxes were withheld at 27.5%. In 2005, his gross interest income from his London bank was £1,200. The average exchange rate for 2005 for purposes of this exercise was £.6 to the U.S. dollar. Charles uses the single filing status on his tax return and claims a standard deduction for 2005. He had earned income of \$60,000 which he excluded. He also had U.S. interest income of \$3,000 and his only other income was a short term capital gain of \$35,000 from a U.S. source. Since 27.5% is also the tax rate for interest income in the United Kingdom, he had no additional income tax due to Great Britain on his interest income. Parts of Charles' Form 1040 are reproduced below. Compute the first page of the Form 1116 for Charles.



		Add numbers from lines above ▶	
d Total number of exemptions claimed			
Income	7 Wages, salaries, tips, etc. Attach Form(s) W-2	7	60,000
	8a Taxable interest. Attach Schedule B if required	8a	5,000
	b Tax-exempt interest. Do not include on line 8a	8b	
	9a Ordinary dividends. Attach Schedule B if required	9a	
	b Qualified dividends (see page 20)	9b	
	10 Taxable refunds, credits, or offsets of state and local income taxes (see page 20)	10	
	11 Alimony received	11	
	12 Business income or (loss). Attach Schedule C or C-EZ	12	
	13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ <input type="checkbox"/>	13	35,000
	14 Other gains or (losses). Attach Form 4797	14	
	15a IRA distributions	15a	
	b Taxable amount (see page 22)	15b	
	16a Pensions and annuities	16a	
	b Taxable amount (see page 22)	16b	
	17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
	18 Farm income or (loss). Attach Schedule F	18	
	19 Unemployment compensation	19	
	20a Social security benefits	20a	
	b Taxable amount (see page 24)	20b	
	21 Other income. List type and amount (see page 24)	21	(60,000)
	22 Add 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 (see page 26)	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 One-half of self-employment tax. Attach Schedule SE		27	
28 Self-employed SEP, SIMPLE, and qualified plans		28	
29 Self-employed health insurance deduction (see page XX)		29	
30 Penalty on early withdrawal of savings		30	
31a Alimony paid b Recipient's SSN ▶		31a	
32 IRA deduction (see page XX)		32	
33 Student loan interest deduction (see page XX)		33	
34 Tuition and fees deduction (see page XX)		34	
35 Domestic production activities deduction. Attach Form 8903		35	
36 Add lines 23 through 31a and 32 through 35		36	
37 Subtract line 36 from line 22. This is your adjusted gross income ▶		37	40,000

Form 1040 (2005)		Page 2	
Tax and Credits	38 Amount from line 37 (adjusted gross income)	38	40,000
	39a Check <input type="checkbox"/> You were born before January 2, 1941, <input type="checkbox"/> Blind. } Total boxes if: <input type="checkbox"/> Spouse was born before January 2, 1941, <input type="checkbox"/> Blind. } checked ▶ 39a <input type="checkbox"/>		
	b If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here ▶ 39b <input type="checkbox"/>		
	40 Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40	5,000
	41 Subtract line 40 from line 38	41	35,000
	42 If line 38 is \$109,475 or less, multiply \$3,200 by the total number of exemptions claimed on line 6d. If line 38 is over \$109,475, see the worksheet on page 33	42	3,200
	43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	31,800
	44 Tax (see page 33). Check if any tax is from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972	44	4,621
	45 Alternative minimum tax (see page 35). Attach Form 6251	45	
	46 Add lines 44 and 45	46	
	47 Foreign tax credit. Attach Form 1116 if required	47	
	48 Credit for child and dependent care expenses. Attach Form 2441	48	
	49 Credit for the elderly or the disabled. Attach Schedule R	49	
	50 Education credits. Attach Form 8863	50	

Standard Deduction for—

- People who checked any box on line 39a or 39b or who can be claimed as a dependent, see page 31.
- All others:

Single or Married filing separately, \$5,000

Married filing

Form **1116**
Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit
(Individual, Estate, or Trust)
▶ Attach to Form 1040, 1040NR, 1041, or 990-T.
▶ See separate instructions.

OMB No. 1545-0121

2005
Attachment
Sequence No. **19**

Name _____ Identifying number as shown on page 1 of your tax return _____

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

- a Passive income
- b High withholding tax interest
- c Financial services income
- d Shipping income
- e Dividends from a DISC or former DISC
- f Certain distributions from a foreign sales corporation (FSC) or former FSC
- g Lump-sum distributions
- h Section 901(j) income
- i Certain income re-sourced by treaty
- j General limitation income

k Resident of (name of country) ▶ _____

Note: If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to more than one foreign country or U.S. possession, use a separate column and line for each country or possession.

Part I Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)

	Foreign Country or U.S. Possession			Total (Add cols. A, B, and C.)
	A	B	C	
1 Enter the name of the foreign country or U.S. possession ▶				
1 Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions):				1
Deductions and losses (Caution: See pages 13 and 14 of the instructions):				
2 Expenses definitely related to the income on line 1 (attach statement)				
3 Pro rata share of other deductions not definitely related:				
a Certain itemized deductions or standard deduction (see instructions)				
b Other deductions (attach statement)				
c Add lines 3a and 3b				
d Gross foreign source income (see instructions)				
e Gross income from all sources (see instructions)				
f Divide line 3d by line 3e (see instructions)				
g Multiply line 3c by line 3f.				
4 Pro rata share of interest expense (see instructions):				
a Home mortgage interest (use worksheet on page 13 of the instructions)				
b Other interest expense				
5 Losses from foreign sources				
6 Add lines 2, 3g, 4a, 4b, and 5				6
7 Subtract line 6 from line 1. Enter the result here and on line 14, page 2 ▶				7

Part II Foreign Taxes Paid or Accrued (see page 14 of the instructions)

Country	Credit is claimed for taxes (you must check one) (m) <input type="checkbox"/> Paid (n) <input type="checkbox"/> Accrued	Foreign taxes paid or accrued							(w) Other foreign taxes paid or accrued	(x) Total foreign taxes paid or accrued (add cols. (t) through (w))
		In foreign currency				In U.S. dollars				
		Taxes withheld at source on:			(s) Other foreign taxes paid or accrued	Taxes withheld at source on:				
(o) Date paid or accrued	(p) Dividends	(q) Rents and royalties	(r) Interest	(s) Other foreign taxes paid or accrued	(t) Dividends	(u) Rents and royalties	(v) Interest			
A										
B										
C										

8 Add lines A through C, column (x). Enter the total here and on line 9, page 2 ▶ **8**

For Paperwork Reduction Act Notice, see page 18 of the instructions.

Cat. No. 11440U

Form **1116** (2005)

Part III. Now that we have completed the front page of the Form 1116, let's go to the back of the form. Part III is the actual computation of the Foreign Tax Credit. This is relatively simple if you just follow the form line by line. If you have utilized tax software and entered all the types of foreign source income and the amounts of tax paid on them to a foreign country, your form is completed at this point, except for three lines, Lines 10, 12 and 15.

Line 10. This line deals with carrybacks and carryovers. This occurs when a taxpayer pays more to a foreign government than he or she does to the United States on income attributable to the taxable income in the separate income category. Since the tax credit is limited to the amount of U.S., the surplus tax credit is available as a carryback or carryover. VRPP volunteers will not be computing carrybacks or carryovers.

Line 12. A reduction to the foreign taxes paid or accrued has to be made under certain circumstances. For our purpose, we will cover the most common situation. This is the reduction for taxes allocable to income excluded under the foreign earned income exclusion. The formula for this reduction is:

$$\frac{\text{Excluded Foreign Earned Income}}{\text{Total Foreign Earned Income}} \times \text{Foreign Tax} = \text{Reduction}$$

For our purposes, if the foreign law taxes foreign earned income and some other income (for example, earned income from U.S. sources or a type of income not subject to U.S. tax), and the taxes cannot be segregated, then the denominator of this fraction is the total amount of income subject to foreign tax.

Let's look at an example.

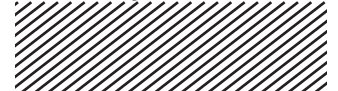
Example 18

Marsha is a U.S. citizen who resides in Germany for all of 2005. She had wages of \$85,000, and excluded \$80,000 on her U.S. tax return. She also earned \$5,000 interest on a German bank account. She paid \$2,000 income tax to Germany on this income. She will allocate the \$2,000 income tax as follows:

Step 1 — Allocate the tax to Passive and to General Limitation Income.

$$\text{Passive Income: } \frac{\$5,000}{\$90,000} \times \$20,000 = \$1,111$$

$$\text{General Limitation Income: } \frac{\$85,000}{\$90,000} \times \$20,000 = \$18,889$$



Step 2 — Calculate the credit reduction attributable to excluded income.

$$\frac{\$80,000 \text{ (excluded income)}}{\$85,000 \text{ (total foreign income)}} \times \$18,889 = \$17,778$$

Exhibit 9

Form 1116

Form 1116 (2005)		Page 2	
Part III Figuring the Credit			
9	Enter the amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I	9	18,889
10	Carryback or carryover (attach detailed computation)	10	
11	Add lines 9 and 10.	11	18,889
12	Reduction in foreign taxes (see page 15 of the instructions)	12	17,778
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit	13	1,111

There are other reductions which can be indicated on line 12. However, they are all beyond the scope of VRPP. These include taxes attributable to boycott operations, or certain mineral income. It is suggested that taxpayers with these types of situations may wish to seek assistance from a paid tax preparer.

Line 15—These adjustments are beyond the scope of VRPP.

More Than One Form 1116. Part IV of the Form 1116 is used as a summary of the foreign tax credit. As you can tell from our discussion thus far, there may be occasions when you will need to complete more than one Form 1116 for the same taxpayer. If this is the case, you would complete Part IV on only one Form 1116. It does not matter which Form 1116 you choose. You would indicate in Part IV of the summary Form 1116 the amount of the credit computed on line 21 of Part III from each Form 1116. Line 30 is then a total of all Forms 1116 and, for our purposes, line 32 should be the same as line 30. Please note that again the reduction of the credit for international boycott operations (line 32) is beyond the scope of this program and will not be discussed.



Form 1116 (2005)

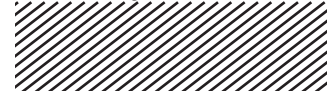
Page 2

Part III Figuring the Credit

9	Enter the amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I	9		
10	Carryback or carryover (attach detailed computation)	10		
11	Add lines 9 and 10.	11		
12	Reduction in foreign taxes (see page 15 of the instructions)	12		
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit	13		
14	Enter the amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I (see page 15 of the instructions)	14		
15	Adjustments to line 14 (see page 16 of the instructions)	15		
16	Combine the amounts on lines 14 and 15. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 17 through 21. However, if you are filing more than one Form 1116, you must complete line 19.)	16		
17	Individuals: Enter the amount from Form 1040, line 41. If you are a nonresident alien, enter the amount from Form 1040NR, line 38. Estates and trusts: Enter your taxable income without the deduction for your exemption. Caution: If you figured your tax using the lower rates on qualified dividends or capital gains, see page 17 of the instructions.	17		
18	Divide line 16 by line 17. If line 16 is more than line 17, enter "1"	18		
19	Individuals: Enter the amount from Form 1040, line 44. If you are a nonresident alien, enter the amount from Form 1040NR, line 41. Estates and trusts: Enter the amount from Form 1041, Schedule G, line 1a, or the total of Form 990-T, lines 36 and 37 Caution: If you are completing line 19 for separate category g (lump-sum distributions), see page 18 of the instructions.	19		
20	Multiply line 19 by line 18 (maximum amount of credit)	20		
21	Enter the smaller of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV (see page 18 of the instructions) ▶	21		

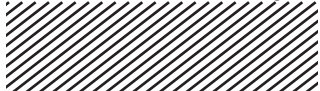
Part IV Summary of Credits From Separate Parts III (see page 18 of the instructions)

22	Credit for taxes on passive income	22		
23	Credit for taxes on high withholding tax interest	23		
24	Credit for taxes on financial services income	24		
25	Credit for taxes on shipping income	25		
26	Credit for taxes on dividends from a DISC or former DISC and certain distributions from a FSC or former FSC	26		
27	Credit for taxes on lump-sum distributions	27		
28	Credit for taxes on certain income re-sourced by treaty	28		
29	Credit for taxes on general limitation income	29		
30	Add lines 22 through 29	30		
31	Enter the smaller of line 19 or line 30	31		
32	Reduction of credit for international boycott operations. See instructions for line 12 on page 15	32		
33	Subtract line 32 from line 31. This is your foreign tax credit . Enter here and on Form 1040, line 47; Form 1040NR, line 44; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a ▶	33		



▶▶ SUMMING UP THIS LESSON ◀◀

- ▶ In order to qualify for a foreign tax credit, income on which the taxes are paid must be foreign source.
- ▶ The tax being paid must be similar to U.S. income tax.
- ▶ The individual paying the tax cannot derive a specific economic benefit and still claim the foreign tax credit.
- ▶ The foreign tax credit is computed on Form 1116.
- ▶ If an individual claims the foreign earned income exclusion, the excluded amount is not shown on line 1 of Part I of the Form 1116.
- ▶ A cash basis taxpayer may choose the accrual method to claim the foreign tax credit. Once the choice has been made, the taxpayer must continue to use the accrual method.
- ▶ If the accrual method of claiming the foreign tax credit is used, use the average annual currency exchange rate to convert the foreign money into U.S. dollars.
- ▶ If there is more than one Form 1116 for the same person, Part IV Summary need only be completed on one of the forms.



FOREIGN TAX

CREDIT

ANSWERS TO EXERCISES

Lesson 9

International Segment

- 1.** c, e
- 2.**
 - a.** no
 - b.** no
 - c.** yes
 - d.** no
- 3.** See completed Form 1116 on the next page.

Form **1116**
 Department of the Treasury
 Internal Revenue Service (99)

Foreign Tax Credit

(Individual, Estate, or Trust)

▶ Attach to Form 1040, 1040NR, 1041, or 990-T.

▶ See separate instructions.

OMB No. 1545-0121

2005

Attachment
 Sequence No. **19**

Name **Charles Green** Identifying number as shown on page 1 of your tax return **000-00-6492**

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

- a Passive income
- b High withholding tax interest
- c Financial services income
- d Shipping income
- e Dividends from a DISC or former DISC
- f Certain distributions from a foreign sales corporation (FSC) or former FSC
- g Lump-sum distributions
- h Section 901(j) income
- i Certain income re-sourced by treaty
- j General limitation income

k Resident of (name of country) ▶

Note: If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to more than one foreign country or U.S. possession, use a separate column and line for each country or possession.

Part I Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)

	Foreign Country or U.S. Possession			Total (Add cols. A, B, and C.)
	A	B	C	
1 Enter the name of the foreign country or U.S. possession ▶ United Kingdom				
1 Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions):				
	2,000			1 2,000
Deductions and losses (Caution: See pages 13 and 14 of the instructions):				
2 Expenses definitely related to the income on line 1 (attach statement)				
3 Pro rata share of other deductions not definitely related:				
a Certain itemized deductions or standard deduction (see instructions)	5,000			
b Other deductions (attach statement)				
c Add lines 3a and 3b	5,000			
d Gross foreign source income (see instructions)	2,000			
e Gross income from all sources (see instructions)	100,000			
f Divide line 3d by line 3e (see instructions)	0.0200			
g Multiply line 3c by line 3f.	100			
4 Pro rata share of interest expense (see instructions):				
a Home mortgage interest (use worksheet on page 13 of the instructions)				
b Other interest expense				
5 Losses from foreign sources				
6 Add lines 2, 3g, 4a, 4b, and 5				6 100
7 Subtract line 6 from line 1. Enter the result here and on line 14, page 2 ▶				7 1,900

Part II Foreign Taxes Paid or Accrued (see page 14 of the instructions)

Country	Credit is claimed for taxes (you must check one)		Foreign taxes paid or accrued						(x) Total foreign taxes paid or accrued (add cols. (t) through (w))	
	(m) <input checked="" type="checkbox"/> Paid (n) <input type="checkbox"/> Accrued	In foreign currency			In U.S. dollars					
		(o) Date paid or accrued	(p) Dividends	(q) Rents and royalties	(r) Interest	(s) Other foreign taxes paid or accrued	(t) Dividends	(u) Rents and royalties		(v) Interest	(w) Other foreign taxes paid or accrued
A		12/31/2005				330			550	550
B										
C										550
8	Add lines A through C, column (x). Enter the total here and on line 9, page 2 ▶									8 550

For Paperwork Reduction Act Notice, see page 18 of the instructions.

Cat. No. 11440U

Form **1116** (2005)

INTRODUCTION AND OBJECTIVES

In this lesson you will learn about adjustments to income. There are seven adjustments covered in this lesson. They are educator expenses, traditional IRA deductions, student loan interest deduction, tuition and fees deduction, penalty on early withdrawal of savings, alimony payments, and jury duty. Lesson 3 discusses an additional adjustment to income covered in the VRPP training — one-half of self employment tax.

The remaining adjustments — moving expenses; self-employed health insurance deduction; and self-employed SEP, SIMPLE, and qualified plans — are not covered in traditional VRPP training. Taxpayers who need assistance with these adjustments should be referred to a paid professional tax preparer.

After completing this lesson you should be able to:

- Calculate and accurately report adjustments to income.
- Identify which IRA contributions are within the scope of the Volunteer Return Preparation Program.
- Identify contribution limits for IRAs.

ADJUSTMENTS TO INCOME

Adjustments are subtractions from total income. Total income minus adjustments results in **adjusted gross income (AGI)**, an important number for tax purposes. Adjusted gross income is used to figure some limitations. In addition, it is used to figure income tax in some states.

Taxpayers cannot take any adjustments to income on Form 1040EZ. On Form 1040EZ total income and adjusted gross income are the same. Form 1040A filers can take adjustments for educator expenses, contributions to a traditional IRA, the student loan interest deduction, and tuition and fees payments. Form 1040 filers can take any of the adjustments for which they are eligible.

ALERT



This lesson contains intermediate tax law. Your course facilitator will only teach the information required to assist taxpayers you will serve.

This tax provision was scheduled to expire at the end of 2003. However, it was extended through 2005. It can be taken by qualifying taxpayers filing a Form 1040A or Form 1040.

Deduction for Educator Expenses

If the taxpayer is an eligible educator, he or she can deduct as an adjustment to income up to \$250 in qualified expenses. The taxpayer can deduct these expenses even if he or she does not itemize deductions on Schedule A (Form 1040). This adjustment to income is for expenses paid or incurred in 2005. If both the taxpayer and spouse are eligible educators and choose to file a joint tax return, they may deduct up to \$500 (\$250 each) of qualified expenses. Prior to 2002 these expenses were deductible only as miscellaneous itemized deductions.

Eligible educator

The taxpayer is an eligible educator if, for the tax year, he or she is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide, and he or she works at least 900 hours during a school year in a school that provides elementary or secondary education as determined under state law.

Qualified expenses

Qualified expenses are the **unreimbursed expenses** paid or incurred for books, supplies, computer equipment (including related software and services), other equipment and supplementary materials that the taxpayer uses in his or her classroom. For courses in health and physical education, expenses for supplies are qualified expenses only if they are related to athletics. To be deductible as an adjustment to income, the qualified expenses must be more than the following amounts for the tax year:

- The interest on qualified U.S. savings bonds that the taxpayer excluded from income because he or she paid qualified higher education expenses.
- Any distributions from a qualified tuition program that the taxpayer excluded from income, or
- Any tax-free withdrawals by the taxpayer from a Coverdell education savings account.

The educator expense can be claimed on Form 1040, line 23 or Form 1040A, line 16.

Example 1

Joe and Mary will file a joint return for 2005. Joe is a high school math teacher and incurred \$500 in qualified unreimbursed expenses. Mary is a grade school principal and incurred \$200 in qualified unreimbursed expenses. Both Joe and Mary meet the definition of eligible educators. They will claim \$450 (\$250 for Joe and \$200 for Mary) on Form 1040, line 23, or on Form 1040A, line 16.

An **Individual Retirement Arrangement (IRA)** is a tax-sheltered savings plan set up by the taxpayer, generally for retirement income. This lesson discusses only **traditional IRAs** (IRAs other than Roth IRAs, SIMPLE IRAs, or Coverdell education savings accounts (ESAs)). Contributions to the nontraditional IRAs are not deductible as adjustments to income.

Information on nontraditional IRAs can be found in Publication 590, *Individual Retirement Arrangements (IRAs)*.

Contributions to a traditional IRA can be either deductible or nondeductible. Earnings and gains on the contributions are not taxed until withdrawn from the traditional IRA account.

Example 2

Anna contributed a total of \$2,500 over the last two years to her traditional IRA account. During 2005 she earned \$140 of interest on her traditional IRA. All of the interest was added to her traditional IRA savings account.

Anna will not have to pay tax on the interest until she withdraws it from her traditional IRA account.

Contributions

Anyone under 70 1/2 years of age (at the end of the tax year) who has taxable compensation can contribute to a traditional IRA.

If the taxpayer and/or spouse have compensation and both are under age 70 1/2, each can set up an IRA. However, they cannot participate in the same IRA — they must have separate accounts.

Compensation includes wages, salaries, commissions, tips, bonuses, professional fees, and earnings from self-employment. Alimony or separate maintenance payments that are included in total income are also compensation for traditional IRA purposes. Compensation **does not include** interest, rents, dividends, pension and annuity income, deferred compensation received, or income you can exclude.

General Contribution Limits

In 2005, the contribution limit to a traditional IRA increased. The most that can be contributed to a traditional IRA is the lesser of:

- \$4,000 (\$4,500 if age 50 or older), or
- Compensation that is includible in gross income for the year.

If a taxpayer has more than one traditional IRA, the taxpayer must combine all of the traditional IRAs and treat them as one when figuring the amount that can be contributed for the year.

Example 3

Dan, a college student, working part time earned \$1,500 in 2005. His IRA contributions for 2005 are limited to \$1,500 (the lesser of \$4,000 or compensation includable in income for the year).

Example 4

George has three traditional IRA accounts. During 2005 he contributed \$1,000 to each. His total IRA contributions for 2005 will be \$3,000.

Deemed IRAs

Employers who provide qualified employer retirement plans can maintain a separate account or annuity under the plan to receive voluntary employee contributions. This separate account is referred to as a deemed IRA. A deemed IRA can be a traditional IRA or a Roth IRA, and the same limits apply whether they are deemed or not. If a taxpayer has both a regular IRA and a deemed IRA, the taxpayer can divide contributions between them in any manner, but total contributions to both cannot exceed the \$4,000/\$4,500 limit.

Spousal IRA limit

If taxpayers file a joint return and one spouse's compensation is less than that of the other spouse's compensation, the most that can be contributed for that spouse is the lesser of:

- 1) \$4,000 (\$4,500 if age 50 or older), or
- 2) The total compensation includible in the gross income of both spouses for the year, reduced by:
 - a) IRA contributions for the spouse with the greater compensation,
 - b) Any contribution for the year to a Roth IRA for the spouse with the greater compensation.

The total combined contributions to both traditional IRAs cannot exceed the lesser of:

- \$8,000 (\$9,000 if both individuals are age 50 or older), or
- The total taxable compensation of both spouses.

Example 5

Kristen, a full time student with no taxable compensation, marries Jeremy during the year. Neither will be 50 by the end of the year. For the year, Jeremy has taxable compensation of \$30,000. He will contribute \$4,000 to a traditional IRA. If he and Kristen file a joint return, each can contribute \$4,000. This is because Kristen, who has no compensation, can add Jeremy's compensation, reduced by his IRA contribution ($\$30,000 - \$4,000 = \$26,000$) to her own compensation (0) to figure her maximum contribution. In her case, \$4,000 is her contribution limit, because \$4,000 is less than \$26,000 (her compensation for purposes of the figuring the spousal IRA).

Example 6

Tom and Darcy are married and both are 53. They both work and each has a traditional IRA. Tom earned \$1,800 and Darcy earned \$48,000 in 2005. Because of the spousal IRA limit rule, even though Tom earned less than \$4,500, they can contribute up to \$4,500 in each of their IRAs if they file a joint return. If they file

separate returns, the amount that can be contributed to Tom's IRA is limited to \$1,800 (his taxable compensation).

Excess Contributions

Generally, an excess contribution is the amount contributed to a traditional IRA that is more than the lesser of the:

- 1) Taxable compensation for the year, or
- 2) \$4,000 (\$4,500 if age 50 or older).

This limit applies whether the contributions are deductible or nondeductible. Contributions made in the year the taxpayer reaches age 70 1/2 and any later year are also excess contributions.

In general, if the excess contribution for a year and any earnings on it are not withdrawn by the due date of the tax return (including extensions), the taxpayer is subject to an additional 6% tax. The additional 6% tax must be paid each year on the excess amounts that remain in the traditional IRA at the end of the tax year. The tax cannot be more than 6% of the value of the IRA as of the end of the tax year. The excise tax is figured on Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*.

A taxpayer who has taxable compensation, but can no longer contribute to a traditional IRA because of age (70 1/2 years or older) may continue to contribute to a spouse's traditional IRA until the year in which the spouse reaches 70 1/2.

Example 7

Eldridge is a 73-year-old attorney. He earned \$12,000 during the year. Eldridge had compensation for traditional IRA purposes but he cannot make an IRA contribution because he is 70 1/2 or older. If Eldridge files a joint return with his spouse who is 68 years old, he can still contribute up to \$4,500 to his spouse's IRA.

Exercise 1

- A. Liz receives alimony which is included in her total income. All of her other income is from interest and dividends. Can Liz make a traditional IRA contribution? Explain. _____
- B. David is 73 and works part time in a hardware store. David's wife, Mary, does not work outside of the home. Mary is 68. Can David make a traditional IRA contribution for Mary? Explain _____
- C. Carla receives all her income from a rental property, interest income, and dividends. Can Carla make a traditional IRA contribution? Explain. _____
- D. Joy is 62 years old. Most of her income comes from a pension. However, Joy did earn \$1,250 doing consumer testing. How much can Joy contribute to a traditional IRA? Explain. _____

Deductible IRA Contributions

Generally, you can deduct the lesser of the contributions to your traditional IRA for the year or the general limit (or the spousal IRA limit, if it applies).

The actual deductible amount for a traditional IRA depends on the following:

- Whether or not the taxpayer or taxpayer's spouse is covered by a retirement plan set up by an employer for any part of the year,
- The taxpayer's **modified adjusted gross income**, and
- The taxpayer's filing status.

Modified Adjusted Gross Income

Generally, **modified adjusted gross income** is the adjusted gross income without consideration of certain deductions. The modified adjusted gross income (MAGI) can be figured as follows:

AGI (Form 1040 Line 36) plus

- IRA deduction
- Student loan interest deduction
- Tuition and fees deduction
- Foreign earned income exclusion
- Foreign housing exclusion or deduction
- Exclusion of qualified savings bond interest shown on Form 8815
- Exclusion of employer-paid adoption expenses shown on Form 8839.

Not covered by an employer retirement plan.

A taxpayer whose filing status is single, head of household, or qualifying widow(er), and who is not covered by an employer retirement plan, can take a full traditional IRA deduction of either his or her taxable compensation or \$4,000 (whichever amount is smaller). The \$4,000 amount is increased to \$4,500 if the taxpayer is age 50 or older.

Example 8

Cyril is single and 40 years of age. His modified adjusted gross income is \$50,000. He is not covered by a retirement plan at work. Cyril's traditional IRA contribution of \$4,000 is deductible.

Married taxpayers who file separate returns for a taxable year and who live apart at all times during the taxable year are treated as single and can take a full IRA deduction, if not covered by an employer plan. This is true even if the other spouse is covered by an employer retirement plan.

Married taxpayers who file jointly or separately may each be able to take the full IRA deduction of \$4,000 (\$4,500 if age 50 or older) or taxable compensation (whichever amount is smaller), if they had taxable compensation and both were not covered by an employer retirement plan. The total deduction for a joint return cannot exceed \$8,000 (\$9,000 if both individuals are age 50 or older). **When determining the allowable deduction each spouse figures the deduction separately.**

Covered by an employer retirement plan.

If the taxpayer is covered by a retirement plan at work, the traditional IRA deduction will be reduced or eliminated, as shown in **Table 1**, depending on filing status and modified AGI.

NOTE: If Box 13, Retirement Plan, on Form W-2 is checked, the taxpayer is covered by an employer retirement plan. If taxpayers do not agree with the Form W-2 they must contact their employer. Volunteers cannot make a determination on whether or not a taxpayer is covered by an employer retirement plan. Refer taxpayers with questions on their employer retirement plans to their employer or Publication 590, Individual Retirement Arrangements (IRAs).

Table 1. Traditional IRA Deduction Phaseout Chart (If taxpayer is covered by an employer retirement plan)			
Filing Status	Allowable traditional IRA deduction is...		
	reduced if modified AGI is:		zero when modified AGI is:
	more than	but less than	
Single or Head of household	\$50,000	\$60,000	\$60,000 or more
Married filing jointly or Qualifying widow(er)	\$70,000	\$80,000	\$80,000 or more
Married filing separately ¹	\$0.01	\$10,000	\$10,000 or more

¹If the taxpayer did not live with his or her spouse at any time during the year, his or her filing status is considered Single for this purpose.

Example 9

Emily, 36 years old, is single. Her modified AGI was \$54,900. She is covered by a retirement plan at work. Emily's \$4,000 traditional IRA contribution will be reduced or modified on her tax return because her modified AGI is between \$50,000 and \$60,000.

If either the taxpayer or the taxpayer's spouse is covered by an employer retirement plan, he or she may be entitled to only a partial deduction or no deduction at all, depending on filing status and modified adjusted gross income, as shown in **Table 2**.

Table 2. Traditional IRA Deduction Phaseout Chart (If taxpayer is not covered, but the spouse is)			
Filing Status	Allowable traditional IRA deduction is...		
	reduced if modified AGI is:		zero when modified AGI is:
	more than	but less than	
Married filing jointly or Qualifying widow(er)	\$150,000	\$160,000	\$160,000 or more
Married filing separately ¹	\$0.01	\$10,000	\$10,000 or more

¹The taxpayer is entitled to the full deduction if he or she did not live with their spouse at any time during the year.

POTENTIAL PITFALLS



When determining the allowable deduction, each spouse figures the deduction separately.

Example 10

David and Ruth are filing a joint return. David earned \$88,000 and is covered by his employer's retirement plan. Ruth, age 32, is a homemaker, and has no compensation. David, age 36, contributed \$2,800 to his traditional IRA and \$3,000 to a traditional IRA for Ruth.

Because David is covered by his employer's retirement plan, the modified AGI limits apply (Table 1). Based on Table 1, David is not allowed a deduction for his traditional IRA contributions. Because David made traditional IRA contributions for Ruth, they can take a deduction on the tax return for her IRA contributions. Ruth is not covered by an employer's retirement plan. Their compensation for IRA purposes is \$88,000 and their modified AGI is not more than \$150,000 (see Table 2).

Example 11

Assume still that David earned \$88,000 and is covered by his employer's retirement plan. Assume too that Ruth is employed; she earned \$56,000 and she is not covered by her employer's retirement plan. David cannot deduct his traditional IRA contribution, but Ruth can deduct hers. The modified AGI limits that apply to David are shown in Table 1. Table 2 modified AGI limits apply to Ruth's deduction. Her deduction would not be reduced unless the couple's modified AGI was more than \$150,000. It would not be eliminated unless their modified AGI was \$160,000 or more.

Exercise 2

- A.** Angela and Joe are married and file a joint return. Joe, age 23, is covered by a retirement plan at work, but Angela, age 25, is not. Joe earned \$25,000 and Angela earned \$20,000; their modified AGI is \$45,000. Is any portion of Angela's traditional IRA contribution deductible, and why? _____

- B.** Annette, age 26, is single. She earned \$23,000, and her modified AGI is \$24,500. She made a \$500 contribution to a traditional IRA. Annette is covered by a retirement plan at work. Is any portion of her contribution deductible, and why? _____

- C.** Richard and Lynn are married and lived together during the year. They file separate returns. Richard is covered by a retirement plan at work. Lynn is not covered by a retirement plan at work. Richard, age 40, earned \$17,000 and contributed \$1,400 to a traditional IRA. Lynn, age 33, worked part-time and earned \$4,500. She contributed \$1,000 to a traditional IRA. Can Richard or Lynn deduct any of the IRA contributions, and why? _____

When to Deduct Traditional IRA Contributions

Individuals may deduct traditional IRA contributions on their 2005 tax return if the contributions are made in 2005 or by the due date for filing their return, not including extensions. For most people, this means that contributions for 2005 must be made by April 17, 2006, since April 15th falls on a Saturday. Taxpayers may not deduct on their 2005 tax return contributions made in 2005 which were deducted on the 2004 tax return. The contributions do not have to be made before the return is filed. However, if the taxpayer deducts traditional IRA contributions on the 2005 tax return but does not make the traditional IRA contributions by April 15, 2006, for the exact amount deducted, the taxpayer must file an amended tax return.

Using the Worksheet and Reporting the Deduction

Use the IRA Deduction Worksheet in the Form 1040A or Form 1040 instructions booklet to figure the traditional IRA deduction.

The traditional IRA deduction is reported on Form 1040A, line 17 or Form 1040, Line 25. On joint returns when both spouses are making deductible traditional IRA contributions, enter the total contribution.

Example 12



Nick and Susan file a joint return. Both work, and Nick, age 27, was covered by a retirement plan, but Susan, age 25, was not. Nick earned \$12,300 and Susan earned \$10,990. Their total income (Form 1040A, line 15) is \$23,400. Nick and Susan each contributed \$500 to a traditional IRA.

The completed worksheet is shown in Exhibit 1. The information for Nick is shown in the column for *Your IRA*. The information for Susan is shown in the column for *Spouse's IRA*.

IRA Deduction Worksheet—Line 17

Keep for Your Records 

Before you begin: ✓ Be sure you have read the list that begins on page 26.

	Your IRA	Spouse's IRA
1a. Were you covered by a retirement plan (see page 29)?	1a. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
b. If married filing jointly, was your spouse covered by a retirement plan?		1b. <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<p>Next. If you checked "No" on line 1a (and "No" on line 1b if married filing jointly), skip lines 2 through 6, enter \$4,000 (\$4,500 if age 50 or older at the end of 2005) on line 7a (and 7b if applicable), and go to line 8. Otherwise, go to line 2.</p>		
2. Enter the amount shown below that applies to you.		
<ul style="list-style-type: none"> • Single, head of household, or married filing separately and you lived apart from your spouse for all of 2005, enter \$80,000 • Qualifying widow(er), enter \$80,000 • Married filing jointly, enter \$80,000 in both columns. But if you checked "No" on either line 1a or 1b, enter \$160,000 for the person who was not covered by a plan • Married filing separately and you lived with your spouse at any time in 2005, enter \$10,000 	2a. <u>80,000</u>	2b. <u>160,000</u>
3. Enter the amount from Form 1040A, line 15	3. <u>23,400</u>	
4. Enter the amount, if any, from Form 1040A, line 16	4. _____	
5. Subtract line 4 from line 3. Enter the result in both columns	5a. <u>23,400</u>	5b. <u>23,400</u>
6. Is the amount on line 5 less than the amount on line 2?		
<input type="checkbox"/> No.  None of your IRA contributions are deductible. For details on nondeductible IRA contributions, see Form 8606.		
<input checked="" type="checkbox"/> Yes. Subtract line 5 from line 2 in each column. If the result is \$10,000 or more, enter \$4,000 (\$4,500 if age 50 or older at the end of 2005) on line 7 for that column and go to line 8. Otherwise, go to line 7	6a. <u>56,600</u>	6b. <u>136,600</u>
7. Multiply lines 6a and 6b by 30% (.30) (or by 35% (.35) in the column for the IRA of a person who is age 50 or older at the end of 2005). If the result is not a multiple of \$10, increase it to the next multiple of \$10 (for example, increase \$490.30 to \$500). If the result is \$200 or more, enter the result. But if it is less than \$200, enter \$200	7a. <u>4,000</u>	7b. <u>4,000</u>
8. Enter the amount from Form 1040A, line 7	8. <u>23,290</u>	
<p> If married filing jointly and line 8 is less than \$8,000 (\$8,500 if one spouse is age 50 or older at the end of 2005; \$9,000 if both spouses are age 50 or older at the end of 2005), stop here and see Pub. 590 to figure your IRA deduction.</p>		
9. Enter traditional IRA contributions made, or that will be made by April 17, 2006, for 2005 to your IRA on line 9a and to your spouse's IRA on line 9b	9a. <u>500</u>	9b. <u>500</u>
10. On line 10a, enter the smallest of line 7a, 8, or 9a. On line 10b, enter the smallest of line 7b, 8, or 9b. This is the most you can deduct. Add the amounts on lines 10a and 10b and enter the total on Form 1040A, line 17. Or, if you want, you may deduct a smaller amount and treat the rest as a nondeductible contribution (see Form 8606)	10a. <u>500</u>	10b. <u>500</u>



You may also be able to take the retirement savings contributions credit. See the instructions for line 32 on page 35.

Nondeductible IRA Contributions

Although the deductible amount of traditional IRA contributions can be reduced or eliminated because of the modified adjusted gross income limitation, a taxpayer can make nondeductible contributions to new or existing traditional IRAs. Earnings and gains on these contributions are not taxed until they are distributed to the taxpayer.

The total traditional IRA contribution, whether deductible or nondeductible, cannot be more than the taxpayer's taxable compensation or \$4,000 (\$4,500 if age 50 or older), whichever amount is smaller.

Taxpayers must complete Form 8606, *Nondeductible IRAs*, for each year that nondeductible contributions are made.

If taxpayers do not report nondeductible contributions, all of the contributions to a traditional IRA will be treated as deductible. This means all distributions will be taxed unless the taxpayer can show, with satisfactory evidence, that nondeductible contributions were made.

Example 13

Rachel, age 35, is single and wants to contribute the maximum amount possible to her traditional IRA. She is covered by her employer's retirement plan. Her earned income, as well as her total income, Form 1040, Line 22, is \$52,000. Her total basis in traditional IRAs from line 14 of her 2004 Form 8606 is \$10,000. The completed IRA Deduction Worksheet and Form 8606 are shown in Exhibits 2 and 3.

IRA Deduction Worksheet—Line 32

Keep for Your Records



- Before you begin:**
- ✓ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).
 - ✓ Be sure you have read the list on page 26.

	Your IRA	Spouse's IRA
1a. Were you covered by a retirement plan (see page 26)?	1a. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
b. If married filing jointly, was your spouse covered by a retirement plan? <i>Next.</i> If you checked "No" on line 1a (and "No" on line 1b if married filing jointly), skip lines 2 through 6, enter \$4,000 (\$43,500 if age 50 or older at the end of 2005) on line 7a (and 7b if applicable), and go to line 8. Otherwise, go to line 2.		1b. <input type="checkbox"/> Yes <input type="checkbox"/> No
2. Enter the amount shown below that applies to you.		
<ul style="list-style-type: none"> • Single, head of household, or married filing separately and you lived apart from your spouse for all of 2005, enter \$60,000 • Qualifying widow(er), enter \$80,000 • Married filing jointly, enter \$80,000 in both columns. But if you checked "No" on either line 1a or 1b, enter \$160,000 for the person who was not covered by a plan • Married filing separately and you lived with your spouse at any time in 2005, enter \$10,000 	2a. <u>60,000</u>	2b. _____
3. Enter the amount from Form 1040, line 22	3. <u>52,000</u>	
4. Enter the total of the amounts from Form 1040, lines 23 through 31a, plus any write-in adjustments you entered on the dotted line next to line 36	4. _____	
5. Subtract line 4 from line 3. Enter the result in both columns	5a. <u>52,000</u>	5b. _____
6. Is the amount on line 5 less than the amount on line 2? <input type="checkbox"/> No. None of your IRA contributions are deductible. For details on nondeductible IRA contributions, see Form 8606. <input checked="" type="checkbox"/> Yes. Subtract line 5 from line 2 in each column. If the result is \$10,000 or more, enter \$4,000 (\$4,500 if age 50 or older at the end of 2005) on line 7 for that column and go to line 8. Otherwise, go to line 7	6a. <u>8,000</u>	6b. _____
7. Multiply lines 6a and 6b by 40% (.40) (or by 45% (.45) in the column for the IRA of a person who is age 50 or older at the end of 2005). If the result is not a multiple of \$10, increase it to the next multiple of \$10 (for example, increase \$490.30 to \$500). If the result is \$200 or more, enter the result. But if it is less than \$200, enter \$200	7a. <u>3,200</u>	7b. _____
8. Enter your wages, and your spouse's if filing jointly, and other earned income from Form 1040, minus any deductions on Form 1040, lines 27 and 28. Do not reduce wages by any loss from self-employment	8. <u>52,000</u>	
<div style="display: flex; align-items: flex-start;"> <div style="margin-right: 10px;"> <p style="font-size: small; margin: 0;">CAUTION</p> </div> <div> <p style="font-size: small; margin: 0;"><i>If married filing jointly and line 8 is less than \$8,000 (\$8,500 if one spouse is age 50 or older at the end of 2005; \$9,000 if both spouses are age 50 or older at the end of 2005), stop here and see Pub. 590 to figure your IRA deduction.</i></p> </div> </div>		
9. Enter traditional IRA contributions made, or that will be made by April 17, 2006, for 2005 to your IRA on line 9a and to your spouse's IRA on line 9b	9a. <u>4,000</u>	9b. _____
10. On line 10a, enter the smallest of line 7a, 8, or 9a. On line 10b, enter the smallest of line 7b, 8, or 9b. This is the most you can deduct. Add the amounts on lines 10a and 10b and enter the total on Form 1040, line 32. Or, if you want, you can deduct a smaller amount and treat the rest as a nondeductible contribution (see Form 8606)	10a. <u>3,200</u>	10b. _____



You may be able to take the retirement savings contributions credit. See the instructions for line 51 on page 36.

Form **8606**
 Department of the Treasury
 Internal Revenue Service (99)

Nondeductible IRAs

▶ See separate instructions.

▶ Attach to Form 1040, Form 1040A, or Form 1040NR.

OMB No. 1545-1007

2005

Attachment
 Sequence No. **48**

Name. If married, file a separate form for each spouse required to file Form 8606. See page 5 of the instructions.

Your social security number

Rachel

000 : 00 : 6220

Fill in Your Address Only if You Are Filing This Form by Itself and Not With Your Tax Return

Home address (number and street, or P.O. box if mail is not delivered to your home)

Apt. no.

City, town or post office, state, and ZIP code

Part I Nondeductible Contributions to Traditional IRAs and Distributions From Traditional, SEP, and SIMPLE IRAs

Complete this part only if:

- You made nondeductible contributions to a traditional IRA for 2005,
- You took distributions from a traditional, SEP, or SIMPLE IRA in 2005 (other than a rollover, conversion, recharacterization, or return of certain contributions) **and** you made nondeductible contributions to a traditional IRA in 2005 or an earlier year, **or**
- You converted part, but not all, of your traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2005 (excluding any portion you recharacterized) **and** you made nondeductible contributions to a traditional IRA in 2005 or an earlier year.

1	Enter your nondeductible contributions to traditional IRAs for 2005, including those made for 2005 from January 1, 2006, through April 17, 2006 (see page 5 of the instructions)	1	800
2	Enter your total basis in traditional IRAs (see page 5 of the instructions)	2	10,000
3	Add lines 1 and 2	3	10,800
<p>In 2005, did you take a distribution from traditional, SEP, or SIMPLE IRAs or make a Roth IRA conversion?</p> <p>No → Enter the amount from line 3 on line 14. Do not complete the rest of Part I.</p> <p>Yes → Go to line 4.</p>			
4	Enter those contributions included on line 1 that were made from January 1, 2006, through April 17, 2006	4	
5	Subtract line 4 from line 3	5	
6	Enter the value of all your traditional, SEP, and SIMPLE IRAs as of December 31, 2005, plus any outstanding rollovers (see page 6 of the instructions)	6	
7	Enter your distributions from traditional, SEP, and SIMPLE IRAs in 2005. Do not include rollovers, conversions to a Roth IRA, certain returned contributions, or recharacterizations of traditional IRA contributions (see page 6 of the instructions)	7	
8	Enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2005. Do not include amounts converted that you later recharacterized (see page 6 of the instructions). Also enter this amount on line 16	8	
9	Add lines 6, 7, and 8	9	
10	Divide line 5 by line 9. Enter the result as a decimal rounded to at least 3 places. If the result is 1.000 or more, enter "1.000"	10	×
11	Multiply line 8 by line 10. This is the nontaxable portion of the amount you converted to Roth IRAs. Also enter this amount on line 17	11	
12	Multiply line 7 by line 10. This is the nontaxable portion of your distributions that you did not convert to a Roth IRA	12	
13	Add lines 11 and 12. This is the nontaxable portion of all your distributions	13	
14	Subtract line 13 from line 3. This is your total basis in traditional IRAs for 2005 and earlier years	14	10,800
15	Taxable amount. Subtract line 12 from line 7. Also include this amount on Form 1040, line 15b; Form 1040A, line 11b; or Form 1040NR, line 16b Note: You may be subject to an additional 10% tax on the amount on line 15 if you were under age 59½ at the time of the distribution (see page 7 of the instructions).	15	

For Paperwork Reduction Act Notice, see page 8 of the instructions.

Cat. No. 63966F

Form **8606** (2005)

Exercise 3

Bill and Kathy are both employed and each earned \$15,000 in 2005. Both Bill and Kathy are age 32. Bill was covered by an employer retirement plan but Kathy was not. In July 2005, Bill contributed \$1,200 to his 2005 traditional IRA. In February 2006, he contributed \$800 to his 2005 traditional IRA. Kathy contributed \$400 to her 2005 traditional IRA. They file a joint return. Their total income on line 22 is \$30,000. They have no other adjustments to income.

Complete their IRA deduction worksheet (Exhibit 4).

Additional Taxes and Penalties

Taxpayers are generally subject to additional taxes and penalties for:

- Contributing more to a traditional IRA than is allowed,
- Making traditional IRA withdrawals before age 59 1/2, and
- Not withdrawing enough traditional IRA funds after age 70 1/2.
- Investing in collectibles
- Prohibited transactions, such as borrowing money from one's own IRA or selling property to it.

There are penalties for overstating the amount of nondeductible contributions and for failure to file Form 8606, if required.

Credit for Qualified Retirement Savings Contribution

Refer to Lesson 6 to determine if a taxpayer is also eligible to receive the credit for qualified retirement savings contributions based on their contributions to an IRA.

IRA Deduction Worksheet—Line 32

Keep for Your Records



- Before you begin:** ✓ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).
 ✓ Be sure you have read the list on page 26.

	Your IRA	Spouse's IRA
1a. Were you covered by a retirement plan (see page 26)?	1a. <input type="checkbox"/> Yes <input type="checkbox"/> No	
b. If married filing jointly, was your spouse covered by a retirement plan?		1b. <input type="checkbox"/> Yes <input type="checkbox"/> No
<p>Next. If you checked "No" on line 1a (and "No" on line 1b if married filing jointly), skip lines 2 through 6, enter \$4,000 (\$43,500 if age 50 or older at the end of 2005) on line 7a (and 7b if applicable), and go to line 8. Otherwise, go to line 2.</p>		
2. Enter the amount shown below that applies to you.		
<ul style="list-style-type: none"> • Single, head of household, or married filing separately and you lived apart from your spouse for all of 2005, enter \$60,000 • Qualifying widow(er), enter \$80,000 • Married filing jointly, enter \$80,000 in both columns. But if you checked "No" on either line 1a or 1b, enter \$160,000 for the person who was not covered by a plan • Married filing separately and you lived with your spouse at any time in 2005, enter \$10,000 	2a. _____	2b. _____
3. Enter the amount from Form 1040, line 22	3. _____	
4. Enter the total of the amounts from Form 1040, lines 23 through 31a, plus any write-in adjustments you entered on the dotted line next to line 36	4. _____	
5. Subtract line 4 from line 3. Enter the result in both columns	5a. _____	5b. _____
6. Is the amount on line 5 less than the amount on line 2?		
<input type="checkbox"/> No. None of your IRA contributions are deductible. For details on nondeductible IRA contributions, see Form 8606.		
<input type="checkbox"/> Yes. Subtract line 5 from line 2 in each column. If the result is \$10,000 or more, enter \$4,000 (\$4,500 if age 50 or older at the end of 2005) on line 7 for that column and go to line 8. Otherwise, go to line 7	6a. _____	6b. _____
7. Multiply lines 6a and 6b by 40% (.40) (or by 45% (.45) in the column for the IRA of a person who is age 50 or older at the end of 2005). If the result is not a multiple of \$10, increase it to the next multiple of \$10 (for example, increase \$490.30 to \$500). If the result is \$200 or more, enter the result. But if it is less than \$200, enter \$200	7a. _____	7b. _____
8. Enter your wages, and your spouse's if filing jointly, and other earned income from Form 1040, minus any deductions on Form 1040, lines 27 and 28. Do not reduce wages by any loss from self-employment	8. _____	
<p> CAUTION If married filing jointly and line 8 is less than \$8,000 (\$8,500 if one spouse is age 50 or older at the end of 2005; \$9,000 if both spouses are age 50 or older at the end of 2005), stop here and see Pub. 590 to figure your IRA deduction.</p>		
9. Enter traditional IRA contributions made, or that will be made by April 17, 2006, for 2005 to your IRA on line 9a and to your spouse's IRA on line 9b	9a. _____	9b. _____
10. On line 10a, enter the smallest of line 7a, 8, or 9a. On line 10b, enter the smallest of line 7b, 8, or 9b. This is the most you can deduct. Add the amounts on lines 10a and 10b and enter the total on Form 1040, line 32. Or, if you want, you can deduct a smaller amount and treat the rest as a nondeductible contribution (see Form 8606)	10a. _____	10b. _____



You may be able to take the retirement savings contributions credit. See the instructions for line 51 on page 36.

STUDENT LOAN INTEREST DEDUCTION

If a taxpayer paid interest on a student loan in 2005, he or she may be able to deduct up to \$2,500 of the interest paid.

If the taxpayer paid \$600 or more in interest to a single lender, the taxpayer should receive a statement from the lender showing the amount of interest paid. This information will assist you in completing the student loan interest deduction.

Qualified Student Loan Interest

Generally, student loan interest is the interest paid during the year on a loan for qualified higher education expenses that were:

1. For the taxpayer, the taxpayer's spouse, or a person who was the taxpayer's dependent when the loan was obtained.
2. Paid within a reasonable period of time before or after obtaining the loan, and
3. For an eligible student.

Interest can be the interest paid during the life of the loan (voluntary and required interest payments), loan origination fees, capitalized interest, interest on revolving lines of credit, and interest on refinanced student loans.

Interest does not include interest on any of the following:

1. A loan from a related person.
2. A loan from a qualified employer plan.
3. A loan for which the taxpayer is not legally liable.

Who Can Claim the Deduction

Generally, a taxpayer can claim the deduction if all the following requirements are met:

1. Taxpayer does not use married filing separately filing status.
2. Taxpayer is not claimed as a dependent on someone else's return.
3. The interest is on a loan to pay tuition and other qualified higher education expenses for the taxpayer, the taxpayer's spouse, or someone whom the taxpayer could claim as a dependent, when the loan was taken out.
4. The education expenses were paid or incurred within a reasonable period of time before or after the loan was taken out.
5. The person for whom the expenses were paid or incurred was an eligible student.

Qualified Higher Education Expenses

Generally, qualified higher education expenses include tuition and fees; room and board; books, supplies and equipment; and other necessary expenses.

These costs must be reduced by the following:

1. Employer provided educational assistance benefits.
2. Tax-free withdrawals from a Coverdell ESA.
3. Tax-free withdrawals from a qualified tuition program.
4. U.S. savings bond interest excluded from income because it is used to pay qualified higher education expenses.
5. Certain scholarships.
6. Veteran's educational assistance benefits.
7. Any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses.

Eligible educational institution

An eligible educational institution is any college, university, vocational school or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited public, nonprofit, and privately owned profit-making postsecondary institutions.

For the student loan interest deduction only, an eligible educational institution also includes an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, hospital, or health care facility that offers postgraduate training.

If a taxpayer does not know if the educational institution is an eligible institution, the taxpayer should contact the school.

Eligible student

An eligible student is a student who is enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential.

The standard for what is half the normal full-time work load is determined by each eligible educational institution.

Deduction Limits

The student loan interest deduction is generally the smaller of \$2,500 or the interest payments paid in 2005.

This amount may be gradually reduced (phased out) or eliminated based on the taxpayer's filing status and modified adjusted gross income (MAGI). Table 3 depicts when the limits apply.

Table 3

Limit on Student Loan Interest Deduction		
If your filing status is	AND your modified AGI is	THEN...
Single, head of household, or qualifying widow(er)	\$50,000 or less	You can deduct all your interest, up to \$2,500
	More than \$50,000, but less than \$65,000	Your deduction is limited
	\$65,000 or more	You cannot claim this deduction.
Married filing jointly	\$100,000 or less	You can deduct all your interest up to \$2,500
	More than \$100,000, but less than \$130,000	Your deduction is limited
	\$130,000 or more	You cannot claim this deduction.

Figuring the Deduction

Use the Student Loan Interest Deduction worksheet found in the Form 1040 or Form 1040A instructions to figure the deduction.

Claiming the Deduction

The student loan interest deduction is entered on Form 1040, Line 33, or Form 1040A, Line 18.

Example 14

During 2005, Rick paid \$2,650 in qualified interest on his student loan. Rick's filing status is Single. His total income, Form 1040, line 22, is \$35,000. He has no other adjustments to his income. His completed student loan interest deduction worksheet, Exhibit 5, shows Rick is entitled to \$2,500. Although his MAGI falls within the income limits, he is only entitled to a maximum \$2,500 deduction.

Student Loan Interest Deduction Worksheet—Line 33

Keep for Your Records



Before you begin: ✓ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).
 ✓ See the instructions for line 33 above.
 ✓ Be sure you have read the **Exception** above to see if you can use this worksheet instead of Pub. 970 to figure your deduction.

1. Enter the total interest you paid in 2005 on qualified student loans (see above). **Do not** enter more than \$2,500 **1.** 2,500
2. Enter the amount from Form 1040, line 22 **2.** 35,000
3. 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 **3.** _____
4. Subtract line 3 from line 2 **4.** 35,000
5. Enter the amount shown below for your filing status.
 - Single, head of household, or qualifying widow(er)—\$50,000
 - Married filing jointly—\$105,000
 } **5.** 50,000
6. Is the amount on line 4 more than the amount on line 5?
 - No.** Skip lines 6 and 7, enter -0- on line 8, and go to line 9.
 - Yes.** Subtract line 5 from line 4 **6.** _____
7. Divide line 6 by \$15,000 (\$30,000 if married filing jointly). Enter the result as a decimal (rounded to at least three places). If the result is 1.000 or more, enter 1.000 **7.** _____
8. Multiply line 1 by line 7 **8.** _____
9. **Student loan interest deduction.** Subtract line 8 from line 1. Enter the result here and on Form 1040, line 33. **Do not** include this amount in figuring any other deduction on your return (such as on Schedule A, C, E, etc.) **9.** 2,500

TUITION AND FEES DEDUCTION

Taxpayers can deduct an amount equal to the qualified tuition and related expenses paid during the tax year as an adjustment to income. The adjustment is reported on Form 1040, Line 34, or Form 1040A, Line 19.

To claim the deduction the taxpayer must have incurred **qualified expenses** for an **eligible student** to attend an **eligible educational institution** during the tax year. In addition, the taxpayer must include on the tax return the name and taxpayer identification number of the qualified student.

Qualified Expenses

Qualified tuition and related expenses include tuition and fees required for enrollment or attendance at an eligible educational institution and generally include fees for:

- Course-related books, supplies and equipment, and

The fees must be paid to the institution as a condition of enrollment or attendance.

Qualified tuition and related expenses do not include the cost of:

- Insurance,
- Medical expenses (including student health fees),
- Room and board,
- Student activities.
- Transportation or similar personal, living or family expenses, even if the fees must be paid to the institution as a condition of enrollment or attendance.
- Athletic fees.
- Other expenses unrelated to an individual's academic course of instruction.

Eligible Student

The deduction can be claimed for the taxpayer, the taxpayer's spouse (if filing a joint return) and any dependent (for whom the taxpayer claims a dependency exemption).

Married taxpayers that file as married filing separately cannot take the deduction.

An individual who is the dependent of another taxpayer cannot claim the deduction.

Eligible Educational Institution

An eligible educational institution is generally any accredited public, nonprofit, or private postsecondary institution eligible to participate in the student aid programs administered by the

Department of Education. It includes virtually all accredited, public, nonprofit, and privately owned profit-making post secondary institutions.

If the taxpayer does not know if the educational institution is an eligible institution, he or she should contact the school.

Deduction Amount

The deduction amount is determined by the taxpayer's filing status and adjusted gross income. Table 4 depicts when the income limitations apply.

The total amount of qualified tuition and related expenses are reduced by:

- Distributions from qualified state tuition programs
- Distributions from Coverdell ESAs
- Interest from savings bonds used for higher education expenses

Table 4

Limit on Tuition and Fees Deduction		
IF the taxpayer's filing status is	AND their modified AGI is	THEN their maximum tuition and fees deduction is...
Single, Head of Household, or Qualifying Widow(er)	not more than \$65,000	\$4,000
	more than \$65,000, but not more than \$80,000	\$2,000
	more than \$80,000	\$0
Married filing joint return	not more than \$130,000	\$4,000
	more than \$130,000 but not more than \$160,000	\$2,000
	more than \$160,000	\$0

Modified adjusted gross income for purposes of the deduction for qualified tuition and related fees is adjusted gross income before the deduction for qualified tuition and related fees and after adding back the following:

- Foreign earned income exclusion,
- Foreign housing exclusion or deduction,
- Exclusion of income for bona fide residents of Guam, Puerto Rico, American Samoa, or the Northern Mariana Islands.

Figuring the Deduction



Use the Tuition and Fees Deduction worksheet found in the Form 1040 or Form 1040A instructions to figure the modified adjusted gross income and the resulting deduction amount.

Example 15

Luis and Priscilla file a joint return for 2005. Their 1040 line 22 total income is \$49,620. In 2005, Priscilla paid \$1,300 for classes taken at the local university. She had allowable IRA deductions of \$1,500. Their allowable tuition and fees deduction is \$1,300, shown in Exhibit 6.

Exhibit 6

Luis and Priscilla's Tuition and Fees Deduction Worksheet

Tuition and Fees Deduction Worksheet—Line 34		<i>Keep for Your Records</i> 
Before you begin:		
✓	Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).	
✓	See the instructions for line 34 above.	
✓	Be sure you have read the Exception above to see if you can use this worksheet instead of Pub. 970 to figure your deduction.	
1.	Enter the amount from Form 1040, line 22	1. <u>49,620</u>
2.	Enter the total of the amounts from Form 1040, lines 23 through 33, plus any write-in adjustments you entered on the dotted line next to line 36	2. <u>1,500</u>
3.	Subtract line 2 from line 1. If the result is more than \$80,000 (\$160,000 if married filing jointly),  You cannot take the deduction for tuition and fees	3. <u>48,120</u>
4.	Tuition and fees deduction. Is the amount on line 3 more than \$65,000 (\$130,000 if married filing jointly)?	
<input type="checkbox"/>	Yes. Enter the total qualified tuition and fees (defined above) you paid in 2005. Do not enter more than \$2,000. Also, enter this amount on Form 1040, line 34.	} 4. <u>1,300</u>
<input checked="" type="checkbox"/>	No. Enter the total qualified tuition and fees (defined above) you paid in 2005. Do not enter more than \$4,000. Also, enter this amount on Form 1040, line 34.	

No Double Benefits

A taxpayer cannot:

- Deduct qualified tuition and related expenses if the same expense is deductible on a different line of the return.
- Claim the Hope Credit or the Lifetime Learning Credit for an individual in the same year as a deduction for qualified tuition and related expenses are claimed.
- Claim a credit based on expenses paid with a tax-free scholarship, grant, or an employer-provided educational assistance.

ONE-HALF OF SELF-EMPLOYMENT TAX

Report on Form 1040, Line 27, the adjustment for one-half of self-employment tax from Schedule SE. This subject was covered in Lesson 3, for volunteers who will be helping self-employed taxpayers.

PENALTY ON EARLY WITHDRAWAL OF SAVINGS

Depositors may withdraw funds from ordinary savings accounts any time they wish. However, if they withdraw funds from a time deposit (such as a certificate of deposit) before the maturity date, a penalty is charged. Form 1099-INT reports the interest earned as well as any early withdrawal penalties.

As you learned in Lesson 3, taxpayers must report the total amount of interest earned. They cannot subtract the early withdrawal penalty from the interest earned and report the difference. The early withdrawal penalty can be claimed as an adjustment only on Form 1040, Line 30. The entire penalty is deducted, even if it is greater than the interest income.

Example 16

Arlene has one Form W-2 and one Form 1099-INT and no other income. Her Form 1099-INT shows both interest income and an early withdrawal penalty. Arlene does not pay alimony, and she did not make a contribution to a traditional IRA. She will not itemize deductions, and she cannot claim any tax credits. Normally, she would be able to file Form 1040A.

However, Arlene must file Form 1040 to claim the adjustment for the penalty on early withdrawal of savings.

ALIMONY PAID

As you learned in Lesson 3, alimony and separate maintenance payments are taxable to the person receiving these payments. The person paying the alimony or separate maintenance can claim it as an adjustment to income. This adjustment can be claimed only on Form 1040. The amount paid during the year and the recipient's social security number are entered on Line 31a and 31b, respectively. Claim the adjustment only for amounts paid during the tax year.

Child support is not the same as alimony or separate maintenance payments. Child support is not taxable to the recipient and cannot be claimed as an adjustment by the payer.

JURY DUTY PAY GIVEN TO EMPLOYER

As you learned in Lesson 3, *Income*, jury duty pay received by taxpayers is included in other income on line 21 of Form 1040.

Some employees receive their regular wages from their employers when they are serving on a jury instead of working at their jobs. Often the jury duty pay the employees receive is turned over to their employers. The amount given to the employer may be claimed as an adjustment to income. On the dotted line next to Line 36, write "jury pay" and the amount. Include jury duty pay with the adjustments claimed on Lines 23 through 36.

OTHER ADJUSTMENTS

The other adjustments that can be claimed on Form 1040 are beyond the scope of the Volunteer Return Preparation Program. Taxpayers who have adjustments that aren't discussed in this lesson should be advised to seek paid professional tax assistance.

TOTAL ADJUSTMENTS AND ADJUSTED GROSS INCOME

Add all adjustments and enter the total on Form 1040A, line 20, or Form 1040, line 36. Subtract the total adjustments from total income on Form 1040A, line 15, or Form 1040, line 22. Enter the result on Form 1040A, line 21, or Form 1040, line 37. This is **adjusted gross income** and is often referred to as "**AGI**." Adjusted gross income is used to compute some limitations, such as the medical and dental deduction on Schedule A and the credit for child and dependent care expenses.

TAXWISE® HINTS

TaxWise® will quickly complete any worksheets needed to determine adjustments to income.

There is one worksheet for student loan interest deduction and tuition and fees deduction. You can link to this form from Form 1040, Lines 33 or 34.

Link to the Deductible and Non-deductible IRA Worksheet from Form 1040, Line 32. Once the IRA contribution is input for the taxpayer (and spouse if married), TaxWise® will complete the Form 8606, if necessary, and input the entry on Form 1040, Line 32.

One-half the self-employment tax will be entered automatically when completing Schedule C or C-EZ.

The penalty on withdrawal from savings should be entered by linking to the Interest Received Worksheet. This worksheet is a link from Schedule B.

TaxWise® breaks out the remaining adjustments. Simply input the appropriate amount.

▶▶ SUMMING UP THIS LESSON ◀◀

- An adjustment is an amount subtracted from total income. The result is adjusted gross income.
- Adjustments covered in the VITA program are:
 - ▶ Educator Expenses
 - ▶ Contributions to a traditional IRA
 - ▶ Student loan interest deduction
 - ▶ Tuition and fees paid
 - ▶ One-half of self-employment tax paid (volunteers trained to prepare Schedule C-EZ and SE can assist taxpayers claiming this adjustment)
 - ▶ Penalty on early withdrawal of savings
 - ▶ Alimony paid
 - ▶ Jury duty pay given to employer
 - ▶ The adjustments for traditional IRA contributions, student loan interest deduction, tuition and fees deduction, and educator expenses deduction can be claimed either on Form 1040A or Form 1040. The other adjustments can be claimed on Form 1040 only.
- Persons 70 1/2 years of age or older by the end of the tax year cannot make traditional IRA contributions for that tax year.
- Traditional IRA contributions generally cannot be more than the taxpayer's taxable compensation or \$4,000 (\$4,500 if age 50 or older), whichever amount is smaller.
- Individuals who are not covered by retirement plans at work may make deductible IRA contributions regardless of their modified adjusted gross income. Taxpayers who are covered by retirement plans at work may deduct all, part, or none of their traditional IRA contributions depending on their modified adjusted gross income and filing status.
- Taxpayers may be subject to additional tax for contributing more to a traditional IRA than is allowed, making traditional IRA withdrawals before age 59 1/2, and not withdrawing enough traditional IRA funds after 70 1/2.

Exercise 1

- (A) Yes; alimony is considered compensation for traditional IRA purposes.
- (B) Yes; But only if they file a joint return.
- (C) No; Carla has no compensation for traditional IRA purposes.
- (D) \$1,250; The lesser of taxable compensation or \$4,500.

Exercise 2

- (A) Yes; all of her contribution up to \$4,000 is deductible because their combined modified adjusted gross income is not more than \$150,000.
- (B) Yes; all of it is deductible because her modified adjusted gross income is less than \$50,000.
- (C) Richard may not deduct any of his contribution because his modified adjusted gross income is at least \$10,000. Lynn will be able to deduct a portion of her IRA contribution because she is not covered by an employer-sponsored retirement plan and her income is less than \$10,000.

ADJUSTMENTS TO INCOME



Exercise 3

Bill and Kathy's IRA Deduction Worksheet

IRA Deduction Worksheet—Line 32

Keep for Your Records 

Before you begin: ✓ Figure any write-in adjustments to be entered on the dotted line next to line 36 (see the instructions for line 36 on page 31).
 ✓ Be sure you have read the list on page 26.

	Your IRA	Spouse's IRA
1a. Were you covered by a retirement plan (see page 26)?	1a. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
1b. If married filing jointly, was your spouse covered by a retirement plan? <small>Next. If you checked "No" on line 1a (and "No" on line 1b if married filing jointly), skip lines 2 through 6, enter \$4,000 (\$43,500 if age 50 or older at the end of 2005) on line 7a (and 7b if applicable), and go to line 8. Otherwise, go to line 2.</small>		1b. <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
2. Enter the amount shown below that applies to you. <ul style="list-style-type: none"> • Single, head of household, or married filing separately and you lived apart from your spouse for all of 2005, enter \$60,000 • Qualifying widow(er), enter \$80,000 • Married filing jointly, enter \$80,000 in both columns. But if you checked "No" on either line 1a or 1b, enter \$160,000 for the person who was not covered by a plan • Married filing separately and you lived with your spouse at any time in 2005, enter \$10,000 	2a. <u>80,000</u>	2b. <u>160,000</u>
3. Enter the amount from Form 1040, line 22	3. <u>30,000</u>	
4. Enter the total of the amounts from Form 1040, lines 23 through 31a, plus any write-in adjustments you entered on the dotted line next to line 36	4. _____	
5. Subtract line 4 from line 3. Enter the result in both columns	5a. <u>30,000</u>	5b. <u>30,000</u>
6. Is the amount on line 5 less than the amount on line 2? <input type="checkbox"/> No.  None of your IRA contributions are deductible. For details on nondeductible IRA contributions, see Form 8606. <input checked="" type="checkbox"/> Yes. Subtract line 5 from line 2 in each column. If the result is \$10,000 or more, enter \$4,000 (\$4,500 if age 50 or older at the end of 2005) on line 7 for that column and go to line 8. Otherwise, go to line 7	6a. <u>50,000</u>	6b. <u>130,000</u>
7. Multiply lines 6a and 6b by 40% (.40) (or by 45% (.45) in the column for the IRA of a person who is age 50 or older at the end of 2005). If the result is not a multiple of \$10, increase it to the next multiple of \$10 (for example, increase \$490.30 to \$500). If the result is \$200 or more, enter the result. But if it is less than \$200, enter \$200	7a. <u>4,000</u>	7b. <u>4,000</u>
8. Enter your wages, and your spouse's if filing jointly, and other earned income from Form 1040, minus any deductions on Form 1040, lines 27 and 28. Do not reduce wages by any loss from self-employment	8. <u>30,000</u>	
<div style="display: flex; align-items: center;">  <p><i>If married filing jointly and line 8 is less than \$8,000 (\$8,500 if one spouse is age 50 or older at the end of 2005; \$9,000 if both spouses are age 50 or older at the end of 2005), stop here and see Pub. 590 to figure your IRA deduction.</i></p> </div>		
9. Enter traditional IRA contributions made, or that will be made by April 17, 2006, for 2005 to your IRA on line 9a and to your spouse's IRA on line 9b	9a. <u>2,000</u>	9b. <u>400</u>
10. On line 10a, enter the smallest of line 7a, 8, or 9a. On line 10b, enter the smallest of line 7b, 8, or 9b. This is the most you can deduct. Add the amounts on lines 10a and 10b and enter the total on Form 1040, line 32. Or, if you want, you can deduct a smaller amount and treat the rest as a nondeductible contribution (see Form 8606)	10a. <u>2,000</u>	10b. <u>400</u>



You may be able to take the retirement savings contributions credit. See the instructions for line 51 on page 36.



Military/International students continue.

All others go to Lesson 11.

INTRODUCTION AND OBJECTIVES

This segment covers the moving expenses of military personnel. When a member of the Armed Forces is transferred to a new permanent duty station he or she may deduct certain moving expenses.

In preparing returns for the military, you will need to:

- Identify qualifying moves by assisting in determining if the move qualifies as a permanent change of station (PCS).
- Determine when allowances and reimbursements must be included in income.
- Identify deductible moving expenses.
- Compute the moving expense deduction using Form 3903, Moving Expenses, for moves within and outside the United States.

PERMANENT CHANGE OF STATION

For military moves, only expenses incurred as a result of a permanent change of station are deductible. A permanent change of station includes:

- A move from home to the area of the first post of duty.
- A move from one permanent post of duty to another.
- A move from the last post of duty to home or to a nearer point in the United States. The member must move within one year of ending active duty or within the period allowed under the Joint Travel Regulations.

Spouse and dependents. If a member of the Armed Forces deserts, is imprisoned, or dies, a permanent change of station for the spouse or dependents includes a move to the place of enlistment, the home of record, or any nearer point in the United States.

If the Armed Forces moves a member and his or her spouse or dependents to or from separate locations, the moves are treated as a single move to the member's post of duty. The qualified expenses of both moves are combined and deducted on the same tax return.

Exercise 1

Which of the following is a permanent change of station?

- A.** A move by an Air Force pilot to an airbase for a 6-month detail.
- B.** A move by an Army sergeant to his home 2 years after he ended active duty.
- C.** A move by a new enlistee from her home to her first post of duty.

Answer _____

REQUIREMENTS

The moving expense deduction includes only expenses that are reasonable for the circumstances of the move. For example, the costs of any side trips for sightseeing are not deductible. The cost of lavish and extravagant lodging also is not deductible.

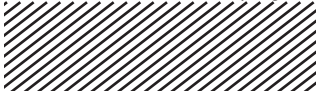
Although civilians must meet a distance test and a time test to deduct moving expenses, members of the military can disregard such tests for moves required by a permanent change of station.

PAYMENTS IN KIND, ALLOWANCES, AND REIMBURSEMENTS

The service member must include in gross income any payments he or she receives from the government for a do-it-yourself (DITY) permanent change of station (PCS) move. A DITY move payment is based on government estimates of the cost to move household goods, not on actual expenses and receipts. The service member will receive a separate Form W-2 for the DITY payment. The amount in box 1 of the Form W-2 must be included on line 7 of Form 1040. He or she must also complete Form 3903 to compute total qualified moving expenses that can be deducted on line 26, Form 1040. These line 7 and line 26 entries on Form 1040 will report the income and applicable related expenses for the move on the Form 1040.

The service member does not include any of the following in his or her gross income.

- Moving or storage services furnished to the member.
- Non-taxable allowances such as:
 - Dislocation allowance
 - Temporary Lodging Allowance
 - Mileage Allowance in Lieu of Transportation
 - Per Diem Allowance



Generally, if total reimbursements or allowances received by the service member are more than his or her qualified moving expenses, the excess will be included with his or her wages in box 1 of Form W-2. However, if reimbursements or allowances (other than nontaxable allowances like the ones listed above) exceed the cost of moving and they are not included in the Form W-2, the service member must still include the excess on line 7 of Form 1040.

Use Form 3903 to deduct qualified expenses that exceed reimbursements and allowances (including nontaxable allowances like the ones listed above).

Exercise 2

- A.** A member of the Armed Forces must include in gross income all reimbursements, allowances, and the value of moving and storage services that the military organization furnishes. True or false?

Answer _____

- B.** If a member of the Armed Forces receives reimbursements or allowances (that are not excludable from gross income) in excess of the actual moving expenses, he or she must include in income only the amount that exceeds actual expenses. True or false?

Answer _____

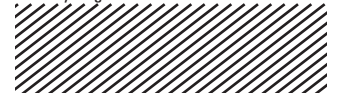
DEDUCTIBLE MOVING EXPENSES

Any qualifying moving expenses that exceed allowances or reimbursements from the government are deductible.

Members of the military will need to determine whether they have excess expenses and, if so, whether the expenses are deductible on their federal tax return.

Qualifying moving expenses are:

- **The cost of moving household goods and personal effects**, including hauling a trailer and packing, storage, and insurance. It does not include the expense of moving furniture or other goods that the taxpayer bought on the way from the old home to the new home.
- **The cost of reasonable travel and lodging expenses** from the old home to the new home, including actual automobile expenses (or 15 cents per mile for the first eight months of 2005 and 22 cents per mile for September 1, 2005 through December 31, 2005), airfare, and lodging for the taxpayer and members of his or her household. Members cannot deduct the cost of meals while traveling from the old home to the new home.



Foreign moves. A foreign move is one from the United States or its possessions to a foreign country or from one foreign country to another. It is not a move from a foreign country to the United States or its possessions.

Exercise 3

Which of the following are deductible moving expenses for Major Boone? (Assume the member received no reimbursements from the government.)

- A. Payment to Fulton Construction Company for home improvements made to Major Boone's former home.
- B. Security deposit to Towner Apartments on the Boones new apartment.
- C. Commission to Mercer Real Estate for the sale of the Boones' former home.
- D. Payment to Shelby Transport Company to ship a piano that the Boones bought on the way to their new home.
- E. Cost of transporting Major Boone's second car to the new job location.
- F. Payment for meals while on the way to the new permanent duty station.

Answer _____

REPORTING MOVING EXPENSES

Moving expenses are deductible as an adjustment to income on Form 1040, line 26. Only deductible expenses that are more than reimbursements and allowances can be claimed.

If the service member was not reimbursed, he or she can deduct allowable moving expenses either in the year incurred and paid or in the year they were paid.

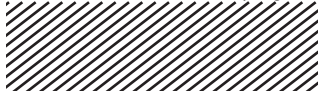
If the member was reimbursed for expenses, he or she can deduct allowable expenses either in the year incurred or in the year paid

If the member uses the cash method of accounting, which is used by most individuals, he or she can choose to deduct moving expenses in the year of reimbursement if:

- (1) The expenses were paid in a year before the year of reimbursement, or
- (2) The expenses were paid in the year immediately after the year of reimbursement but by the due date, including extensions, for filing his or her return for the reimbursement year.

Moving expenses are reported on Form 3903, *Moving Expenses*. For more information, see Publication 521, *Moving Expenses*.

The following example illustrates applications of the rules discussed in this lesson.



Example

Capt. Shirley M. Holmes (SSN 000-00-9876) transferred in 2005 from one base to another. The government reimbursed her \$350 for her travel and lodging expenses on the way to her new job location. The travel and lodging reimbursements were not reported as income on Form W-2. The \$5,000 expense for transporting her household goods was furnished in kind by the military. No other reimbursements or allowances were made.

Capt. Holmes incurred the following expenses:

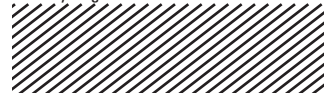
Travel and lodging en route – \$500

The moving expense is computed on Form 3903 as follows:

Exhibit 1

Form 3903

<p>Form 3903</p> <p>Department of the Treasury Internal Revenue Service</p>	<p>Moving Expenses</p> <p>► Attach to Form 1040.</p>	<p>OMB No. 1545-0062</p> <p>2005</p> <p>Attachment Sequence No. 62</p>
<p>Name(s) shown on Form 1040 <u>Shirley M. Holmes</u></p>		<p>Your social security number <u>000:00:9876</u></p>
<p>Before you begin: ✓ See the Distance Test and Time Test in the instructions to find out if you can deduct your moving expenses. ✓ See Members of the Armed Forces on the back of the form, if applicable.</p>		
<p>1 Transportation and storage of household goods and personal effects (see instructions)</p> <p>2 Travel (including lodging) from your old home to your new home (see instructions). Do not include the cost of meals</p> <p>3 Add lines 1 and 2</p> <p>4 Enter the total amount your employer paid you for the expenses listed on lines 1 and 2 that is not included in box 1 of your Form W-2 (wages). This amount should be shown in box 12 of your Form W-2 with code P</p> <p>5 Is line 3 more than line 4?</p> <p><input type="checkbox"/> No. You cannot deduct your moving expenses. If line 3 is less than line 4, subtract line 3 from line 4 and include the result on Form 1040, line 7.</p> <p><input checked="" type="checkbox"/> Yes. Moving expense deduction. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 26</p>	<p>1</p> <p>2</p> <p>3</p> <p>4</p> <p>5</p>	<p></p> <p>500</p> <p>500</p> <p>350</p> <p>150</p>



Note: The \$5,000 expense for transporting her household goods was not included because the Armed Forces paid for this service.

The travel and lodging expenses for moving from the old home to the new home are shown on Line 2 of Form 3903.

Reimbursements are shown on Line 4.

To figure the moving expense deduction on Form 3903, subtract the total reimbursements on Line 4 from the amount on line 3. Check the "Yes" box and enter the result on Line 5 and on Form 1040, Line 26.

Exercise 4

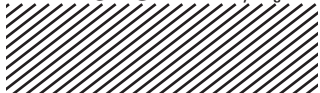
Greg T. (SSN 000-00-4567) and Diane E. Coe are filing a joint return. Greg T. Coe, an airman in the Air Force, was transferred from Maxwell Air Force Base to Scott Air Force Base. The government reimbursed Greg \$400 for travel expenses incurred on the way to his new job location. He also received a \$1,000 dislocation allowance. The travel and lodging reimbursements and the dislocation allowance were not reported as wages on Form W-2. Using the following information furnished by the Coes, complete Form 3903.

Dislocation expenses:	\$ 1,000
Travel and lodging en route:	\$ 575
Meals en route:	\$ 200
Security deposit for new apartment:	\$ 350

Exhibit 2

Form 3903

Form 3903 Department of the Treasury Internal Revenue Service	Moving Expenses ▶ Attach to Form 1040.	OMB No. 1545-0062 2005 Attachment Sequence No. 62
Name(s) shown on Form 1040		Your social security number
<p>Before you begin: ✓ See the Distance Test and Time Test in the instructions to find out if you can deduct your moving expenses. ✓ See Members of the Armed Forces on the back of the form, if applicable.</p>		
1 Transportation and storage of household goods and personal effects (see instructions)	1	
2 Travel (including lodging) from your old home to your new home (see instructions). Do not include the cost of meals	2	
3 Add lines 1 and 2	3	
4 Enter the total amount your employer paid you for the expenses listed on lines 1 and 2 that is not included in box 1 of your Form W-2 (wages). This amount should be shown in box 12 of your Form W-2 with code P	4	
5 Is line 3 more than line 4? <input type="checkbox"/> No. You cannot deduct your moving expenses. If line 3 is less than line 4, subtract line 3 from line 4 and include the result on Form 1040, line 7. <input type="checkbox"/> Yes. Moving expense deduction. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 26	5	

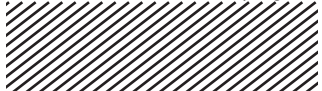


1. c.
2. a. False
b. True
3. e.
4. See completed Form 3903. The Coes are entitled to a \$175 moving expense deduction. Only the travel and lodging en route can be claimed on Form 3903, line 2. The security deposit and the meals are not deductible expenses. In addition, the dislocation allowance is netted against dislocation expenses. Only if the dislocation expenses exceeded the dislocation allowance would the Coes have reported the difference as an additional moving expense on Form 3903.

▶▶ SUMMING UP THIS SEGMENT ◀◀

In this segment you learned what moves qualify for tax benefits, what expenses are deductible, and how to use Form 3903 to compute the moving expense deduction. These expenses are deductible as an adjustment to income on Form 1040, line 26.

Form 3903 Department of the Treasury Internal Revenue Service	Moving Expenses ▶ Attach to Form 1040.	OMB No. 1545-0062 2005 Attachment Sequence No. 62															
Name(s) shown on Form 1040: Greg T. and Diane E. Coe		Your social security number: 000;00;4567															
<p>Before you begin: ✓ See the Distance Test and Time Test in the instructions to find out if you can deduct your moving expenses. ✓ See Members of the Armed Forces on the back of the form, if applicable.</p>																	
<p>1 Transportation and storage of household goods and personal effects (see instructions)</p> <p>2 Travel (including lodging) from your old home to your new home (see instructions). Do not include the cost of meals</p> <p>3 Add lines 1 and 2</p> <p>4 Enter the total amount your employer paid you for the expenses listed on lines 1 and 2 that is not included in box 1 of your Form W-2 (wages). This amount should be shown in box 12 of your Form W-2 with code P</p> <p>5 Is line 3 more than line 4?</p> <p><input type="checkbox"/> No. You cannot deduct your moving expenses. If line 3 is less than line 4, subtract line 3 from line 4 and include the result on Form 1040, line 7.</p> <p><input checked="" type="checkbox"/> Yes. Moving expense deduction. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 26</p>	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 20px; text-align: center;">1</td><td style="width: 60px;"></td><td style="width: 60px;"></td></tr> <tr><td style="text-align: center;">2</td><td style="text-align: right;">575</td><td></td></tr> <tr><td style="text-align: center;">3</td><td style="text-align: right;">575</td><td></td></tr> <tr><td style="text-align: center;">4</td><td style="text-align: right;">400</td><td></td></tr> <tr><td style="text-align: center;">5</td><td style="text-align: right;">175</td><td></td></tr> </table>	1			2	575		3	575		4	400		5	175		
1																	
2	575																
3	575																
4	400																
5	175																



INTRODUCTION AND OBJECTIVES

This lesson covers pensions, annuities, social security benefits, railroad retirement benefits and individual retirement arrangements.

After completing this lesson, you should be able to:

- Determine the taxable portion of different types of retirement income
- Determine how to report retirement income on the tax return
- Explain when a minimum distribution is required
- Determine when an adjustment to withholding should be made

This lesson will refer to forms that are used to report pension and annuity income. The most current version of each form is available at www.irs.gov (Note: Railroad Retirement and Social Security forms are not available on this site.)

This Lesson contains Intermediate and Advanced tax law course topics. Pensions, where the taxable amount has been determined, Social Security and Tier 1 Railroad Retirement Benefits, and the Withholding topics are included in the Intermediate course. All the other Pension and Retirement Income topics covered in this Lesson are part of the Advanced course.

PENSIONS AND ANNUITIES

Pensions and annuities provide cash payments, usually after a person has retired. The payments may be for life or a fixed period of time. They may begin at retirement or at a specific age.

- A **pension** is generally a series of definitely determinable payments made to an employee or survivor (the beneficiary of a deceased employee's pension) after the employee retires from work. Payments are made regularly and are for past services with an employer.
- An **annuity** is a series of payments under a contract from an insurance company, a trust company, or an individual. Annuity payments are made at regular intervals over a period of more than one full year.

ALERT



This lesson contains intermediate and advanced tax law. Your course facilitator will only teach the information required to assist taxpayers you will serve.

POTENTIAL PITFALLS



While the software will do an excellent job of calculating the return, you are the key to determining the correct tax treatment of your customer's pension or annuity income. As you work through this lesson, note what questions you may need to ask your customer. A thorough interview can help eliminate common errors.

POTENTIAL PITFALLS



Retirement distributions for civil service retirees may appear on Form CSA-1099. Retirement distributions for railroad retirees are reported on RRB-1099 forms (covered later in this lesson).

- A **qualified employee plan** is an employer's stock bonus, pension or profit-sharing plan that is for the exclusive benefit of employees. The plan must meet Internal Revenue Code requirements. Most plans that you will be working with will be qualified plans.
- A **401(k) plan** is an arrangement that permits an employee to elect to have the employer contribute part of the employee's cash wages to a retirement plan on a pre-tax basis. These deferred wages are not subject to income tax withholding at the time of deferral. The deferred wages are not reflected on Form 1040 since they are not includable in taxable wages of box 1, Form W-2. (However, they are included as wages subject to social security, Medicare, and federal unemployment taxes.)

The most common form used to report pension and annuity distributions is **Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts etc.** This lesson will help you understand how to treat the amounts listed on the Form 1099-R.

PENSIONS AND ANNUITIES – FULLY OR PARTIALLY TAXABLE

A pension is fully or partially taxable depending on whether the employee contributed to the pension plan. Employee contributions are “after-tax” amounts that the employee paid into the pension fund. The employer usually deducts the contributions from wages and deposits them into the pension fund on behalf of the employee. Each year, the employee pays tax on the amount that he or she contributed to the pension that year. The employee's contributions are included in his or her Form W-2. Employee contributions are often referred to as the **cost** of the pension or as the **investment** in the annuity contract. For pensions discussed here, the employer will also have contributed to the pension fund.

■ **Fully Taxable Pensions**

If a taxpayer receives periodic payments of retirement benefits in the form of pension or annuity payments from a qualified employer retirement plan, the amounts received may be fully taxable or partially taxable. Periodic payments are amounts paid at regular intervals for a period of time greater than one year.

Generally, if the taxpayer did not contribute to the cost of the pension plan, the pension benefits received are fully taxable. Military pensions are noncontributory and, therefore, fully taxable.

(Note: If the taxpayer participates in the uniformed services Thrift Savings Plan, their account may include contributions from combat zone pay. This pay is tax-exempt and contributions attributable to that pay are tax-exempt when they are distributed.)

Fully taxable pension payments are reported on line 16b, Form 1040, or line 12b, Form 1040A. You should make no entry on line 16a, Form 1040, or line 12a, Form 1040A.

■ Partially Taxable Pensions and Annuities

If a taxpayer contributed to a pension plan with after-tax dollars while employed, part of the pension received is a return of the income taxed in earlier years and, therefore, is nontaxable. If the taxpayer has paid tax on the pension contribution (it was included in wages), the amount contributed to the pension is not taxed again when the pension is received.

For periodic payments that began after 1992, the payer is required to enter the taxpayer's contributions to a profit-sharing or retirement plan, or insurance premiums that the taxpayer may recover tax-free this year in box 5, Form 1099-R.

Example 1

Rudy retired from The Mart in 2003. He started receiving pension payments in October, 2003. His 2005 Form 1099-R shows an amount of \$2,043 in box 5. This is the amount of his 2005 payments that are considered a recovery of his cost. He will not include this portion of the payment in his income.

If the payer is unable to reasonably obtain the data necessary to compute the taxpayer's cost, box 5 can be left blank.

Exercise 1

Wanda retired from the flour company in 2004. She receives a monthly pension of \$1,000 from her former employer's pension plan. She shows you her 2005 Form 1099-R. The amount in box 5 is \$892. How much of Wanda's 2005 distribution is considered a recovery of her cost in the plan? _____

In the next section, you will learn how to determine the taxable portion of a partially taxable pension or annuity when the payer has not determined the taxable portion of the payment.



Advanced students continue.

Intermediate students go to page 11-15
(Social Security and Tier 1 Railroad Retirement Benefits).

DETERMINING TAXABLE RETIREMENT INCOME

If the taxpayer has a cost to recover from the pension or annuity plan, he or she can exclude part of each annuity payment from income as a recovery of cost, until all of the cost has been recovered. The tax-free part of the payment is figured when the annuity starts and remains the same each year, even if the amount of the payment changes.

The Simplified Method for Figuring Taxable Retirement Income

If the taxpayer's annuity starting date is after November 18, 1996, generally the Simplified Method must be used to figure the taxable portion of the pension if the taxpayer participated in a qualified plan.

If the payer does not calculate the taxable portion of the distribution, you will need to complete a **Simplified Method Worksheet** if this is the first year of the distribution. The tax-free amount remains the same each month, even if the amount of the payment changes.

The **Simplified Method Worksheet** requires that you figure the tax-free part of each annuity payment by dividing the taxpayer's cost (or investment) by the total number of anticipated monthly payments. The number of anticipated monthly payments is based on the annuitant's age when the payments start and is determined from a table that is included in the worksheet.

Example 2

Peter, age 65, receives retirement benefits under a joint and survivor annuity, to be paid over the joint lives of Peter and his wife, Mary, age 62. Peter's annuity starting date is January 1, 2005. He contributed \$31,000 to a qualified plan and did not receive any distributions before the annuity starting date. Peter receives monthly payments of \$1,200 and his tax-free monthly amount is \$100. Mary will receive monthly survivor benefits of \$600 upon her husband's death. See Exhibit 1 for a completed Simplified Method Worksheet for Peter.

Use the Simplified Method for Peter because his annuity starting date is after November 18, 1996, and the payments are from a qualified plan. In addition, because his annuity is payable over the lives of more than one annuitant, you must combine his age with his wife's age in completing line 3 of the worksheet.

Exhibit 1 – Peter's Simplified Method Worksheet

Simplified Method Worksheet—Lines 16a and 16b		<i>Keep for Your Records</i>																		
<p>Before you begin: ✓ If you are the beneficiary of a deceased employee or former employee who died before August 21, 1996, include any death benefit exclusion that you are entitled to (up to \$5,000) in the amount entered on line 2 below.</p> <p>Note. If you had more than one partially taxable pension or annuity, figure the taxable part of each separately. Enter the total of the taxable parts on Form 1040, line 16b. Enter the total pension or annuity payments received in 2005 on Form 1040, line 16a.</p>																				
<p>1. Enter the total pension or annuity payments received in 2005. Also, enter this amount on Form 1040, line 16a</p>	<p>1. <u>14,400</u></p>																			
<p>2. Enter your cost in the plan at the annuity starting date</p>	<p>2. <u>31,000</u></p>																			
<p>3. Enter the appropriate number from Table 1 below. But if your annuity starting date was after 1997 and the payments are for your life and that of your beneficiary, enter the appropriate number from Table 2 below</p>	<p>3. <u>310</u></p>																			
<p>4. Divide line 2 by the number on line 3</p>	<p>4. <u>100</u></p>																			
<p>5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was before 1987, skip lines 6 and 7 and enter this amount on line 8. Otherwise, go to line 6</p>	<p>5. <u>1,200</u></p>																			
<p>6. Enter the amount, if any, recovered tax free in years after 1986</p>	<p>6. <u>0</u></p>																			
<p>7. Subtract line 6 from line 2</p>	<p>7. <u>31,000</u></p>																			
<p>8. Enter the smaller of line 5 or line 7</p>	<p>8. <u>1,200</u></p>																			
<p>9. Taxable amount. Subtract line 8 from line 1. Enter the result, but not less than zero. Also, enter this amount on Form 1040, line 16b. If your Form 1099-R shows a larger amount, use the amount on this line instead of the amount from Form 1099-R</p>	<p>9. <u>13,200</u></p>																			
<p>Table 1 for Line 3 Above</p> <p style="text-align: center;">AND your annuity starting date was—</p> <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left; border-bottom: 1px solid black; padding: 5px;">IF the age at annuity starting date (see above) was . . .</th> <th style="text-align: center; border-bottom: 1px solid black; padding: 5px;">before November 19, 1996, enter on line 3 . . .</th> <th style="text-align: center; border-bottom: 1px solid black; padding: 5px;">after November 18, 1996, enter on line 3 . . .</th> </tr> </thead> <tbody> <tr> <td style="padding: 5px;">55 or under</td> <td style="text-align: center; padding: 5px;">300</td> <td style="text-align: center; padding: 5px;">360</td> </tr> <tr> <td style="padding: 5px;">56–60</td> <td style="text-align: center; padding: 5px;">260</td> <td style="text-align: center; padding: 5px;">310</td> </tr> <tr> <td style="padding: 5px;">61–65</td> <td style="text-align: center; padding: 5px;">240</td> <td style="text-align: center; padding: 5px;">260</td> </tr> <tr> <td style="padding: 5px;">66–70</td> <td style="text-align: center; padding: 5px;">170</td> <td style="text-align: center; padding: 5px;">210</td> </tr> <tr> <td style="padding: 5px;">71 or older</td> <td style="text-align: center; padding: 5px;">120</td> <td style="text-align: center; padding: 5px;">160</td> </tr> </tbody> </table>			IF the age at annuity starting date (see above) was . . .	before November 19, 1996, enter on line 3 . . .	after November 18, 1996, enter on line 3 . . .	55 or under	300	360	56–60	260	310	61–65	240	260	66–70	170	210	71 or older	120	160
IF the age at annuity starting date (see above) was . . .	before November 19, 1996, enter on line 3 . . .	after November 18, 1996, enter on line 3 . . .																		
55 or under	300	360																		
56–60	260	310																		
61–65	240	260																		
66–70	170	210																		
71 or older	120	160																		
<p>Table 2 for Line 3 Above</p> <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left; border-bottom: 1px solid black; padding: 5px;">IF the combined ages at annuity starting date (see above) were . . .</th> <th style="text-align: center; border-bottom: 1px solid black; padding: 5px;">THEN enter on line 3 . . .</th> </tr> </thead> <tbody> <tr> <td style="padding: 5px;">110 or under</td> <td style="text-align: center; padding: 5px;">410</td> </tr> <tr> <td style="padding: 5px;">111–120</td> <td style="text-align: center; padding: 5px;">360</td> </tr> <tr> <td style="padding: 5px;">121–130</td> <td style="text-align: center; padding: 5px;">310</td> </tr> <tr> <td style="padding: 5px;">131–140</td> <td style="text-align: center; padding: 5px;">260</td> </tr> <tr> <td style="padding: 5px;">141 or older</td> <td style="text-align: center; padding: 5px;">210</td> </tr> </tbody> </table>			IF the combined ages at annuity starting date (see above) were . . .	THEN enter on line 3 . . .	110 or under	410	111–120	360	121–130	310	131–140	260	141 or older	210						
IF the combined ages at annuity starting date (see above) were . . .	THEN enter on line 3 . . .																			
110 or under	410																			
111–120	360																			
121–130	310																			
131–140	260																			
141 or older	210																			

After Peter excludes \$31,000 from taxable income, the rest of his retirement benefits will be fully taxable. Because this is a joint and survivor annuity, if Peter dies before recovering all of the pension cost, his wife will also exclude \$100 from her \$600 monthly payment until the pension cost is fully recovered. If she dies before recovering all of the pension cost, the remaining unrecovered cost will be deducted on her final income tax return as a miscellaneous itemized deduction on Schedule A (Form 1040) (not subject to the 2-percent of adjusted-gross-income limitation).

Note: The Simplified Method Worksheet is part of the 1099R input screen in the TaxWise® software. Scroll to the bottom of the input screen to see the worksheet.

Exercise 2

George, age 65, began receiving pension income under a joint and survivor annuity. George's annuity starting date is January 1, 2005. George had contributed \$26,000 to a qualified plan and had received no distribution before 2005. George is to receive a monthly retirement benefit of \$1,000 and his wife, age 68, is to receive a monthly survivor benefit of \$500 upon George's death. Using the 2005 Form 1099-R (Exhibit 2) for George, complete the Simplified Method Worksheet (Exhibit 3).

Exhibit 2 – George's Form 1099-R

<input type="checkbox"/> CORRECTED (if checked)		OMB No. 1545-0119		2005 Form 1099-R	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
PAYER'S name, street address, city, state, and ZIP code The Company 1 Maple Square Your City, State Zip		1 Gross distribution \$ 12,000	2a Taxable amount \$		
PAYER'S Federal identification number XX-XXXXXXX		2b Taxable amount not determined <input checked="" type="checkbox"/> Total distribution <input type="checkbox"/>			
RECIPIENT'S identification number XXX-XX-XXXX		3 Capital gain (included in box 2a) \$	4 Federal income tax withheld \$		Copy B Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.
RECIPIENT'S name George Lincoln		5 Employee contributions or insurance premiums \$	6 Net unrealized appreciation in employer's securities \$		
Street address (including apt. no.) 123 Calhoun Ave City, state, and ZIP code Your City, State Zip		7 Distribution code(s) 7 7	IRA/SEP/SIMPLE <input type="checkbox"/>	8 Other \$ %		This information is being furnished to the Internal Revenue Service.
Account number (see instructions)		9a Your percentage of total distribution %	9b Total employee contributions \$ 26,000.00		
State tax withheld \$		11 State/Payer's state no.		12 State distribution \$	
Local tax withheld \$		14 Name of locality		15 Local distribution \$	

Form **1099-R**

Department of the Treasury - Internal Revenue Service

Exhibit 3 – George’s Simplified Method Worksheet

Keep for Your Records 

Simplified Method Worksheet—Lines 16a and 16b

Before you begin: ✓ If you are the beneficiary of a deceased employee or former employee who died **before** August 21, 1996, include any death benefit exclusion that you are entitled to (up to \$5,000) in the amount entered on line 2 below.

Note. If you had more than one partially taxable pension or annuity, figure the taxable part of each separately. Enter the total of the taxable parts on Form 1040, line 16b. Enter the total pension or annuity payments received in 2005 on Form 1040, line 16a.

1. Enter the total pension or annuity payments received in 2005. Also, enter this amount on Form 1040, line 16a **1.** _____
2. Enter your cost in the plan at the annuity starting date **2.** _____
3. Enter the appropriate number from **Table 1** below. **But** if your annuity starting date was **after** 1997 **and** the payments are for your life and that of your beneficiary, enter the appropriate number from **Table 2** below **3.** _____
4. Divide line 2 by the number on line 3 **4.** _____
5. Multiply line 4 by the number of months for which this year’s payments were made. If your annuity starting date was **before** 1987, skip lines 6 and 7 and enter this amount on line 8. Otherwise, go to line 6 **5.** _____
6. Enter the amount, if any, recovered tax free in years after 1986 **6.** _____
7. Subtract line 6 from line 2 **7.** _____
8. Enter the **smaller** of line 5 or line 7 **8.** _____
9. **Taxable amount.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also, enter this amount on Form 1040, line 16b. If your Form 1099-R shows a larger amount, use the amount on this line instead of the amount from Form 1099-R **9.** _____

Table 1 for Line 3 Above

IF the age at annuity starting date (see above) was . . .	AND your annuity starting date was—	
	before November 19, 1996, enter on line 3 . . .	after November 18, 1996, enter on line 3 . . .
55 or under	300	360
56–60	260	310
61–65	240	260
66–70	170	210
71 or older	120	160

Table 2 for Line 3 Above

IF the combined ages at annuity starting date (see above) were . . .	THEN enter on line 3 . . .
110 or under	410
111–120	360
121–130	310
131–140	260
141 or older	210

Reporting Retirement Income

It is important that you enter the retirement income on the correct line of the tax return. Tax software will make the correct entries if you input the income information correctly.

Type of Retirement Income	Form 1040A Line(s)	Form 1040 Line(s)
Fully taxable IRA distribution	11b	15b
Nontaxable IRA Rollover	11a & 11b (zero)	15a & 15b (zero)
Fully taxable pension or annuity	12b	16b
Partially taxable pension or annuity	12a & 12b	16a & 16b
Social Security and RRB Tier 1 No portion subject to tax	14b (zero) if filing separate and did not live with spouse	20b (zero) if filing separate and did not live with spouse
Partially taxable Social Security and RRB Tier 1	14a & 14b	20a & 20b

Disability pension income

If the taxpayer retired on disability, he or she generally must include in income any disability pension received under a plan that is paid for by the employer. Taxable disability payments are treated as wages (and entered on line 7 of the Form 1040 or Form 1040A) until the taxpayer reaches minimum retirement age. The minimum retirement age generally is the age at which the taxpayer could first receive a pension or annuity, from that employer, if he or she was not disabled. (The payer may report the disability income on a Form W-2 or a Form 1099-R with code 3 in box 7.)

Example 3

Jason, age 41, retired on permanent and total disability in August due to multiple sclerosis. He received \$700 per month (starting in August) from a plan for which his employer paid. Jason received \$10,000 in wages from January 1 until his disability retirement. Jason will report the following income on line 7 of his tax return:

Wages	\$10,000
Disability (5 x \$700)	<u>3,500</u>
Total	\$ 13,500

When Jason reaches minimum retirement age, the monthly amount will no longer be treated as wages; it will be considered pension income.

Lump-sum Distributions

A **lump-sum distribution** is the distribution or payment within one tax year of an employee's entire balance (less deductible voluntary employee contributions and certain amounts forfeited or subject to forfeiture) from all qualified pension, stock bonus, or profit-sharing plans that the employer maintains.

If the taxpayer received a lump-sum distribution from a qualified retirement plan or a qualified retirement annuity and the plan participant was born before 1936, the taxpayer may be able to elect optional methods of figuring the tax on the distribution. These optional methods can be elected only once after 1986 for any eligible plan participant. **If the plan participant was born after January 2, 1936, the elections for lump-sum distributions do not apply.**

Usually, lump-sum distributions are reported on Form 1099-R. Some lump-sum distributions qualify for special tax treatments. Code A in box 7 of the 1099-R indicates that it is a lump-sum distribution and it may qualify for special tax treatments. The application of the special tax treatment is beyond the scope of the volunteer program. Suggest that the taxpayer seek the assistance of a paid tax preparer.

Minimum Required Distributions

To make sure that most retirement benefits are paid during the taxpayer's lifetime, rather than to the taxpayer's beneficiaries, payments from qualified retirement plans (other than Roth IRAs) must begin no later than the **required beginning date**.

Generally, the **required beginning date** is April 1 of the year following the later of:

- The calendar year in which the taxpayer reached age 70 ½, or
- The calendar year in which the taxpayer retired from employment with the employer maintaining the plan.

By the required beginning date, the taxpayer must either receive their entire interest in the plan or begin receiving periodic distributions based on life expectancy. The amount that must be taken out is known as the **minimum required distribution**.

The minimum required distribution is:

- The entire amount in the pension plan, or
- Regular periodic distributions in an amount large enough to use up the entire amount in the pension plan over:
 1. The taxpayer's life expectancy,
 2. The joint life expectancies of the taxpayer and a designated surviving beneficiary, or
 3. A shorter period of time than these life expectancies.

IMPORTANT! If the taxpayer does not receive the minimum required distribution, an excise tax may be imposed. The tax is 50 percent of the difference between the minimum distribution and the amount actually distributed for the tax year.

Individual Retirement Arrangement (IRA) Distributions

As a volunteer, you can complete the return of a taxpayer who received either a fully taxable or a totally tax free distribution from an IRA. If only part of the distribution is taxable, the taxpayer should consult a paid tax preparer.

A **traditional IRA** is any IRA that is not a Roth IRA or a SIMPLE IRA. A traditional IRA is sometimes called an ordinary or regular IRA.

A **Roth IRA** is an individual retirement arrangement that is designated as a Roth when it is set up. Taxpayers cannot deduct contributions to a Roth IRA. However, if the taxpayer satisfies the requirements described later, qualified distributions are tax-free.

A **Savings Incentive Match Plan for Employees (SIMPLE)** is a tax-favored retirement plan that certain small employers (including self-employed individuals) can set up for the benefit of their employees. For SIMPLE plan purposes, the term employee includes a self-employed individual who received earned income.

Traditional IRA - Taxation of Distributions

General Rules

In general, distributions from a traditional IRA are taxable in the year received. Taxable distributions from traditional IRAs are treated as ordinary income. The taxpayer cannot use the 10-year tax option or the capital gain treatment for a lump-sum distribution from an IRA.

Fully Taxable

If only deductible contributions were made to a traditional IRA, the taxpayer has no basis (cost or investment) in the IRA. Because the taxpayer has no basis, any distribution from the IRA is fully taxable when received.

Partly Taxable

If the taxpayer made nondeductible contributions to a traditional IRA, he or she has a cost basis (investment in the contract) equal to the amount of those contributions. The nondeductible contributions are not taxed when they are distributed because they represent a return of the investment in the IRA. The volunteer program does not cover distributions that are partly taxable.

If the taxpayer receives a distribution from a traditional IRA, he or she will receive Form 1099-R, or similar statement. IRA distributions are shown in boxes 1 and 2 of Form 1099-R. The IRA box to the right of box 7 should be checked.

Example 6

Tyrone contributed \$500 a year to a traditional IRA. Each year he deducted his traditional IRA contribution from his income. This year he received his first distribution from the traditional IRA. It

is fully taxable. Tyrone will pay income tax on the distributions he receives which represent the contributions he made and deducted as well as the money the contributions have earned over the years.

Traditional IRAs - Minimum Required Distributions

Taxpayers cannot keep funds in a traditional IRA indefinitely. Eventually, the funds must be distributed. The owner of a traditional IRA must start taking distributions from the IRA when he or she reaches age 70½. The taxpayer must take the first minimum distribution from the IRA by April 1 of the year following the year in which he or she reaches age 70½ (the required beginning date). The required minimum distribution for any year after the year the taxpayer turns 70½ must be made by December 31 of that later year. Therefore, the taxpayer will need to take two distributions in the same tax year if he or she postpones the first distribution until the year following the year he or she turns 70½.

If there are no distributions or the distributions are not large enough, the taxpayer may have to pay an additional 50% excise tax (described earlier in this lesson) on the amount not distributed.

Roth IRAs - Taxation of Distributions

In general, taxpayers do not include **qualified distributions** from Roth IRAs in gross income.

A qualified distribution is generally any payment or distribution made after the 5-year period beginning with the first taxable year for which a contribution was made to a Roth IRA and the payment or distribution is made:

- On or after the taxpayer reaches age 59½, or
- Because the taxpayer is disabled, or
- To a beneficiary or an estate after the death of the taxpayer, or
- To buy, build or rebuild a first home (up to a \$10,000 lifetime limit)

Part of any distribution that is not a qualified distribution may be taxable as ordinary income and subject to the additional 10% tax on early distributions. Distributions of conversion contributions within a 5-year period following a conversion from a traditional IRA to a Roth IRA may be subject to the 10% early distribution tax, even if the contributions have been included as income in an earlier year.

Taxpayers are not required to take distributions from a Roth IRA at any age. The minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive. The amount withdrawn from a Roth IRA cannot be used to satisfy the minimum distribution requirements for the taxpayer's traditional IRA(s), if any.

Railroad Retirement Benefits and Reporting Forms RRB-1099

Benefits paid under the Railroad Retirement Act fall into **two categories**. These categories are treated differently for income tax purposes.

1. The **first category** is the amount of tier 1 railroad retirement benefits that equal the social security benefit that a railroad employee or beneficiary would have been entitled to receive under the social security system.

This part of the tier 1 benefit is called the “social security equivalent benefit” and is treated for tax purposes like social security benefits. It is shown on the blue part of the Form RRB-1099, *Payments by the Railroad Retirement Board*. Use the amount from box 5 of Form RRB-1099.

2. The **second category** contains the rest of the tier 1 benefits, called the “non-social security equivalent benefit,” any tier 2 benefits, vested dual benefits, and supplemental annuity benefits.

This category of benefits, shown on Form RRB-1099-R, *Annuities or Pensions by the Railroad Retirement Board*, is treated as an amount received from a qualified employer plan. Vested dual benefits and supplemental annuity benefits are fully taxable pensions.

Example 4

David is retired from the Drake Railroad Line. He files Form 1040, jointly with his wife Elizabeth. He received a Form RRB-1099 (Exhibit 4) and a Form RRB-1099-R (Exhibit 5) for 2005. Elizabeth also received a Form RRB-1099-R (Exhibit 6). Elizabeth had wages of \$7,390 (line 7, Form 1040). They had \$3,598 of interest income (line 8a, Form 1040). They also had ordinary dividends of \$2,019 (line 9a, Form 1040) and \$480 (line 13, Form 1040) in capital gain distributions.

Since box 3 on the Forms RRB-1099-R is blank, the payments shown in box 4 are fully taxable. The amount in box 6 is also fully taxable. They will include the \$13,544 (\$3,054 + \$10,490) on line 16b of their Form 1040.

The Social Security (and Tier 1 Equivalent) Benefits worksheet (Exhibit 7) reveals that \$613 of the amount on Form RRB-1099 is taxable.

Exhibit 4 – David’s Form RRB-1099

PAYER'S NAME, STREET ADDRESS, CITY, STATE, AND ZIP CODE UNITED STATES RAILROAD RETIREMENT BOARD 844 N RUSH ST CHICAGO IL 60611-2092		2005		PAYMENTS BY THE RAILROAD RETIREMENT BOARD	
PAYER'S FEDERAL IDENTIFYING NO. 36-3314600		3. Gross Social Security Equivalent Benefit Portion of Tier 1 Paid in 2005		12,390.00	COPY C - FOR RECIPIENT'S RECORDS THIS INFORMATION IS BEING FURNISHED TO THE INTERNAL REVENUE SERVICE.
1. Claim Number and Payee Code x xxxxxxx		4. Social Security Equivalent Benefit Portion of Tier 1 Repaid to RRB in 2005		0.00	
2. Recipient's Identification Number xxx-xx-xxxx		5. Net Social Security Equivalent Benefit Portion of Tier 1 Paid in 2005		12,390.00	
Recipient's Name, Street Address, City, State, and Zip Code David Yale 1900 S State St Your City, State Zip		6. Workers' Compensation Offset in 2005		0.00	
		7. Social Security Equivalent Benefit Portion of Tier 1 Paid for 2004		25.00	
		8. Social Security Equivalent Benefit Portion of Tier 1 Paid for 2003			
		9. Social Security Equivalent Benefit Portion of Tier 1 Paid for Years Prior to 2003			
		10. Federal Income Tax Withheld		120.00		11. Medicare Premium Total	799.00

FORM RRB-1099

DO NOT ATTACH TO YOUR INCOME TAX RETURN

Draft as of July 15, 2005 - Subject to Change

Exhibit 5 – David’s Form RRB-1099-R

PAYER'S NAME, STREET ADDRESS, CITY, STATE, AND ZIP CODE UNITED STATES RAILROAD RETIREMENT BOARD 844 N RUSH ST CHICAGO IL 60611-2092		2005		ANNUITIES OR PENSIONS BY THE RAILROAD RETIREMENT BOARD		
PAYER'S FEDERAL IDENTIFYING NO. 36-3314600		3. Employee Contributions		COPY B - REPORT THIS INCOME ON YOUR FEDERAL TAX RETURN. IF THIS FORM SHOWS FEDERAL INCOME TAX WITHHELD IN BOX 9 ATTACH THIS COPY TO YOUR RETURN. THIS INFORMATION IS BEING FURNISHED TO THE INTERNAL REVENUE SERVICE.		
1. Claim Number and Payee Code x xxxxxxx		4. Contributory Amount Paid				9,906.00
2. Recipient's Identification Number xxx-xx-xxxx		5. Vested Dual Benefit				
Recipient's Name, Street Address, City, State, and ZIP Code David Yale 1900 S State St Your City, State Zip		6. Supplemental Annuity				584.00
		7. Total Gross Paid				10,490.00
		8. Repayments				
		9. Federal Income Tax Withheld				0.00
		10. Rate of Tax					11. Country	12. Medicare Premium Total

FORM RRB-1099-R

Draft as of July 15, 2005 - Subject to Change

Exhibit 6 – Elizabeth’s Form RRB-1099-R

PAYER'S NAME, STREET ADDRESS, CITY, STATE, AND ZIP CODE UNITED STATES RAILROAD RETIREMENT BOARD 844 N RUSH ST CHICAGO IL 60611-2092		2005		ANNUITIES OR PENSIONS BY THE RAILROAD RETIREMENT BOARD		
PAYER'S FEDERAL IDENTIFYING NO. 36-3314600		3. Employee Contributions		COPY B - REPORT THIS INCOME ON YOUR FEDERAL TAX RETURN. IF THIS FORM SHOWS FEDERAL INCOME TAX WITHHELD IN BOX 9 ATTACH THIS COPY TO YOUR RETURN. THIS INFORMATION IS BEING FURNISHED TO THE INTERNAL REVENUE SERVICE.		
1. Claim Number and Payee Code x xxxxxxx		4. Contributory Amount Paid				2,470.00
2. Recipient's Identification Number xxx-xx-xxxx		5. Vested Dual Benefit				
Recipient's Name, Street Address, City, State, and ZIP Code Elizabeth Yale 1900 S State St Your City, State Zip		6. Supplemental Annuity				584.00
		7. Total Gross Paid				3,054.00
		8. Repayments				
		9. Federal Income Tax Withheld				1,280.00
		10. Rate of Tax					11. Country	12. Medicare Premium Total

FORM RRB-1099-R

Draft as of July 15, 2005 - Subject to Change



Social Security Benefits Worksheet—Lines 20a and 20b

- 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 on page 31).
 - ✓ If you are married filing separately and you lived apart from your spouse for all of 2005, enter “D” to the right of the word “benefits” on line 20a.
 - ✓ Be sure you have read the **Exception** on page 24 to see if you can use this worksheet instead of a publication to find out if any of your benefits are taxable.

<p>1. Enter the total amount from box 5 of all your Forms SSA-1099 and Forms RRB-1099</p> <p>2. Enter one-half of line 1</p> <p>3. Enter the total of the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21</p> <p>4. Enter the amount, if any, from Form 1040, line 8b</p> <p>5. Add lines 2, 3, and 4</p> <p>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</p> <p>7. Is the amount on line 6 less than the amount on line 5? <input type="checkbox"/> No. None of your social security benefits are taxable. <input checked="" type="checkbox"/> Yes. Subtract line 6 from line 5</p> <p>8. If you are: <ul style="list-style-type: none"> • 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 2005, enter \$25,000 • Married filing separately and you lived with your spouse at any time in 2005, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17 </p> <p>9. Is the amount on line 8 less than the amount on line 7? <input type="checkbox"/> No. None of your social security benefits are taxable. You do not have to enter any amounts on line 20a or 20b of Form 1040. But if you are married filing separately and you lived apart from your spouse for all of 2005, enter -0- on line 20b. Be sure you entered “D” to the right of the word “benefits” on line 20a. <input checked="" type="checkbox"/> Yes. Subtract line 8 from line 7</p> <p>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 2005 . .</p> <p>11. Subtract line 10 from line 9. If zero or less, enter -0-</p> <p>12. Enter the smaller of line 9 or line 10</p> <p>13. Enter one-half of line 12</p> <p>14. Enter the smaller of line 2 or line 13</p> <p>15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-</p> <p>16. Add lines 14 and 15</p> <p>17. Multiply line 1 by 85% (.85)</p> <p>18. Taxable social security benefits. Enter the smaller of line 16 or line 17 <ul style="list-style-type: none"> • Enter the amount from line 1 above on Form 1040, line 20a. • Enter the amount from line 18 above on Form 1040, line 20b. </p>	<p>1. 12,390</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>2. 6,195</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>3. 27,031</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>4. 0</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>5. 33,226</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>6. 0</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>7. 33,226</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>8. 32,000</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>9. 1,226</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>10. 12,000</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>11. 0</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>12. 1,226</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>13. 613</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>14. 613</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>15. 0</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>16. 613</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>17. 10,532</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <p>18. 613</p> <hr style="width: 50%; margin-left: auto; margin-right: 0;"/>
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TIP If any of your benefits are taxable for 2005 **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.

SOCIAL SECURITY AND TIER 1 RAILROAD RETIREMENT BENEFITS

This section explains the federal income tax rules for social security benefits and equivalent tier 1 railroad retirement benefits. Social security benefits (as they are used in this lesson) include monthly survivor and disability benefits. They do not include supplemental security benefits (SSI) which are not taxable.

The Social Security Administration issues Form SSA-1099 to social security benefit recipients. The net benefit for the year is listed in box five (5). The social security equivalent of the Railroad Retirement Benefits is shown in box five (5) of Form RRB-1099.

To determine whether any of the taxpayer's benefits may be taxable, you must select the **base amount** for the taxpayer. The base amounts are as follows:

- \$25,000 if the filing status is single, head of household, or qualifying widow(er),
- \$25,000 if the filing status is married filing separately and the taxpayer lived apart from the spouse for all of the year,
- \$32,000 if the filing status is married filing jointly, or
- \$-0- if the filing status is married filing separately and the taxpayer lived with the spouse at any time during the year

Next, compare the base amount with the total of:

- One-half of the social security benefits (and equivalent tier 1 railroad retirement benefits), plus
- All other income, including tax-exempt interest

If the total is more than the base amount for the filing status, a portion of the taxpayer's social security benefit may be subject to federal income tax.

If part of the benefits is taxable, how much is taxable depends on the total amount of the benefits and other income. Generally, the higher that total amount, the greater the taxable part of the benefits.

The person who has the legal right to receive the benefits is the one who must consider whether the benefits are taxable.

Form SSA-1099

Social security benefits are reported to the taxpayer on Form SSA-1099, *Social Security Benefit Statement*. The amount in box 5, *Net benefits for 2005*, is entered on a worksheet to figure if any of the benefits are taxable. Make sure you enter the amount from box 5 of Form SSA-1099 on line 1 of the worksheet. If filing a joint return, include Box 5 amounts from SSA-1099s for both spouses. Do not include a dependent's SSA-1099 received in the dependent's name. Neither Form SSA-1099 nor the worksheet (explained below) is attached to the income tax return. They are kept with the taxpayer's other personal records.

A worksheet to figure the taxable portion of the social security benefits (and equivalent tier 1 railroad retirement benefits) is included in the instructions to the Form 1040 and the Form 1040A. If you are using software to prepare the return, you may not actually complete a worksheet. The software can make the determination of the taxable portion of the benefits based on the personal and financial information you enter for the taxpayer. Taxable portions of social security benefits (and equivalent tier 1 railroad retirement benefits) cannot be reported on Form 1040EZ.

Example 5

Gilbert, age 72, is single and files Form 1040A. In addition to receiving social security payments, he received a fully taxable pension of \$18,600 (line 12b), wages from a part-time job of \$9,400 (line 7) and taxable interest income of \$990 (line 8a), for a total of \$28,990. He received a Form SSA-1099 that shows his net social security benefits of \$5,980 in box 5. His completed worksheet is shown in Exhibit 8. On line 14a of his Form 1040A, Gilbert will enter \$5,980. On line 14b he will enter the taxable benefit of \$2,990.



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 on page 31).
- ✓ If you are married filing separately and you lived apart from your spouse for all of 2005, enter “D” to the right of the word “benefits” on line 20a.
- ✓ Be sure you have read the **Exception** on page 24 to see if you can use this worksheet instead of a publication to find out if any of your benefits are taxable.

<p>1. Enter the total amount from box 5 of all your Forms SSA-1099 and Forms RRB-1099</p> <p>2. Enter one-half of line 1</p> <p>3. Enter the total of the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21</p> <p>4. Enter the amount, if any, from Form 1040, line 8b</p> <p>5. Add lines 2, 3, and 4</p> <p>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</p> <p>7. Is the amount on line 6 less than the amount on line 5? <input type="checkbox"/> No. None of your social security benefits are taxable.</p> <p><input checked="" type="checkbox"/> Yes. Subtract line 6 from line 5</p> <p>8. If you are: <ul style="list-style-type: none"> • 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 2005, enter \$25,000 • Married filing separately and you lived with your spouse at any time in 2005, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17 </p> <p>9. Is the amount on line 8 less than the amount on line 7? <input type="checkbox"/> No. None of your social security benefits are taxable. You do not have to enter any amounts on line 20a or 20b of Form 1040. But if you are married filing separately and you lived apart from your spouse for all of 2005, enter -0- on line 20b. Be sure you entered “D” to the right of the word “benefits” on line 20a.</p> <p><input checked="" type="checkbox"/> Yes. Subtract line 8 from line 7</p> <p>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 2005</p> <p>11. Subtract line 10 from line 9. If zero or less, enter -0-</p> <p>12. Enter the smaller of line 9 or line 10</p> <p>13. Enter one-half of line 12</p> <p>14. Enter the smaller of line 2 or line 13</p> <p>15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-</p> <p>16. Add lines 14 and 15</p> <p>17. Multiply line 1 by 85% (.85)</p> <p>18. Taxable social security benefits. Enter the smaller of line 16 or line 17 <ul style="list-style-type: none"> • Enter the amount from line 1 above on Form 1040, line 20a. • Enter the amount from line 18 above on Form 1040, line 20b. </p>	<p>1. <u>5,980</u></p> <p>2. <u>2,990</u></p> <p>3. <u>28,990</u></p> <p>4. <u>0</u></p> <p>5. <u>31,980</u></p> <p>6. <u>0</u></p> <p>7. <u>31,980</u></p> <p>8. <u>25,000</u></p> <p>9. <u>6,980</u></p> <p>10. <u>9,000</u></p> <p>11. <u>0</u></p> <p>12. <u>6,980</u></p> <p>13. <u>3,490</u></p> <p>14. <u>2,990</u></p> <p>15. <u>0</u></p> <p>16. <u>2,990</u></p> <p>17. <u>5,083</u></p> <p>18. <u>2,990</u></p>
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TIP *If any of your benefits are taxable for 2005 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.*

Lump-Sum Social Security Benefits Payments – Figuring the Taxable Portion

Some taxpayers may have received a **lump-sum benefit payment** in 2005. This payment could be for both the current tax year and prior tax year(s). The lump-sum payment will be included

in box 3 of the Form SSA-1099 or Form RRB-1099 that the taxpayer receives. The form will also show the year, or years, of the payment. This type of lump-sum benefit payment should not be confused with the lump-sum death benefits that both the Social Security Administration and the Railroad Retirement Board pay to many of their beneficiaries. No part of the lump-sum death benefit is subject to tax.

When figuring the taxable portion of lump-sum social security benefits, (and RRB Tier1 equivalents), two options are available.

1. The first option requires the taxpayer to report the whole payment in the year it was received. When the taxpayer chooses this option, complete the *Social Security Benefits Worksheet* as usual by including the entire lump-sum payment on line 1.
2. The taxpayer also has the option of treating the payment as received in the earlier year or years. This is done by making an election and figuring whether any part of these benefits is taxable, based on the earlier year's income. Any part that is taxable is then added to any taxable benefits for the current year (2005) and included on Form 1040, line 20b.

If the taxpayer chooses to make the lump-sum election and spread the payments back to earlier years, only 2005 income will be adjusted. The taxpayer does not file amended returns for the earlier years. However, a special procedure **must** be used to figure the taxable portion of the benefits assigned to the earlier years. If the taxpayer wants to make this election, he or she should consult a paid tax preparer.

PENSION WITHHOLDING AND ESTIMATED TAX PAYMENTS

Income tax is normally withheld from the taxable part of a pension or annuity. The taxpayer can adjust the withholding amount or stop the withholding completely by notifying the payer. The taxpayer usually communicates these changes by completing Form W-4P, *Withholding Certificate for Pension or Annuity Payments*, and providing it to the payer of the pension.

A taxpayer who chooses not to have tax withheld (or has too little tax withheld) may have to make estimated tax payments. Taxpayers, who owe more than \$1,000 when they file their tax return, may be penalized for failure to estimate (and pay) the proper amount of tax.

Summary Exercise

Using the concepts you learned in this lesson, complete the following summary exercise.

Bart, age 66, and Mildred, age 56, are filing a joint return for 2005. They want to file their return on a Form 1040 because that is what they have always done. They had the following income:

Mildred's wages	\$9,500
Interest (joint)	500
Dividends	2,000
Bart's pension	20,900
Bart's traditional IRA distribution	3,400
Bart's Social Security	9,500

Bart never made any after-tax contributions to his pension plan.

All of Bart's IRA contributions were tax-deductible when made.

- A) How much of the pension income is taxable? _____
- B) What line(s) will you list the pension income on? _____
- C) How much of the IRA distribution is taxable? _____
- D) What line(s) will you list the IRA distribution on? _____
- E) Will any portion of the social security benefits be taxable? _____ Use Exhibit 9, Social Security Benefits Worksheet, to assist with answer.

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 on page 31).
 - ✓ If you are married filing separately and you lived apart from your spouse for all of 2005, enter “D” to the right of the word “benefits” on line 20a.
 - ✓ Be sure you have read the **Exception** on page 24 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** 1. _____
2. Enter one-half of line 1 2. _____
3. Enter the total of the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21 3. _____
4. Enter the amount, if any, from Form 1040, line 8b 4. _____
5. Add lines 2, 3, and 4 5. _____
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.** None of your social security benefits are taxable.
 - Yes.** Subtract line 6 from line 5 7. _____
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 2005, enter \$25,000
 - Married filing separately and you lived with your spouse at any time in 2005, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17
 } 8. _____
9. Is the amount on line 8 less than the amount on line 7?
 - No.** None of your social security benefits are taxable. You do not have to enter any amounts on line 20a or 20b of Form 1040. **But** if you are married filing separately and you **lived apart** from your spouse for all of 2005, enter -0- on line 20b. 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 2005 .. 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 18. _____
 - Enter the amount from line 1 above on Form 1040, line 20a.
 - Enter the amount from line 18 above on Form 1040, line 20b.

TIP If any of your benefits are taxable for 2005 **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.

▶▶ SUMMING UP THIS LESSON ◀◀

In this lesson, you learned about the taxability of several types of retirement income.

- ▶ Pension benefits are fully taxable if the taxpayer did not contribute to the cost of the pension plan.
- ▶ Pension benefits are partially taxable if the taxpayer made after-tax contributions to the pension plan.
- ▶ The Simplified Method Worksheet is used to compute the taxable portion of a partially taxable pension or annuity.
- ▶ A portion of social security benefits may be taxable if total income exceeds a specified base amount.
- ▶ The Social Security Benefits Worksheet is used to calculate the taxable portion of social security benefits received.
- ▶ Distributions from a traditional IRA are fully taxable if the taxpayer does not have basis in the IRA.
- ▶ Distributions from a traditional IRA are partially taxable if the taxpayer made nondeductible contributions to the IRA.
- ▶ The scope of the volunteer program does not include partly taxable IRA distributions.
- ▶ Qualified Roth IRA distributions are not taxable.
- ▶ Some taxpayers may need to make estimated tax payments.

Exercise 1

\$892.00

The amount in box 5 of Form 1099R is considered the amount of the current year's pension distribution that is considered a recovery of cost or investment.

Exercise 2

Please see Exhibit 10 on the following page for George's completed Simplified Method worksheet.

Answer to Summary Exercise

A. \$20,900

Since Bart did not make any after-tax contributions to the pension plan, the entire distribution is taxable.

B. 16b

The pension is fully taxable; no entry should be made on 16a.

C. \$3,400

Bart was able to deduct all of his contributions to the traditional IRA, the distribution is fully taxable.


D. 15b

The distribution is fully taxable. No entry should be made on 15a.

E. Yes.

The joint income (with $\frac{1}{2}$ the social security benefits added) is \$41,050. This exceeds the base amount for a married filing joint taxpayer. A portion of the social security benefits will be subject to tax. See Exhibit 11 for Bart and Mildred's completed Social Security Benefits Worksheet.

Simplified Method Worksheet—Lines 16a and 16b

Keep for Your Records 

Before you begin: ✓ If you are the beneficiary of a deceased employee or former employee who died **before** August 21, 1996, include any death benefit exclusion that you are entitled to (up to \$5,000) in the amount entered on line 2 below.

Note. If you had more than one partially taxable pension or annuity, figure the taxable part of each separately. Enter the total of the taxable parts on Form 1040, line 16b. Enter the total pension or annuity payments received in 2005 on Form 1040, line 16a.

1. Enter the total pension or annuity payments received in 2005. Also, enter this amount on Form 1040, line 16a **1.** 12,000
2. Enter your cost in the plan at the annuity starting date **2.** 26,000
3. Enter the appropriate number from **Table 1** below. **But** if your annuity starting date was **after** 1997 **and** the payments are for your life and that of your beneficiary, enter the appropriate number from **Table 2** below **3.** 260
4. Divide line 2 by the number on line 3 **4.** 100
5. Multiply line 4 by the number of months for which this year’s payments were made. If your annuity starting date was **before** 1987, skip lines 6 and 7 and enter this amount on line 8. Otherwise, go to line 6 **5.** 1,200
6. Enter the amount, if any, recovered tax free in years after 1986 **6.** 0
7. Subtract line 6 from line 2 **7.** 26,000
8. Enter the **smaller** of line 5 or line 7 **8.** 1,200
9. **Taxable amount.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also, enter this amount on Form 1040, line 16b. If your Form 1099-R shows a larger amount, use the amount on this line instead of the amount from Form 1099-R **9.** 10,800

Table 1 for Line 3 Above

IF the age at annuity starting date (see above) was . . .	AND your annuity starting date was—	
	before November 19, 1996, enter on line 3 . . .	after November 18, 1996, enter on line 3 . . .
55 or under	300	360
56–60	260	310
61–65	240	260
66–70	170	210
71 or older	120	160

Table 2 for Line 3 Above

IF the combined ages at annuity starting date (see above) were . . .	THEN enter on line 3 . . .
110 or under	410
111–120	360
121–130	310
131–140	260
141 or older	210

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 on page 31).
 - ✓ If you are married filing separately and you lived apart from your spouse for all of 2005, enter "D" to the right of the word "benefits" on line 20a.
 - ✓ Be sure you have read the **Exception** on page 24 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	1.	9,500	
2. Enter one-half of line 1	2.	4,750	
3. Enter the total of the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21	3.	36,300	
4. Enter the amount, if any, from Form 1040, line 8b	4.	0	
5. Add lines 2, 3, and 4	5.	41,050	
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.	0	
7. Is the amount on line 6 less than the amount on line 5?			
<input type="checkbox"/> No. None of your social security benefits are taxable.			
<input checked="" type="checkbox"/> Yes. Subtract line 6 from line 5	7.	41,050	
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 2005, enter \$25,000			
• Married filing separately and you lived with your spouse at any time in 2005, 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?			
<input type="checkbox"/> No. None of your social security benefits are taxable. You do not have to enter any amounts on line 20a or 20b of Form 1040. But if you are married filing separately and you lived apart from your spouse for all of 2005, enter -0- on line 20b. Be sure you entered "D" to the right of the word "benefits" on line 20a.			
<input checked="" type="checkbox"/> Yes. Subtract line 8 from line 7	9.	9,050	
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 2005 ..	10.	12,000	
11. Subtract line 10 from line 9. If zero or less, enter -0-	11.	0	
12. Enter the smaller of line 9 or line 10	12.	9,050	
13. Enter one-half of line 12	13.	4,525	
14. Enter the smaller of line 2 or line 13	14.	4,525	
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	15.	0	
16. Add lines 14 and 15	16.	4,525	
17. Multiply line 1 by 85% (.85)	17.	8,075	
18. Taxable social security benefits. Enter the smaller of line 16 or line 17	18.	4,525	
• Enter the amount from line 1 above on Form 1040, line 20a.			
• Enter the amount from line 18 above on Form 1040, line 20b.			

TIP If any of your benefits are taxable for 2005 **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.

INTRODUCTION AND OBJECTIVES

This lesson discusses gains and losses on the sale (or redemption) of stock or other investment property, including how to figure the basis.

After completing this lesson you should be able to:

- Compute the adjusted basis of stock or other investment property
- Determine if an asset's holding period is long-term or short-term
- Calculate the taxable gain or deductible loss using Schedule D
- Calculate the correct tax liability

The forms mentioned in this lesson are used in the exercise at the end of the lesson. The exercise can be completed using tax preparation software.

INVESTMENT PROPERTY DEFINITION

Investment Property is property that produces investment income. Investment income includes interest, dividends and capital gains derived from the sale of the property. Some examples of investment property are stocks, bonds, mutual funds, and Treasury bills and notes. Property used in a trade or business is not investment property.

Example 1

Arthur owns shares in a mutual fund and some shares of corporate stock. He also holds several municipal bonds. All of these items are considered investment property.

A capital gain exists when a *capital asset* is sold for a profit. (Of course, money can be lost when a capital asset is sold, resulting in a *capital loss*.) Any asset held as an investment (stocks, bonds, mutual funds, for example) is a capital asset.

The resulting gain or loss is determined by deducting the **adjusted basis** of the asset from the **amount realized** from the sale. This lesson will provide guidance on how to assist the taxpayer in determining the adjusted

ALERT



This lesson contains advanced tax law. Your course facilitator will only teach the information required to assist taxpayers you will serve.

basis of the investment property. It will also provide instruction on how to determine the amount realized from the sale. Then you will learn how to report the sale on the tax return.

GENERAL INFORMATION ON THE BASIS OF INVESTMENT PROPERTY

Gain or loss on the sale of investment property is usually determined by comparing the adjusted basis to the sales price. Thus, the **adjusted basis** is crucial in determining the correct gain or loss on the sale of investment property.

Unfortunately, many taxpayers have not maintained the records that are needed to determine the adjusted basis of their investment property. This lesson will provide you with basic information to help a taxpayer determine the adjusted basis of his or her investment property.

It may be necessary for the taxpayer to consult a broker or a financial advisor for additional assistance in determining the adjusted basis of the investment property. Keep in mind that if the taxpayer can't determine the basis, the IRS could deem the basis to be zero, thus resulting in a fully taxable sale.

General Rule

The **basis** of property is usually its cost. The basis may also include amounts paid for commissions and fees to acquire and dispose of the property. The original basis in property is adjusted (increased or decreased) by certain events. This results in an adjusted basis for the property. For example, when a stock dividend or stock split is declared, the stockholder receives additional shares of stock. This changes the basis per share of the original shares.

Example 2

Betty paid \$1,100 for 100 shares of ABC, Inc. stock. She received 10 additional shares of ABC's stock as a tax-free stock dividend in 2005. Her \$1,100 basis must be spread over 110 shares (100 original shares plus the 10-share stock dividend). Her basis decreases from \$11 to \$10 per share.

Dividend Reinvestment

Another frequent adjustment to basis of **stock** results from a **dividend reinvestment program** (sometimes referred to as a DRIP). This plan lets the taxpayer choose to use his or her dividends to buy more shares of stock in the corporation instead of receiving the dividends in cash. Since the dividends are included in income in the year they are earned, they increase the basis of the investment property.

Dividends (and capital gain distributions) from **mutual funds** are often reinvested unless the shareholder specifically instructed otherwise. Thus, it is very common to have part of the basis of a

mutual fund account be shares bought with such distributions. Later in this lesson, you will learn how to calculate the basis of mutual fund shares.

Example 3

Charlie bought 100 shares of DEF stock for \$1,000 on March 1, 2002 and chose to participate in the dividend reinvestment program. He handed you the following information that provided details of all his transactions. On November 3, 2005, he sold all of his DEF stock for \$1,560. His adjusted basis was \$1300 (the original \$1,000 plus the \$300 of reinvested dividends).

DEF STOCK				
Date	Transaction	No of Shares	Total Shares	TOTAL
03/01/02	BOUGHT 100 @ \$10/Share	100	100	\$1000
12/31/02	Reinvested Dividends \$100	10	110	\$1100
12/31/03	Reinvested Dividends \$100	10	120	\$1200
12/31/04	Reinvested Dividends \$100	10	130	\$1300
11/03/05	SOLD 130 @ \$12/Share			

Received as a Gift

To figure the basis of property received as a gift, taxpayers must know its adjusted basis to the donor just before it was given to the taxpayer. They will also need to know the fair market value (FMV) at the time of the donation and the amount of any gift tax paid on the donation. Fair market value is the price at which the property would change hands between a buyer and a seller. For publicly traded securities, the FMV is usually the value of the stock on the exchange on which it is traded. Determination of the adjusted basis of property received by gift can be very complex. It is outside the scope of the Volunteer Return Preparation Program. Advise the taxpayer to seek the assistance of a paid tax preparer or legal counsel.

Inherited Property

The basis of inherited property is generally the FMV of the property at the date of the decedent's death. However, this can vary if the personal representative of the estate elects to use an alternate valuation date. Alternate valuation issues can be complex and the taxpayer may need to seek the assistance of a paid tax preparer or legal counsel.

To determine the FMV of inherited (or gifted) stock, the taxpayer may need to go to the local library or do some research on the Internet. Generally, the taxpayer will take the average of the high and low prices on the date of death (or gift). Taxpayers should not wait until they sell the stock to try to determine the basis.

Example 4

Debbie inherited some stock from her grandmother. The FMV on the date of her grandmother's death was \$62 per share. No alternate valuation date was elected. She inherited 100 shares, so her total basis in the stock is \$6,200.

Bonds and Other Tax-Exempt Obligations

Many individual investors limit their bond holdings to tax-exempt bonds. They may purchase the bonds individually. Alternatively, they may invest in a mutual fund that holds tax-exempt bonds.

The basis for these assets is usually the purchase price. The basis may need to be adjusted for Original Issue Discount, if applicable. This adjustment can be complex. If such an adjustment is necessary, the taxpayer may be able to get the basis from his/her broker or financial advisor. If not available, he/she may need to seek the assistance of a paid tax preparer.

Also, if the taxpayer holds bonds that were bought at a premium or a market discount, he or she may need to seek the assistance of a paid tax preparer. The calculation of the amortization of the bond premium is outside the scope of the volunteer program.

Employee Stock Option Plans

Corporations may grant their employees the option to purchase stock in the corporation. Stock options may be given to employees. However, options may also be sold to employees. Basically, a stock option is an agreement under which the employee who holds the option has the right, but not the obligation, to purchase corporate shares at a fixed price on a fixed date or within a range of dates.

Determining the basis of stock that was acquired through stock options can be complex. If taxpayers need assistance with determining the basis of these types of shares, they may need to seek the assistance of a paid tax preparer.

Recordkeeping

The value of good recordkeeping is perhaps one of the most useful suggestions that you can pass on to the taxpayers who visit your site. Indeed, your job and their job will be much easier if good records have been maintained. Something as simple as a spiral notebook can be used to record dates and amounts of purchase, stock splits, reinvested dividends etc. Retaining information related to spin-offs and splits will help determine the correct basis when the stock is sold. Sometimes, a trip to the local library or a little Internet research can be useful in trying to reconstruct the taxpayer's basis. He or she can look up the company in question

and trace all of the capital changes over the years. Ultimately, it is the taxpayer's responsibility to determine the basis of the investment property.

Exercise 1

Zelda has 150 shares of ZYX stock that she purchased for \$20 per share. The stock has never split and she has never reinvested her dividends. What is Zelda's basis in the ZYX stock? _____

Exercise 2

Yosef bought \$200 worth of WVU stock in 2003. He received \$20 in dividends in 2003 and \$40 of dividends in 2004 and in 2005. He reinvested his dividends. What is his adjusted basis in the WVU stock at the end of 2005? _____

Exercise 3

Xavier inherited 400 shares of TSR stock from his grandmother in 2005. On the date of his grandmother's death (June 2, 2005), the stock traded for an average price of \$10 per share. No alternate valuation method was elected. What is Xavier's basis in his stock?

WHAT IS A SALE OF INVESTMENT PROPERTY

When investment property is sold or exchanged, a gain or loss is usually realized. This section explains certain transactions and events that are treated as sales of investment property. A sale is generally a transfer of property for money or for a mortgage, note or other promise to pay. Even though some taxpayers may state that they “traded their stock in,” the event was most likely a sale. See the following sections for more information.

Redemption of Stock or Bonds

Generally, redemption of stock or the calling of a bond for early redemption is treated as a sale and is subject to the capital gain or loss provisions (covered later in this lesson). If the redemption was considered a sale, the taxpayer should receive a Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, or equivalent statement from the broker. The form will show the proceeds, or amount realized, from the sale. The IRS will also get a copy of Form 1099-B from the broker.

Mutual Fund Shares

When a taxpayer sells or exchanges mutual fund shares, he or she will generally have a taxable gain or deductible loss. It is important to note that if a taxpayer exchanges one fund for another in the same fund family, this is still considered a sale. The taxpayer should receive a Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, or equivalent statement from the broker. The form will show the proceeds, or the amount realized, from the sale. The IRS will also get a copy of Form 1099-B from the broker.

Example 5

Eldon owned 50 shares of GHI Discovery Fund. On July 12, 2005, Eldon told his broker to “move” his GHI Discovery Fund shares to GHI International Fund. The “move” is actually considered a sale for tax purposes. Eldon should receive a Form 1099-B (or equivalent) from his broker.

Exercise 4

Walter owned 100 shares of QPO Mutual Investors Fund. In January of 2005, he transferred his holdings to QPO Energy Fund. Is this considered a sale of investment property?

Worthless Securities

Stocks, stock rights, and bonds (other than those held for sale by a securities dealer) that become worthless during the tax year are treated as though they were sold on the last day of the tax year. Just because a company is in bankruptcy or its stock isn't trading, doesn't mean that it's worthless. Even if it is worth only a few pennies per share, it still has value. To qualify as worthless, there must be no reasonable hope investors will ever get anything for their holdings. It is best if this position can be supported by written information provided by the company or broker.

Example 6

On August 23, 2005, Francine received a letter from JKL, a dot-com business. The letter stated that the company had finalized its bankruptcy proceedings and that investors would receive two cents per share in 2006. This would be the only payment that the investors would receive. Francine had invested \$12,000 (\$1 per share) in the company in 2003. Francine can't take a loss on her 2005 tax return because the stock still has some value. She will be able to take a loss on her 2006 tax return when she receives the payment.

Other Sales and Trades

There are many other ways in which taxpayers trade or sell investment property. Those transactions are outside of the scope of the volunteer program. They include trading investment property for an annuity, constructive sales and marked-to-market transactions. If your customer was involved with these types of transactions, he or she needs to seek the assistance of a paid tax preparer.

Example 7

Greg comes in to your site for help with his tax return. He tells you that he has some losses from commodities trading. He says that he had some 1256 contracts. You explain that his issues are outside of the scope of the volunteer program and you suggest that he seek the assistance of a paid tax preparer.

IDENTIFYING WHAT WAS SOLD AND ITS BASIS

When a taxpayer sells less than his entire investment, it is necessary to identify which shares were sold. This will affect how much of the basis is allocated to the sale.

Specific Identification

If the taxpayer can adequately identify the shares of stock sold during the tax year, the basis is the cost or other basis of those particular shares. If the taxpayer told the broker or other agent the particular stock to be sold and the taxpayer received a written confirmation of the sale, the stock is considered to have been specifically identified.

Example 8

Hilda comes to your site and tells you that she sold some of her MNO stock in 2005. She had bought stock in MNO as follows:

1999	100 shares for \$1,000
2001	200 shares for \$2,300
2003	150 shares for \$1,100

Hilda told her broker to sell the shares she acquired in 2001. The broker did so and provided written confirmation of the sale. For 2005, Hilda has a sale of 200 shares with a basis of \$2,300.

Exercise 5

Victor comes to your site for help with his stock sale. He had purchased NML stock as follows:

2000	300 shares for \$5,000
2002	100 shares for \$7,500
2004	200 shares for \$1,000

Victor told his broker that he wanted to sell the 100 shares he purchased in 2002. The broker sold the stock for \$890 and sent the written confirmation along with the check. What is the basis of the 100 shares that were sold in 2005? _____

Identification Not Possible

If the taxpayer buys and sells investment property at various times in varying quantities and he or she cannot adequately identify the shares that were sold, the securities acquired first are generally considered sold first. This is sometimes referred to as the **FIFO method**—or **First In First Out**. (Except for certain mutual fund shares discussed later, the taxpayer cannot use the average price per share to figure the gain or loss on the sale of the shares.)

Example 9

Isabella bought 100 shares of stock of PQR Corporation in 1991 for \$10 a share. In January 1992, Isabella bought another 200 shares for \$11 a share. In December 1994 she bought 100 shares for \$9 per share. In April 2005, she sold 150 shares. She cannot identify the shares that she sold. She is considered to have sold the 100 shares that she purchased in 1991 and 50 of the shares that she purchased in 1992. Her total basis in the stock she sold is \$1,550 (100 shares at \$10 per share and 50 shares at \$11 per share).

Exercise 6

Ursula sold some stock this year and she doesn't know how to report it on her return. She has a 1099-B that shows she received \$1,600 from the sale of KJI stock. She tells you that she sold 16 shares. She had bought 20 shares at \$90 per share in 2000. She also bought 10 shares at \$100 per share in 2003. She did not specifically identify which stock was to be sold in 2005. What is the basis of the stock she sold? _____

Mutual Fund Sales

Mutual fund shares are generally acquired at various times, in various quantities, and at various prices. Therefore, figuring the basis of the shares sold can be more difficult. The taxpayer can choose either a **cost basis** or **average basis**. The taxpayer cannot use the cost basis if he or she has ever used the average basis for sales of other shares of the same mutual fund.

To use the **cost basis** calculation, the taxpayer must use either the specific share identification method or the FIFO method to identify which shares were sold. These methods were discussed above.

Example 10

Jack sold 100 shares of STU International Fund in 2005. He did not specify which shares were to be sold. He had bought 150 shares at \$10 per share in 2001. He bought additional shares each year through dividend reinvestment. He is not electing to use the average basis. His basis method is FIFO. The basis of the shares sold is \$1,000 (100 shares at \$10).

The taxpayer can use the **average basis** if he or she acquired the mutual fund shares at various times and prices. Once the average basis is elected, it must be used for all accounts in the same fund. The actual calculation of the average basis is beyond the scope of the volunteer program; however, many investment companies provide the average basis figures to the taxpayers. If the taxpayer has the information for the average basis, you can prepare the return.

Example 11

Kendra sold 130 shares of VWX High-Yield fund in 2005. She originally bought 120 shares of this fund in 1990. She has been letting her dividends reinvest for the last 15 years. She shows you the combined Form 1099 from her broker, and you see the following information:

Date	Description	Price/share	Gross proceeds	Average basis	Gain/Loss
6-22-05	130 sh High-Yield	\$40	\$5,200	\$4,900	\$300

Since she has the information for the average basis, you can complete her return. The average basis for the stock she sold is \$4,900. If she had not had this information and she still wanted to elect to use the average basis method, she would need to seek the assistance of a paid tax preparer.

HOLDING PERIOD

If the taxpayer sold investment property, you must determine the holding period for the property. The holding period determines whether any capital gain or loss was short-term or long-term.

In General

If the taxpayer held the investment for more than one year, any capital gain or loss is considered long-term. An investment held by the taxpayer one year or less has a short-term holding period. To determine how long the taxpayer held the property, begin counting on the day after the acquisition date. The day that the stock is sold is counted as part of the holding period.

For securities traded on an established securities market, the holding period begins the day after the trade date for the purchase of the securities and ends on the trade date they were sold. Do not confuse the trade date with the settlement date, which is the date by which the stock must be delivered and payment must be made.

Example 12

Nathan bought 400 shares of HIJ in 2005. His trade date for the purchase was 8-15-05 and his settlement date was 8-19-05. His holding period begins on 8-16-05, the day after the trade date for the shares.

Example 13

Luther sold stock at a gain on December 29, 2005. Under the rules of the stock exchange, the sale was closed by delivery of the stock three trading days after the sale (on January 4, 2006). The taxpayer received the payment on January 4, 2006. The gain is reported on the 2005 return even though the payment was received in 2006.

Inherited Property

If the taxpayer inherited investment property, the capital gain or loss is treated as long-term. This is true regardless of how long he or she actually held the property.

Example 14

Michael inherited 200 shares of EFG stock from his grandfather's estate on 8-23-05. He sold the shares on 9-20-05. His holding period is long-term even though he held the stock for less than a month.

Stock Dividends

The holding period for new stock received as a nontaxable stock dividend begins on the same day as the holding period of the original stock. This rule also applies to stock acquired in a “spin-off”, which is a distribution of stock or securities in a controlled corporation.

Exercise 7

Tom bought 100 shares of HGF. His trade date was for the purchase was 5-2-05. His settlement date was 5-5-05. What date does he use for the beginning of his holding period? _____

Exercise 8

Shameka inherited 50 shares of EDC stock from her grandmother on 7-6-05. She sold the shares in September 2005. Is her holding period short-term or long-term? _____

HOW TO DETERMINE GAIN OR LOSS

We have discussed how to determine the adjusted basis of investment property. Remember, it is the taxpayer’s responsibility to know the basis of the property that was sold. If a taxpayer cannot determine his or her adjusted basis in the investment property sold, the IRS can deem it to be zero. We have covered what types of transactions are considered sales and how to identify the property that was sold. We have also discussed how to determine if the holding period is long-term or short-term. It is now time to pull all of that information together and determine if the sale resulted in a gain or a loss.

In General

As we stated at the beginning of this lesson, you figure the gain or loss on a sale of property by comparing the amount realized with the adjusted basis of the property. If the amount realized from the sale is more than the adjusted basis of the property, then the difference is a gain. If the adjusted basis of the property is more than the amount realized, then the difference is a loss.

Example 15

Oscar had 100 shares of EFG stock with an adjusted basis of \$400. He sold the stock for \$500. Since the sales price (amount realized) is more than his adjusted basis, he has a gain (of \$100) on the sale.

Example 16

Phyllis had 300 shares of HIJ Index Fund with an adjusted basis of \$964. She sold her shares for \$300. Since the sales price (amount realized) is less than her adjusted basis, she has a loss (of \$664) on the sale.

Commissions and Fees

Often, the taxpayer has to pay a commission or fee to acquire or sell investment property. These charges affect the taxpayer's basis in the property and thus become part of the calculation of the gain or loss. Amounts paid to acquire the property adjust (increase) the basis of the investment property.

Example 17

Quentin bought 100 shares of KLM stock for \$200. He had to pay a \$10 fee to acquire the stock. His adjusted basis in the stock is \$210.

Amounts paid to sell the property may be considered an adjustment to the basis. The Form 1099-B requires the issuer to indicate whether the amount reported on the form is gross proceeds or gross proceeds less commissions (net proceeds). If the gross amount has been reported on the form, then any commissions or fees paid on the sale are added to the basis of property. If net proceeds are reflected on the Form 1099-B, no basis adjustment is needed.

Example 18

Ruth sold her NOP stock for \$2,300. Her Form 1099-B reports this as her gross proceeds. She did not have to pay a fee when she bought the stock for \$2,000. She had to pay a \$50 fee when she sold the stock. Her adjusted basis is \$2,050 (the original \$2,000 plus the \$50 selling fee). Her gain on the sale is \$250.

Wash Sales

A wash sale occurs when the taxpayer sells stock or securities, and within 30 days before or after the sale buys substantially identical stock or securities. Taxpayers cannot deduct losses from wash sales, however, gains from wash sales are required to be reported. Taxpayers with these types of transactions may need to consult a paid tax preparer.

Exercise 9

Ruth owned 100 shares of BZZ stock with an adjusted basis of \$500. She sold the stock for \$700. She did not have any fees or other costs when she bought the stock, nor when she sold it.

- Does she have a gain or a loss? _____
- How much is her gain or loss? _____

Exercise 10

Quavidas owned 100 shares of YXW stock with an adjusted basis of \$780. She sold the stock for \$600. There were no fees or other costs when the stock was purchased, nor when it was sold.

- Is there a gain or a loss on the sale? _____
- How much is the gain or loss? _____

Exercise 11

Penelope bought 200 shares of VUT stock for \$600. She also paid a \$50 fee to acquire the shares. She sold all of the shares for \$900. She paid a 5% (\$45) commission to sell the shares. Her 1099-B form lists gross proceeds of \$900.

- What is the adjusted basis of her shares? _____
- Does she have a gain or a loss? _____
- How much is the gain or loss? _____

REPORTING THE TRANSACTION ON THE TAX RETURN

This section discusses how to report capital gains and losses. Enter capital gains and losses on Schedule D (Form 1040), *Capital Gains and Losses* on line 1 or line 8, as described below. Include all capital gain and loss transactions even if the taxpayer did not receive a reporting document (Form 1099-B).

Information for Schedule D

Schedule D is divided into three sections. Use Part I to report short-term transactions. Use Part II to report long-term transactions. Use Part III to determine the net taxable gain or the net deductible loss.

Both Part I line 1, and Part II line 8, ask for detailed information about the transaction. Use the following table to determine where you can find the information needed to complete these lines.

Schedule D Columns on Line 1 and Line 8	Where to find the information:
(a) Description of property	Form 1099-B (or its equivalent) box 7
(b) Date acquired	Taxpayer's records
(c) Date sold	Form 1099-B (or its equivalent) box 1a
(d) Sales price	Form 1099-B (or its equivalent) box 2
(e) Cost or other basis	Taxpayer's records
(f) Gain or loss	Mathematical calculation

See Exhibit 8 included with the Comprehensive Exercise at the end of this lesson for a sample Form 1099-B.

Carryover Losses

Capital losses are used first to offset capital gains. If the taxpayer has capital losses that are more than his or her capital gains, a capital loss deduction can be claimed. The amount of loss that can be claimed in one year is limited to the lesser of:

- \$3,000 (\$1,500 if married filing separately), or
- The total net loss

If the total net losses exceed the yearly limit, the taxpayer may carry over the unused portion to the next year and treat it as if he or she had incurred it in that next year. If part of the loss is still unused, it can be carried over to later years until it is completely used up. When a loss is carried over, it remains long-term or short-term. A short-term capital loss carryover is listed on line 6 of the Schedule D; long-term capital loss carryovers are listed on line 14 of the Schedule D.

If the carryover is not claimed in any year (e.g., income is below filing requirement), then the unused portion still could decrease by \$3,000, or more, or less. If there are any capital gains or losses during the year, Schedule D and the Carryover Worksheet need to be completed (even if not filed) to calculate the carryover for the following year. It is recommended that a tax return be filed each year until the carryover is exhausted.

Example 19

In 2004, Ted had a \$4,000 capital gain, and a capital loss of \$11,400. He used \$4,000 of the capital loss to offset the capital gain: that left a net capital loss of \$7,400. He claimed \$3,000 of the loss on his 2004 return. The effect was to reduce his taxable income by \$3,000. The remaining \$4,400 of capital loss carried over to his 2005 return.

In 2005, he had a \$500 capital gain and no capital losses except for the carryover. So he used \$500 of the \$4,400 carryover to offset the gain, leaving a capital loss of \$3,900. Once again, Ted deducts \$3,000 of the loss — and carries over the remaining \$900 to 2006.

Example 20

Stan and Tina sold stock in 2004. The sales resulted in a net long-term capital loss of \$7,000. They took \$3,000 of the loss off on their 2004 return. The remaining \$4,000 is listed on line 14 of their 2005 Schedule D. It will be added with their other capital gain or loss transactions, if any, to determine the net gain or loss for 2005.

When the capital loss carryover is figured, use the short-term capital losses first, even if they were incurred after the long-term losses. If the limit on the capital loss deduction hasn't been reached after using the short-term capital loss, use the long-term capital losses until the maximum is reached.

Schedule D Not Always Required

If the taxpayer had only capital gain distributions (reported on Form 1099-DIV), then Schedule D is not required. The distributions can be reported directly on the Form 1040A or Form 1040. If the taxpayer had other capital transactions (such as stock sales), the capital gain distributions are reported on line 13 of Schedule D and become part of the net capital gain or loss.

Capital Gains and Qualified Dividends Tax Rates

The tax rates that apply to net long-term capital gain are generally lower than the tax rates that apply to other income. If the capital gain is short-term it will be taxed as ordinary income. The lower rates are called the maximum capital gain rates. The term “net capital gain” means the amount by which the net long-term capital gain for the year is more than the net short-term capital loss, if any.

If you are preparing a tax return manually, you will need to complete a worksheet to determine the correct amount of tax for the return. The worksheet, which is in the tax form instruction book, will calculate the correct tax on the net capital gain (and qualified dividends) and the correct tax for the remainder of the income. If you are using tax software to prepare the return, properly entering the income information should result in the correct tax computation.

DAY-TRADING AND E-TRADING

The Internet has opened up the possibility of individual taxpayers initiating electronic stock purchases and sales. These transactions are treated the same as “traditional” transactions. Each sales transaction is listed separately on Schedule D. If the number of transactions exceeds the space on the Schedule D, use as many Schedule D-1s as needed for continuation sheets.

A day-trader is a taxpayer with trading activity that is substantial, frequent, regular and continuous. This type of activity may be considered self-employment. Preparation of a day-trader’s return is outside the scope of the volunteer program.

SUMMARY EXAMPLE AND EXERCISE

Example 21

Thelma Emerson is single and, in addition to wages from her job, she has income from investments. Thelma has all of her investments in the same brokerage service. Her consolidated 1099 Form and her completed schedule D are presented at the end of this example. Her broker kept track of the stock that she purchased.

Thelma sold stock in two different companies that she held for less than a year. On June 1, 2005, she sold 100 shares of Car Co. stock that she had bought on February 23, 2005. She had an adjusted basis of \$650 in the stock and sold it for \$900, for a gain of \$250. On July 5 2005, she sold 25 shares of Technology Co. that she bought on June 22, 2005. She had an adjusted basis in the stock of \$2,500 and she sold it for \$2,000, for a loss of \$500. She reports these short-term transactions on line 1 in Part I of Schedule D.

Thelma had two other stock sales that she reports as long-term transactions on line 8 in Part II of Schedule D. On February 23, 2005 she sold 20 shares of Tractor Co. for \$2,100. She had inherited the Tractor Co. stock from her father. Its fair market value at the time of his death was \$2,500, which became her basis. Her loss on the sale is \$400. Because she had inherited the stock, her loss is a long-term loss, regardless of how long she and her father actually held the stock.

On June 22, 2005, she sold 500 shares of Couch Co. stock for \$14,000. She had bought 100 of those shares in 1993 for \$1,000. She had bought 100 more shares in 1995 for \$2,200 and an additional 300 shares in 1998 for \$1,500. Her total basis in the stock is \$4,700. She has a \$9,300 ($\$14,000 - \$4,700$) gain on the sale.

Thelma has a capital loss carryover to 2005 of \$800, of which \$300 is short-term capital loss, and \$500 is long-term capital loss.

See the next two pages for her consolidated Form 1099 and her completed Schedule D. For 2005, she has a net short-term loss of \$550 and a net long-term gain of \$10,101.

Thelma Emerson 123 Any Street Your City, State Zip Account Number: 1234-5678-9012 SSN: XXX-XX-XXXX		ABC Investments 456 Main Street Your City, State Zip Phone (XXX) XXX-XXXX FEIN: XX-XXXXXXX		2005 12-31-05	
Substitute 1099-B					
Date of Sale <u>Box 1a</u>	Stocks, Bonds-Proceeds <u>Box 2 (less commission)</u>	Description <u>Box 7</u>	Federal Income Tax Withheld <u>Box 4</u>		
2-23-05	\$ 2,100.00	20 shares Tractor Company	\$0.00		
6-1-05	\$ 900.00	100 shares Car Company	\$0.00		
6-22-05	\$14,000.00	500 shares Couch Company	\$0.00		
7-5-05	\$ 2,000.00	25 shares Technology Company	\$0.00		
Substitute 1099-DIV					
Payer	Ord. Div. <u>Box 1a</u>	Qual. Div. <u>Box 1b</u>	Cap. Gain. Dist. <u>Box 2a</u>	FIT Withheld <u>Box 4</u>	Foreign Tax <u>Box 6</u>
Car Company	\$ 45.00	\$ 45.00	\$ 0.00	\$0.00	\$ 0.00
Couch Company	\$910.00	\$910.00	\$ 0.00	\$0.00	\$ 0.00
Technology Company	\$ 26.00	\$ 26.00	\$ 0.00	\$0.00	\$ 0.00
BCD High Yield Fund	\$ 53.00	\$ 49.00	\$714.00	\$0.00	\$39.00
BCD International Fund	\$ 29.00	\$ 29.00	\$987.00	\$0.00	\$64.00
Additional Information					
Sales/Trades Description	Date Bought	Date Sold	Sales Price	Basis	Gain/(Loss) ST/LT
20 sh Tractor Co.	undetermined	2-23-05	\$ 2,100	undetermined	undetermined
100 sh Car Co.	2-23-05	6-1-05	\$ 900	\$ 650	\$ 250 ST
500 sh Couch Co	various	6-22-05	\$14,000	\$4,700	\$9,300 LT
25 sh Tech. Co	6-22-05	7-5-05	\$ 2,000	\$2,500	(\$500) ST

**SCHEDULE D
(Form 1040)**

Capital Gains and Losses

OMB No. 1545-0074

2005

Attachment
Sequence No. **12**

Department of the Treasury
Internal Revenue Service (99)

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

Name(s) shown on Form 1040

Your social security number

Thelma Emerson

XXX XX XXXX

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1					
100 sh. Car Co.	2/23/05	6/01/05	900	650	250
25 sh. Technology Co.	6/22/05	7/05/05	2,000	2,500	(500)
2 Enter your short-term totals, if any, from Schedule D-1, line 2			2		
3 Total short-term sales price amounts. Add lines 1 and 2 in column (d)			3 2,900		
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824				4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet on page D-6 of the instructions				6 (300)	
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f)				7 (550)	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8					
20 sh. Tractor Co.	Inherit	2/23/05	2,100	2,500	(400)
500 sh. Couch Co.	Various	6/22/05	14,000	4,700	9,300
9 Enter your long-term totals, if any, from Schedule D-1, line 9			9		
10 Total long-term sales price amounts. Add lines 8 and 9 in column (d)			10 16,100		
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12	
13 Capital gain distributions. See page D-1 of the instructions				13 1,701	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet on page D-6 of the instructions				14 (500)	
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Then go to Part III on the back				15 10,101	

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2005


Exercise 12

Donald Judson needs your help with his tax return. Use the following information to complete his 2005 federal income tax return. You may complete the return on the forms provided or by using tax software.

- Donald is single and he does not want to contribute to the Presidential Election Campaign. He has no dependents.
- Donald's address is 123 Any Street, Your City, State, Zip.
- His birthday is 3-16-1942.
- Donald had wages from his job as a machinist. His W-2 is displayed below.
- His only other income is from dividends and the sale of stock. See the Triple A Investments combined Form 1099 on the next page for more information.
- Donald inherited the Kitchen Co. shares from his father. The fair market value on the date of death was \$1,700. (No alternate valuation date was elected.)
- Donald did not make any contributions to a retirement plan and he did not make any estimated payments.

Exhibit 3

2005 Form W-2

a Control number		OMB No. 1545-0008		Safe, accurate, FAST! Use 		Visit the IRS website at www.irs.gov/efile .		
b Employer identification number (EIN) XX-XXXXXXX				1 Wages, tips, other compensation \$50,000	2 Federal income tax withheld \$7,836			
c Employer's name, address, and ZIP code Remco Industries 100 Main Street Your City, State Zip				3 Social security wages \$50,000		4 Social security tax withheld \$3,100		
				5 Medicare wages and tips \$50,000		6 Medicare tax withheld \$725		
				7 Social security tips		8 Allocated tips		
d Employee's social security number XXX-XX-XXXX				9 Advance EIC payment		10 Dependent care benefits		
e Employee's first name and initial Donald		Last name Judson		11 Nonqualified plans		12a See instructions for box 12		
123 Any Street Your City, State Zip				13 Statutory employee <input type="checkbox"/> Retirement plan <input type="checkbox"/> Third-party sick pay <input type="checkbox"/>		12b		
				14 Other		12c		
f Employee's address and ZIP code				12d				
15 State	Employer's state ID number XX-XXXXXXX	16 State wages, tips, etc. \$50,000	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name		

Form **W-2** Wage and Tax Statement

2005

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Donald Judson
 123 Any Street
 Your City, State Zip
 Account Number: 1234-5678-9012
 SSN: XXX-XX-XXXX

Triple A Investments
456 Main Street
Your City, State Zip
Phone (XXX) XXX-XXXX
FEIN: XX-XXXXXXX

2005
12-31-05

Substitute 1099-B

Date of Sale	Stocks, Bonds-Proceeds	Description	Federal Income Tax Withheld
<u>Box 1a</u>	<u>Box 2 (less commission)</u>	<u>Box 7</u>	<u>Box 4</u>
3-17-05	\$1,900	20 shares Kitchen Co.	\$0.00
6-20-05	\$2,700	50 shares Den Co.	\$0.00
7-28-05	\$4,300	100 shares ABC High Yield Fund	\$0.00
9-14-05	\$1,200	10 shares XYZ International Fund	\$0.00

Substitute 1099-DIV

Payor	Ord. Div.	Qual. Div.	Cap. Gain Dist.	FIT Withheld	Foreign Tax Paid
	<u>Box 1a</u>	<u>Box 1b</u>	<u>Box 2a</u>	<u>Box 4</u>	<u>Box 6</u>
Den Co.	\$ 9.00	\$ 9.00	\$0.00	\$0.00	\$0.00
ABC High Yield	\$ 26.00	\$ 26.00	\$0.00	\$0.00	\$0.00
XYZ International Fund	\$ 31.00	\$ 31.00	\$ 7.00	\$0.00	\$ 3.00
JKL Energy Fund	\$ 79.00	\$ 79.00	\$ 283.00	\$0.00	\$ 9.00

Additional Information

Sales/Trades

Description	Date Bought	Date Sold	Sales Price	Basis	Gain/(Loss)	ST/LT
20 sh Kitchen Co.	undetermined	3-17-05	1900.00	undetermined	undetermined	undetermined
50 sh Den Co.	3-17-05	6-20-05	2700.00	2800.00	(100.00)	ST
100 sh ABC HYF	various	7-28-05	4300.00	3900.00(average)	400.00	LT
10 sh XYZ IF	various	9-14-05	1200.00	500.00	700.00	LT

Form **1040**

Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2005

(99) IRS Use Only—Do not write or staple in this space.

Label

(See instructions on page 16.)

Use the IRS label.

Otherwise, please print or type.

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For the year Jan. 1–Dec. 31, 2005, or other tax year beginning _____, 2005, ending _____, 20

Your first name and initial	Last name	OMB No. 1545-0074 Your social security number
If a joint return, spouse's first name and initial	Last name	
Home address (number and street). If you have a P.O. box, see page 16.		Apt. no. You must enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.		

Presidential Election Campaign

Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 16) **You** **Spouse**

Filing Status

Check only one box.

- 1 Single
- 2 Married filing jointly (even if only one had income)
- 3 Married filing separately. Enter spouse's SSN above and full name here. ▶
- 4 Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
- 5 Qualifying widow(er) with dependent child (see page 17)

Exemptions

If more than four dependents, see page 18.

6a **Yourself.** If someone can claim you as a dependent, **do not** check box 6a

b **Spouse**

c Dependents:

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if qualifying child for child tax credit (see page 18)
				<input type="checkbox"/>
				<input type="checkbox"/>
				<input type="checkbox"/>
				<input type="checkbox"/>

d Total number of exemptions claimed

Boxes checked on 6a and 6b _____

No. of children on 6c who:

- lived with you _____
- did not live with you due to divorce or separation (see page 18) _____

Dependents on 6c not entered above _____

Add numbers on lines above ▶

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	
8a	Taxable interest. Attach Schedule B if required	8a	
b	Tax-exempt interest. Do not include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required	9a	
b	Qualified dividends (see page 20)	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 20)	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/>	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	IRA distributions	15a	
b	Taxable amount (see page 22)	15b	
16a	Pensions and annuities	16a	
b	Taxable amount (see page 22)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits	20a	
b	Taxable amount (see page 24)	20b	
21	Other income. List type and amount (see page 24)	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your total income ▶	22	

Adjusted Gross Income

23	Educator expenses (see page 26)	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	One-half of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction (see page XX)	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid	31a	
b	Recipient's SSN ▶		
32	IRA deduction (see page XX)	32	
33	Student loan interest deduction (see page XX)	33	
34	Tuition and fees deduction (see page XX)	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 31a and 32 through 35	36	
37	Subtract line 36 from line 22. This is your adjusted gross income ▶	37	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 75.

Cat. No. 11320B

Form **1040** (2005)

Tax and Credits

Standard Deduction for—

• People who checked any box on line 39a or 39b or who can be claimed as a dependent, see page 31.

• All others:

Single or Married filing separately, \$5,000

Married filing jointly or Qualifying widow(er), \$10,000

Head of household, \$7,300

38 Amount from line 37 (adjusted gross income)
39a Check if: You were born before January 2, 1941, Blind. Spouse was born before January 2, 1941, Blind. Total boxes checked
40 Itemized deductions (from Schedule A) or your standard deduction
41 Subtract line 40 from line 38
42 If line 38 is \$109,475 or less, multiply \$3,200 by the total number of exemptions claimed on line 6d. If line 38 is over \$109,475, see the worksheet on page 33
43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-
44 Tax (see page 33). Check if any tax is from: a Form(s) 8814 b Form 4972
45 Alternative minimum tax (see page 35). Attach Form 6251
46 Add lines 44 and 45
47 Foreign tax credit. Attach Form 1116 if required
48 Credit for child and dependent care expenses. Attach Form 2441
49 Credit for the elderly or the disabled. Attach Schedule R
50 Education credits. Attach Form 8863
51 Retirement savings contributions credit. Attach Form 8880
52 Child tax credit (see page 37). Attach Form 8901 if required
53 Adoption credit. Attach Form 8839
54 Credits from: a Form 8396 b Form 8859
55 Other credits. Check applicable box(es): a Form 3800 b Form 8801 c Specify
56 Add lines 47 through 55. These are your total credits
57 Subtract line 56 from line 46. If line 56 is more than line 46, enter -0-

Other Taxes

58 Self-employment tax. Attach Schedule SE
59 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137
60 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required
61 Advance earned income credit payments from Form(s) W-2
62 Household employment taxes. Attach Schedule H
63 Add lines 57 through 62. This is your total tax

Payments

If you have a qualifying child, attach Schedule EIC.

64 Federal income tax withheld from Forms W-2 and 1099
65 2005 estimated tax payments and amount applied from 2004 return
66a Earned income credit (EIC)
66b Nontaxable combat pay election
67 Excess social security and tier 1 RRTA tax withheld (see page 54)
68 Additional child tax credit. Attach Form 8812
69 Amount paid with request for extension to file (see page 54)
70 Payments from: a Form 2439 b Form 4136 c Form 8885
71 Add lines 64, 65, 66a, and 67 through 70. These are your total payments

Refund

Direct deposit? See page 54 and fill in 73b, 73c, and 73d.

72 If line 71 is more than line 63, subtract line 63 from line 71. This is the amount you overpaid
73a Amount of line 72 you want refunded to you
73b Routing number
73c Type: Checking Savings
73d Account number
74 Amount of line 72 you want applied to your 2006 estimated tax

Amount You Owe

75 Amount you owe. Subtract line 71 from line 63. For details on how to pay, see page 55
76 Estimated tax penalty (see page 55)

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 56)? Yes. Complete the following. No
Designee's name Phone no. Personal identification number (PIN)

Sign Here

Joint return? See page 17. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.
Your signature Date Your occupation Daytime phone number
Spouse's signature. If a joint return, both must sign. Date Spouse's occupation

Paid Preparer's Use Only

Preparer's signature Date Check if self-employed Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code EIN Phone no.

**SCHEDULE D
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Name(s) shown on Form 1040

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074

2005

Attachment
Sequence No. **12**

Your social security number

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1					
2 Enter your short-term totals, if any, from Schedule D-1, line 2					
3 Total short-term sales price amounts. Add lines 1 and 2 in column (d)					
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824					4
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1					5
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet on page D-6 of the instructions					6 ()
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f)					7

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8					
9 Enter your long-term totals, if any, from Schedule D-1, line 9					
10 Total long-term sales price amounts. Add lines 8 and 9 in column (d)					
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824					11
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1					12
13 Capital gain distributions. See page D-1 of the instructions					13
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet on page D-6 of the instructions					14 ()
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Then go to Part III on the back					15

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2005

Part III Summary

16 Combine lines 7 and 15 and enter the result. If line 16 is a loss, skip lines 17 through 20, and go to line 21. If a gain, enter the gain on Form 1040, line 13, and then go to line 17 below . . .

16

17 Are lines 15 and 16 **both** gains?

- Yes.** Go to line 18.
- No.** Skip lines 18 through 21, and go to line 22.

18 Enter the amount, if any, from line 7 of the **28% Rate Gain Worksheet** on page D-7 of the instructions ▶

18

19 Enter the amount, if any, from line 18 of the **Unrecaptured Section 1250 Gain Worksheet** on page D-8 of the instructions ▶

19

20 Are lines 18 and 19 **both** zero or blank?

- Yes.** Complete Form 1040 through line 43, and then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 34 of the Instructions for Form 1040. **Do not** complete lines 21 and 22 below.
- No.** Complete Form 1040 through line 43, and then complete the **Schedule D Tax Worksheet** on page D-9 of the instructions. **Do not** complete lines 21 and 22 below.

21 If line 16 is a loss, enter here and on Form 1040, line 13, the **smaller** of:

- The loss on line 16 or
- (\$3,000), or if married filing separately, (\$1,500) }

21 ()

Note. When figuring which amount is smaller, treat both amounts as positive numbers.

22 Do you have qualified dividends on Form 1040, line 9b?

- Yes.** Complete Form 1040 through line 43, and then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 34 of the Instructions for Form 1040.
- No.** Complete the rest of Form 1040.

Qualified Dividends and Capital Gain Tax Worksheet—Line 44

Keep for Your Records



Before you begin: ✓ See the instructions for line 44 on page 33 to see if you can use this worksheet to figure your tax.
 ✓ If you do not have to file Schedule D and you received capital gain distributions, be sure you checked the box on line 13 of Form 1040.

1. Enter the amount from Form 1040, line 43 **1.** _____
2. Enter the amount from Form 1040, line 9b **2.** _____
3. Are you filing Schedule D?
 - Yes.** Enter the **smaller** of line 15 or 16 of Schedule D, but do not enter less than -0-
 - No.** Enter the amount from Form 1040, line 13
 } **3.** _____
4. Add lines 2 and 3 **4.** _____
5. If you are claiming investment interest expense on Form 4952, enter the amount from line 4g of that form. Otherwise, enter -0- **5.** _____
6. Subtract line 5 from line 4. If zero or less, enter -0- **6.** _____
7. Subtract line 6 from line 1. If zero or less, enter -0- **7.** _____
8. Enter the **smaller** of:
 - The amount on line 1, or
 - \$29,700 if single or married filing separately, \$59,400 if married filing jointly or qualifying widow(er), \$39,800 if head of household.
 } **8.** _____
9. Is the amount on line 7 equal to or more than the amount on line 8?
 - Yes.** Skip lines 9 through 11; go to line 12 and check the "No" box.
 - No.** Enter the amount from line 7 **9.** _____
10. Subtract line 9 from line 8 **10.** _____
11. Multiply line 10 by 5% (.05) **11.** _____
12. Are the amounts on lines 6 and 10 the same?
 - Yes.** Skip lines 12 through 15; go to line 16.
 - No.** Enter the **smaller** of line 1 or line 6 **12.** _____
13. Enter the amount from line 10 (if line 10 is blank, enter -0-) **13.** _____
14. Subtract line 13 from line 12 **14.** _____
15. Multiply line 14 by 15% (.15) **15.** _____
16. Figure the tax on the amount on line 7. Use the Tax Table or Tax Computation Worksheet, whichever applies **16.** _____
17. Add lines 11, 15, and 16 **17.** _____
18. Figure the tax on the amount on line 1. Use the Tax Table or Tax Computation Worksheet, whichever applies **18.** _____
19. **Tax on all taxable income.** Enter the **smaller** of line 17 or line 18. Also include this amount on Form 1040, line 44 **19.** _____

<input type="checkbox"/> CORRECTED (if checked)		Proceeds From Broker and Barter Exchange Transactions	
PAYER'S name, street address, city, state, ZIP code, and telephone no.		1a Date of sale or exchange	OMB No. 1545-0715
		1b CUSIP no.	2005
		Form 1099-B	
		2 Stocks, bonds, etc.	Reported } <input type="checkbox"/> Gross proceeds to IRS } <input type="checkbox"/> Gross proceeds less commissions and option premiums
		\$	
PAYER'S Federal identification number	RECIPIENT'S identification number	3 Bartering	4 Federal income tax withheld
		\$	\$
RECIPIENT'S name Street address (including apt. no.) City, state, and ZIP code		5 No. of shares exchanged	6 Classes of stock exchanged
		7 Description	
		8 Profit or (loss) realized in 2005	9 Unrealized profit or (loss) on open contracts—12/31/2004
		\$	\$
CORPORATION'S name, street address, city, state, and ZIP code		10 Unrealized profit or (loss) on open contracts—12/31/2005	11 Aggregate profit or (loss)
		\$	\$
Account number (see instructions)		12 If the box is checked, the recipient cannot take a loss on their tax return based on the amount in box 2 . . . <input type="checkbox"/>	
Form 1099-B		(keep for your records)	
		Department of the Treasury - Internal Revenue Service	

**Copy B
For Recipient**

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

▶▶ LESSON SUMMARY ◀◀

- ▶ The gain or loss on the sale of investment property is calculated by comparing the adjusted basis to the amount realized.
- ▶ The basis of investment property is generally its cost.
- ▶ The adjusted basis of investment property reflects the original cost plus or minus any required adjustments (such as commissions).
- ▶ Schedule D is used to report capital gains and losses

I have investment property. What does the term “basis” mean? Basis is your investment in property for tax purposes. Before you can figure any gain or loss on a sale, exchange, or other disposition of property, you must determine the basis. Your original basis is usually your cost to acquire the asset. Adjusted basis is the result of increasing or decreasing your original basis according to certain events.

How do I figure the cost basis of stock that has split, giving me more of the same stock, so I can figure my capital gain (or loss) of the sale of the stock? When the old stock and the new stock are identical, the basis of the old shares must be allocated to the old and the new shares. Thus, you generally divide the adjusted basis of the old stock by the number of shares of stock held after the split. The result is your new basis per share of stock.

How do I figure the cost basis when the stocks I’m selling were purchased at various times and at different prices? If you can identify which shares of stock you sold, your basis is what you paid for the shares sold (plus sales commissions). If you sell a block of the same kind of stock, you can report all the shares sold at the same time as one sale, writing VARIOUS in the “date acquired” column of Schedule D. What you enter in the “cost or other basis” column is the total of all the acquisition costs of the shares sold. If you cannot adequately identify the shares you sold, and you bought the shares at various times for different prices, the basis of the stock sold is the basis of the shares you acquired first (first-in first-out). Except for mutual fund shares, you cannot use the average price per share to figure gain or loss.

How do we show on our tax form that dividends are reinvested? Some corporations and most mutual funds allow investors to choose to use their dividends to buy more shares instead of receiving the dividend in cash. If you are a member of this type of plan, you must still report the dividend payment as income on your return. You do not actually show that the dividends were reinvested on your return. Keep good records of the dollar amount of the reinvested dividends, the number of additional shares purchased, and the purchase date. You will need this information when you sell the shares.

How do I compute the basis for stock I sold, when I received the stock over several years through a dividend reinvestment plan? The basis of the stock you sold is the cost of the shares plus any adjustments, such as sales commissions. If you have not kept detailed records of your dividend reinvestments, you may be able to reconstruct those records with the help of public records from sources such as the media, your broker, or the company that issued the dividends. If you cannot specifically identify which shares were sold, you must use the first-in first-out rule. This means that you deem that you sold the oldest shares first, then the next oldest, then the next-to-the-next oldest, until you have accounted for the number of shares in the sale. To establish the basis of these shares, you need to have kept adequate documentation of all your purchases, including those that were through the dividend reinvestment plan. You may not use an average cost basis. Only mutual fund shares may have an average cost basis.

How do I report an employee stock purchase plan on my tax return? If your stock option is granted under an employee stock purchase plan, you do not include any amount in your gross income as a result of the grant or exercise of your option. When you sell the stock that you purchased by exercising the option, you may have to report compensation and capital gain or capital loss.

Do I need to pay taxes on stock I gained as a result of a split? No, you generally do not need to pay tax on the additional shares of stock you received due to the stock split. You will need to adjust your per-share cost of the stock. Your overall cost basis has not changed, but your per-share cost has changed. You will have to pay taxes if you have gain when you sell the stock. Gain is the amount of the proceeds from the sale, minus sales commissions, that exceeds the adjusted basis of the stock sold.

I bought stock for \$1,000 and sold it for 1,200. My gain was only \$200, but my broker reported \$1,200 on my Form 1099-B. What should I do? Brokers generally do not report the amount of the gain. They report the amount you received on the sale. By reporting the sale on Schedule D (Form 1040), you will end up including only the \$200 in your income.

How do return-of-principal payments affect my cost basis when I sell mutual funds? A return of principal (or return of capital) reduces your basis in your mutual fund shares. This is also sometimes referred to as a nontaxable distribution. Unlike a dividend or a capital gain distribution, a return of capital is a return of part of your investment (cost). However, basis cannot be reduced below zero. Once your basis reaches zero, any return of principal is capital gain and must be reported on Form 1040 Schedule D, Capital Gains and Losses.

If I used an average basis method for shares of one mutual fund I sold, do I have to use it for all mutual funds I sell? No, you may use a different method, as long as you have not used an average basis method for that fund previously. Once you have elected to use an average basis method to compute the gain or loss on shares in a mutual fund, you must use that same method for the sale of shares from any account in that same fund.

Is a capital gain on the sale of my tax-exempt bond fund taxable? While dividend income from tax-exempt funds is exempt from federal income tax, capital gains are subject to taxation.

I received a 1099-DIV showing a capital gain. Why do I have to report capital gains from my mutual funds if I never sold any shares? A mutual fund is a regulated investment company that pools funds of investors, allowing them to take advantage of a diversity of investments and professional asset management. You own shares in the fund, but the fund owns assets such as shares of stock, corporate bonds, government obligations, etc. One of the ways the fund makes money for its investors is to sell these assets at a gain. If the asset was held by the mutual fund for more than one year, the nature of the income is capital gain, which gets passed on to you. These are called capital gain distributions. Capital gain distributions are taxed as long-term capital gains regardless of how long you have owned the shares in the mutual fund. If your capital gains distribution is automatically reinvested, the reinvested amount is the basis of the additional shares purchased.

My stocks went up but I didn't sell yet. How much gain should I report? You don't report capital gain or loss until you sell the stock.

My mutual fund reported that I sold shares even though I didn't take any money out! Why? If you move money from one fund to another within the same family of funds, you're selling one fund and buying another. The sale results in a reportable event. All of your sales transactions should be reported on Schedule D (Form 1040) If the first fund sold for more than your adjusted basis in the fund, you will have a capital gain.

I own stock which became worthless last year. Can I take a bad-debt deduction on my tax return? If you own securities and they become totally worthless, you can take a deduction for a loss, but not for a bad debt. The worthless securities are treated as though they were capital assets sold on the last day of the tax year if they were capital assets in your hands. Report worthless securities on line 1 or line 8 of Form 1040, Schedule D, whichever applies. In columns (c) and (d), write "Worthless."

I had a major loss on my investments. How can I put this on my tax form? Can I divide this loss over the next five years on my tax forms? If you actually sold investments and had a capital loss you can deduct this using Schedule D of Form 1040. A maximum of \$3,000 in losses may be taken in one year. Any remainder is carried over until the following year. If you had only "paper losses", i.e., you did not actually sell any investments, they are not deductible.

I inherited 160 shares of stock from my mother. On the date of her death, the stock was worth \$23 per share. Since her death, the stock had split; doubling the shares (320). I sold the stock last year at \$6 per share. Is this sale a capital gain or loss? Your basis in the 320 shares of stock is \$3,680 (160 x \$23), the fair value of the stock when you inherited it. The subsequent split does not affect your total basis, just the per-share basis, which after the split became \$11.50 (1/2 of \$23 per share). So, by selling all 320 of your shares at \$6, or \$1,920, you have a capital loss of \$1,760 (\$3,680 basis minus \$1,920 proceeds). Gains or losses on all inherited investment property are considered long-term, no matter how long it's been since you inherited it. Report the sale transaction on line 8 of Schedule D.

Does a capital loss reduce my income? As a general rule, you can deduct capital losses up to the full amount of your capital gain plus \$3,000. If your capital losses exceed your capital gains by more than \$3,000, the excess is carried forward to the next year.

I had a \$14,000 net capital loss in 2004. I deducted \$3,000 on line 13 of my 2004 Form 1040. I didn't buy or sell anything in 2005. Can I just put my \$3,000 loss on line 13 and skip the Schedule D? No, you will need to complete a Schedule D to properly record the carryover of the loss. You will then transfer the allowable loss to line 13 of Form 1040.

I have a large capital loss carryover, but this year I do not have enough income to file a return. Can I just save my capital loss and deduct it when I have income? The calculation of the allowable loss must be made each year. Use Schedule D and the

Capital Loss Carryover Worksheet to determine the amount. When you figure any capital loss carryover to the next year, you must take the current year's allowable deduction into account, whether or not you claimed it.

My traditional IRA is invested in stocks and last year my account value went down. How do I report this? Losses in your IRA portfolio are usually not deductible. Your basis in traditional IRAs is the total of all your nondeductible contributions to traditional IRAs minus the total of all your nontaxable distributions.

I had capital gains in my IRA. How much tax is owed? Until you take the money out of your IRA, nothing is taxed. But, when money comes out of a traditional IRA, at least a portion of the distribution will be taxable. Of course, if you have a Roth IRA and meet all of the requirements, you will pay no tax even when the distribution occurs.

1. \$3,000 (150 shares \times \$20)
2. \$300 (\$200 + \$20 + \$40 + \$40)
3. \$4,000 (400 shares \times \$10)
4. yes
5. \$7,500
6. \$1,440 (16 shares \times \$90)
7. 5-3-05, the day after the trade date
8. long-term
9. a. gain b. \$200
10. a. loss b. \$180
11. a. \$695 (\$600 + \$50 + \$45)
 b. gain
 c. \$205 (\$900 – \$695)
12. Please see the completed Form 1040 and Schedule D on the following pages.

Form **1040** Department of the Treasury—Internal Revenue Service **2005** (99) IRS Use Only—Do not write or staple in this space.

Label (See instructions on page 16.) **Use the IRS label.** Otherwise, please print or type.

Label Here

For the year Jan. 1–Dec. 31, 2005, or other tax year beginning _____, 2005, ending _____, 20 _____ OMB No. 1545-0074

Your first name and initial: **Donald** Last name: **Judson** Your social security number: **XXX ; XX ; XXXX**

If a joint return, spouse's first name and initial: _____ Last name: _____ Spouse's social security number: _____

Home address (number and street). If you have a P.O. box, see page 16. Apt. no. **123 Any Street**

City, town or post office, state, and ZIP code. If you have a foreign address, see page 16. **Your City, State ZIP**

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 16) You Spouse

Filing Status

1 Single 4 Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ _____

2 Married filing jointly (even if only one had income)

3 Married filing separately. Enter spouse's SSN above and full name here. ▶ _____

5 Qualifying widow(er) with dependent child (see page 17)

Check only one box.

Exemptions

6a Yourself. If someone can claim you as a dependent, do not check box 6a } **Boxes checked on 6a and 6b** **1**

b Spouse } **No. of children on 6c who:**

c **Dependents:** (1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) if qualifying child for child tax credit (see page 18)

If more than four dependents, see page 18.

d Total number of exemptions claimed **1**

Income

7 Wages, salaries, tips, etc. Attach Form(s) W-2 **7** **50,000**

8a Taxable interest. Attach Schedule B if required **8a**

b Tax-exempt interest. Do not include on line 8a **8b**

9a Ordinary dividends. Attach Schedule B if required **9a** **145**

b Qualified dividends (see page 20) **9b** **145**

10 Taxable refunds, credits, or offsets of state and local income taxes (see page 20) **10**

11 Alimony received **11**

12 Business income or (loss). Attach Schedule C or C-EZ **12**

13 Capital gain or (loss). Attach Schedule D if required. If not required, check here **13** **1,490**

14 Other gains or (losses). Attach Form 4797 **14**

If you did not get a W-2, see page 19.

15a IRA distributions **15a** **15b** Taxable amount (see page 22)

16a Pensions and annuities **16a** **16b** Taxable amount (see page 22)

17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E **17**

18 Farm income or (loss). Attach Schedule F **18**

19 Unemployment compensation **19**

20a Social security benefits **20a** **20b** Taxable amount (see page 24)

21 Other income. List type and amount (see page 24) **21**

22 Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶ **22** **51,635**

Adjusted Gross Income

23 Educator expenses (see page 26) **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 One-half of self-employment tax. Attach Schedule SE **27**

28 Self-employed SEP, SIMPLE, and qualified plans **28**

29 Self-employed health insurance deduction (see page XX) **29**

30 Penalty on early withdrawal of savings **30**

31a Alimony paid b Recipient's SSN ▶ _____ **31a**

32 IRA deduction (see page XX) **32**

33 Student loan interest deduction (see page XX) **33**

34 Tuition and fees deduction (see page XX) **34**

35 Domestic production activities deduction. Attach Form 8903 **35**

36 Add lines 23 through 31a and 32 through 35 **36**

37 Subtract line 36 from line 22. This is your **adjusted gross income** ▶ **37** **51,635**

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 75. Cat. No. 11320B Form **1040** (2005)

Form 1040 (2005)

Page **2**

Tax and Credits

Standard Deduction for—

- People who checked any box on line 39a or 39b or who can be claimed as a dependent, see page 31.
- All others:

Single or Married filing separately, \$5,000

Married filing jointly or Qualifying widow(er), \$10,000

Head of household, \$7,300

38	Amount from line 37 (adjusted gross income)	38	51,635
39a	Check <input type="checkbox"/> You were born before January 2, 1941, <input type="checkbox"/> Blind. <input type="checkbox"/> Spouse was born before January 2, 1941, <input type="checkbox"/> Blind. Total boxes checked ▶ 39a		
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here ▶ 39b <input type="checkbox"/>		
40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40	5,000
41	Subtract line 40 from line 38	41	46,635
42	If line 38 is \$109,475 or less, multiply \$3,200 by the total number of exemptions claimed on line 6d. If line 38 is over \$109,475, see the worksheet on page 33	42	3,200
43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	43,435
44	Tax (see page 33). Check if any tax is from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972	44	7,366
45	Alternative minimum tax (see page 35). Attach Form 6251	45	
46	Add lines 44 and 45	46	7,366
47	Foreign tax credit. Attach Form 1116 if required	47	12
48	Credit for child and dependent care expenses. Attach Form 2441	48	
49	Credit for the elderly or the disabled. Attach Schedule R	49	
50	Education credits. Attach Form 8863	50	
51	Retirement savings contributions credit. Attach Form 8880	51	
52	Child tax credit (see page 37). Attach Form 8901 if required	52	
53	Adoption credit. Attach Form 8839	53	
54	Credits from: a <input type="checkbox"/> Form 8396 b <input type="checkbox"/> Form 8859	54	
55	Other credits. Check applicable box(es): a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8801 c <input type="checkbox"/> Specify	55	
56	Add lines 47 through 55. These are your total credits	56	12
57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0-	57	7,354

Other Taxes

58	Self-employment tax. Attach Schedule SE	58	
59	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	59	
60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	60	
61	Advance earned income credit payments from Form(s) W-2	61	
62	Household employment taxes. Attach Schedule H	62	
63	Add lines 57 through 62. This is your total tax	63	7,354

Payments

If you have a qualifying child, attach Schedule EIC.

64	Federal income tax withheld from Forms W-2 and 1099	64	7,836
65	2005 estimated tax payments and amount applied from 2004 return	65	
66a	Earned income credit (EIC)	66a	
b	Nontaxable combat pay election ▶ 66b		
67	Excess social security and tier 1 RRTA tax withheld (see page 54)	67	
68	Additional child tax credit. Attach Form 8812	68	
69	Amount paid with request for extension to file (see page 54)	69	
70	Payments from: a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136 c <input type="checkbox"/> Form 8885	70	
71	Add lines 64, 65, 66a, and 67 through 70. These are your total payments	71	7,836

Refund

Direct deposit? See page 54 and fill in 73b, 73c, and 73d.

72	If line 71 is more than line 63, subtract line 63 from line 71. This is the amount you overpaid	72	482
73a	Amount of line 72 you want refunded to you	73a	482
b	Routing number	c	Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings
d	Account number		
74	Amount of line 72 you want applied to your 2006 estimated tax	74	

Amount You Owe

75	Amount you owe. Subtract line 71 from line 63. For details on how to pay, see page 55	75	
76	Estimated tax penalty (see page 55)	76	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 56)? **Yes.** Complete the following. **No**

Designee's name ▶	Phone no. ▶ ()	Personal identification number (PIN) ▶
-------------------	-----------------	--

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See page 17. Keep a copy for your records.

Your signature	Date	Your occupation	Daytime phone number ()
Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed <input type="checkbox"/>	Preparer's SSN or PTIN SXXXXXXXX
Firm's name (or yours if self-employed), address, and ZIP code ▶	EIN	Phone no. ()	

Form **1040** (2005)

<p>SCHEDULE D (Form 1040)</p> <p>Department of the Treasury Internal Revenue Service (99)</p> <p>Name(s) shown on Form 1040 Donald Judson</p>	<p>Capital Gains and Losses</p> <p>▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040). ▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.</p>	<p>OMB No. 1545-0074</p> <p style="font-size: 2em; font-weight: bold;">2005</p> <p>Attachment Sequence No. 12</p> <p>Your social security number XXX XX XXXX</p>			
<p>Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less</p>					
(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1					
50 sh. Den Co.	3/17/05	6/20/05	2,700	2,800	(100)
2 Enter your short-term totals, if any, from Schedule D-1, line 2	2				
3 Total short-term sales price amounts. Add lines 1 and 2 in column (d)	3		2,700		
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4				
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5				
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet on page D-6 of the instructions	6				()
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f)	7				(100)
<p>Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year</p>					
(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8					
20 sh. Kitchen Co.	Inherit	3/17/05	1,900	1,700	200
100 sh. ABC High Yield	Various	7/28/05	4,300	3,900	400
100 sh XYZ International	Various	9/14/05	1,200	500	700
9 Enter your long-term totals, if any, from Schedule D-1, line 9	9				
10 Total long-term sales price amounts. Add lines 8 and 9 in column (d)	10		7,400		
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11				
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12				
13 Capital gain distributions. See page D-1 of the instructions	13				290
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet on page D-6 of the instructions	14				()
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Then go to Part III on the back	15				1,590
For Paperwork Reduction Act Notice, see Form 1040 instructions.			Cat. No. 11338H		Schedule D (Form 1040) 2005

Part III Summary

<p>16 Combine lines 7 and 15 and enter the result. If line 16 is a loss, skip lines 17 through 20, and go to line 21. If a gain, enter the gain on Form 1040, line 13, and then go to line 17 below . . .</p>	16	1,490	
<p>17 Are lines 15 and 16 both gains? <input checked="" type="checkbox"/> Yes. Go to line 18. <input type="checkbox"/> No. Skip lines 18 through 21, and go to line 22.</p>			
<p>18 Enter the amount, if any, from line 7 of the 28% Rate Gain Worksheet on page D-7 of the instructions ▶</p>	18		
<p>19 Enter the amount, if any, from line 18 of the Unrecaptured Section 1250 Gain Worksheet on page D-8 of the instructions ▶</p>	19		
<p>20 Are lines 18 and 19 both zero or blank? <input checked="" type="checkbox"/> Yes. Complete Form 1040 through line 43, and then complete the Qualified Dividends and Capital Gain Tax Worksheet on page 34 of the Instructions for Form 1040. Do not complete lines 21 and 22 below. <input type="checkbox"/> No. Complete Form 1040 through line 43, and then complete the Schedule D Tax Worksheet on page D-9 of the instructions. Do not complete lines 21 and 22 below.</p>			
<p>21 If line 16 is a loss, enter here and on Form 1040, line 13, the smaller of:</p> <ul style="list-style-type: none"> • The loss on line 16 or • (\$3,000), or if married filing separately, (\$1,500) } <p>Note. When figuring which amount is smaller, treat both amounts as positive numbers.</p>	21	()	
<p>22 Do you have qualified dividends on Form 1040, line 9b? <input type="checkbox"/> Yes. Complete Form 1040 through line 43, and then complete the Qualified Dividends and Capital Gain Tax Worksheet on page 34 of the Instructions for Form 1040. <input type="checkbox"/> No. Complete the rest of Form 1040.</p>			

Qualified Dividends and Capital Gain Tax Worksheet—Line 44

Keep for Your Records 

Before you begin: ✓ See the instructions for line 44 on page 33 to see if you can use this worksheet to figure your tax.
 ✓ If you do not have to file Schedule D and you received capital gain distributions, be sure you checked the box on line 13 of Form 1040.

1. Enter the amount from Form 1040, line 43	1.	<u>43,435</u>
2. Enter the amount from Form 1040, line 9b	2.	<u>145</u>
3. Are you filing Schedule D? <input checked="" type="checkbox"/> Yes. Enter the smaller of line 15 or 16 of Schedule D, but do not enter less than -0- <input type="checkbox"/> No. Enter the amount from Form 1040, line 13	3.	<u>1,490</u>
4. Add lines 2 and 3	4.	<u>1,635</u>
5. If you are claiming investment interest expense on Form 4952, enter the amount from line 4g of that form. Otherwise, enter -0-	5.	<u>0</u>
6. Subtract line 5 from line 4. If zero or less, enter -0-	6.	<u>1,635</u>
7. Subtract line 6 from line 1. If zero or less, enter -0-	7.	<u>41,800</u>
8. Enter the smaller of: • The amount on line 1, or • \$29,700 if single or married filing separately, \$59,400 if married filing jointly or qualifying widow(er), \$39,800 if head of household.	8.	<u>29,700</u>
9. Is the amount on line 7 equal to or more than the amount on line 8? <input checked="" type="checkbox"/> Yes. Skip lines 9 through 11; go to line 12 and check the "No" box. <input type="checkbox"/> No. Enter the amount from line 7	9.	_____
10. Subtract line 9 from line 8	10.	_____
11. Multiply line 10 by 5% (.05)	11.	_____
12. Are the amounts on lines 6 and 10 the same? <input type="checkbox"/> Yes. Skip lines 12 through 15; go to line 16. <input checked="" type="checkbox"/> No. Enter the smaller of line 1 or line 6	12.	<u>1,635</u>
13. Enter the amount from line 10 (if line 10 is blank, enter -0-)	13.	<u>0</u>
14. Subtract line 13 from line 12	14.	<u>1,635</u>
15. Multiply line 14 by 15% (.15)	15.	<u>245</u>
16. Figure the tax on the amount on line 7. Use the Tax Table or Tax Computation Worksheet, whichever applies	16.	<u>7,121</u>
17. Add lines 11, 15, and 16	17.	<u>7,366</u>
18. Figure the tax on the amount on line 1. Use the Tax Table or Tax Computation Worksheet, whichever applies	18.	<u>7,521</u>
19. Tax on all taxable income. Enter the smaller of line 17 or line 18. Also include this amount on Form 1040, line 44	19.	<u>7,366</u>

STUDENT NOTES

INTRODUCTION AND OBJECTIVES

In this lesson we will learn the simplified rules that apply to homeowners who sell their principal residence or “main home” during the tax year. Taxpayers, who meet all of the eligibility requirements, may exclude up to \$250,000 (\$500,000 if Married Filing Jointly) of gain from their taxable income.

After completing this lesson, you will be able to:

- Determine whether a home is the taxpayer’s main home
- Determine whether a taxpayer meets the ownership and use test
- Determine the amount of gain an eligible taxpayer may exclude if a primary residence is sold
- Determine when the 5-year ownership/use test period is suspended

The sale of a main home used as rental property or partially for business is outside the scope of the volunteer program.

ELIGIBILITY REQUIREMENTS FOR THE EXCLUSION

To be eligible for the \$250,000 (\$500,000 if married filing jointly) exclusion, taxpayers must:

- 1) Meet the ownership test
- 2) Meet the use test
- 3) Not have excluded gain in the two years before the current sale of the home

These requirements are discussed in more detail below.

Period of Ownership and Use

To claim the exclusion on the gain from the sale of a home, the taxpayer must meet the ownership and use test. This means that during the five-year period ending on the date of the sale, the taxpayer must have:

ALERT



This lesson contains advanced tax law. Your course facilitator will only teach the information required to assist taxpayers you will serve.

- 1) Owned the home for at least two years (the ownership test), and
- 2) Lived in the home as his or her main home (defined later) for at least two years (the use test)

In addition, during the two-year period ending on the date of the sale, the taxpayer must not have claimed exclusion of a gain from the sale of another home.

The taxpayer meets the test if he or she can show that they owned and lived in the property as their main home for either 24 full months or 730 days during the five-year period. Short, temporary absences, even if the property is rented during those absences, are counted as periods of use.

Ownership and use tests can be met during different two-year periods. However, a taxpayer must meet both tests during the five-year period ending on the date of the sale.

Example 1

In 1997, Helen Jones lived in a rented apartment. The apartment building was later changed to a condominium, and she bought her apartment on December 1, 2002. In 2003, Helen became ill and on April 14 of that year she moved in to her daughter's home. On July 10, 2005, while still living in her daughter's home, she sold her apartment.

Helen can exclude all the gain on the sale of her apartment because she met the ownership and use tests. Her 5-year period is from July 11, 2000, to July 10, 2005, the date she sold the apartment. She owned her apartment from December 1, 2002, to July 10, 2005 (over 2 years). She lived in the apartment from July 11, 2000 (the beginning of the 5-year period), to April 14, 2003 (over 2 years).

Definition of Main Home

It is important to have a clear understanding of what is, and what is not, the taxpayer's main home. Only a gain from the sale of a taxpayer's main home is eligible to be excluded from the taxpayer's income.

A gain from a sale of a home that is not the taxpayer's main home will generally have to be reported as income. Any gain that must be reported as income is a taxable gain and is reported on Schedule D, (Form 1040), Capital Gains and Losses. The sale of a home that is not the taxpayer's main home is outside the scope of the Volunteer Return Preparation Program.

A taxpayer's main home does not have to be a traditional house. It simply has to be the residence where the taxpayer lives most of the time and must have cooking, sleeping, and bathroom facilities. A taxpayer's main home can be a house, boat, mobile home, cooperative apartment, or condominium (house or apartment).

More than One Home

Taxpayers who have more than one home cannot choose which home to designate as their main home. If a taxpayer has more than one home, you must determine which home he or she lives in most of the time.

In most cases, taxpayers own and live in one home. You still have to be sure that the owner of a single home meets the requirement of living in the home most of the time.

Example 2

Lucille owns a home in a Colorado ski area (the ski home). She stays at the ski home most weekends and spends the entire months of December, January, and February there. When she is not at the ski home, she lives in a four-room apartment that she rents in Denver. For over half the year, she lives in Denver.

Lucille's main home is her rental apartment in Denver, because she lives there most of the time, even though she does not own the apartment in Denver.

Example 3

Christopher owns two homes. One residence is located in St. Louis where he works and the other is located in a resort area approximately 100 miles away. Christopher lives in his St. Louis home during the week (Monday through Friday) and travels to his weekend home on the weekends. Christopher's main home is his St. Louis home, because he lives there Monday through Friday, traveling to his weekend home only on Saturdays and Sundays.

Other Factors Used to Determine Main Home

In addition to the amount of time a taxpayer lived in each home, other factors are relevant in determining which home is his or her main home. Those factors include the following:

1. Taxpayer's place of employment.
2. The location of other family members' main home.
3. The property location where the "homestead exemption" is claimed for county and/or city property tax purposes.
4. The mailing address for bills and correspondence.
5. The address listed on:
 - a. Federal and state tax returns
 - b. Driver's license
 - c. Car registration, and
 - d. Voter registration card
6. The location of banks used.

ALERT



Never assume that a house sold during the year was the taxpayer's main home, even if the house was the only one owned by the taxpayer. Be sure to check that the house was, in fact, the individual's main home.

7. The location of recreational club and religious organization memberships.

Married Homeowners

The ownership and use tests are applied somewhat differently to married homeowners. Married homeowners can exclude up to \$500,000 if they meet all the following conditions:

- They file a joint return
- Either spouse meets the ownership test
- Both individuals meet the use test
- Neither spouse excluded gain from the sale of another home in the two years before the current sale of the home

If either spouse does not satisfy all these requirements, they cannot claim the maximum \$500,000 exclusion. The most that can be claimed by the couple is the total of the maximum exclusions that each spouse would qualify for if not married and the amounts were figured separately. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property. This calculation is outside of the scope of the volunteer program.

Reduced Exclusion

Taxpayers who owned and used a home for less than two years (and so do not meet the ownership and use test) may be able to claim a reduced exclusion, if the taxpayer sold the home due to:

- 1) A change in place of employment
- 2) Health, or
- 3) Unforeseen circumstances

The calculation of the reduced exclusion is outside of the scope of the volunteer program.

Reporting the Exclusion

Taxpayers do not have to report the sale of a home on their tax return unless they have a gain and at least part of it is taxable (i.e., the gain exceeds the exclusion amount of \$250,000 or \$500,000). The amount of the taxable gain (total gain less exclusion) from the sale of the residence should be reported on Schedule D and combined with other gains and losses before entering on line 13 of the Form 1040.

A loss on the sale of the taxpayer's main home cannot be deducted on his or her tax return.

5-YEAR TEST PERIOD SUSPENSION—ARMED FORCES PERSONNEL

The taxpayer can choose to have the 5-year test period for ownership and use suspended during any period when he/she or his/her spouse serve on **qualified official extended duty** as a member of the Armed Forces. This means that the taxpayer may be able to meet the 2-year use test even if, because of his/her service, he/she did not actually live in the home for at least the required 2 years during the 5-year period ending on the date of sale. The period of suspension cannot last more than 10 years. The suspension cannot be used on more than one property at a time.

The taxpayer is on **qualified official extended duty** if he/she serves on extended duty either at a duty station at least 50 miles from his/her main home or while he/she lives in Government quarters under Government order. The taxpayer is considered on extended duty when he/she is called or ordered to active duty for a period of more than 90 days or for an indefinite period.

Example 4

Peter bought a home in 1997. He lived in it as his main home for 2 ½ years (1997–1999). From 2000–2005 he did not live in the home because he was on qualified official extended duty with the U.S. Army. He sold the home in 2005 and had a \$12,000 gain. Under the general sale of home rules, Peter would have to include the gain on his tax return because he did not meet the ownership and use test (2 out of the last 5 years). Peter chooses to suspend the 5-year test period for the 6 years he was on qualifying official extended duty. Therefore, Peter's 5-year test period consists of the 5 years before he went on qualifying official extended duty. He meets the ownership and use tests and can exclude the gain from his tax return.

GAIN ON SALE OF MAIN HOME

If the selling price of the taxpayer's home is less than the exclusion the taxpayer is entitled to, you do not need to calculate the gain on the sale of the home.

Example 5

Jason and Elizabeth sold their home for \$126,000. They had owned and lived in this home from 1972 until they sold it in 2005. They had done many improvements over the years. Since their sales price (\$126,000) is less than the amount (\$500,000) that they can exclude, you do not need to calculate the gain on the sale of their home.

If you are assisting a taxpayer who may have a gain that exceeds the exclusion amount, use the following information to determine the gain on the sale.

To figure the gain (or loss) on the sale of a taxpayer's main home, you must know the following about the home:

- 1. The selling price.** The selling price is the total amount the taxpayer (seller) received for his or her main home. It includes money, all notes, mortgages, or other debts taken over by the buyer as part of the sale, and the fair market value of any other property or services that the seller received. If the taxpayer received a Form 1099-S, box 2 (gross proceeds) will generally show the total amount received from the sale of the home.
- 2. The amount realized.** The amount realized is the selling price minus selling expenses. Selling expenses include commissions, advertising fees, legal fees, and loan charges paid by the seller, such as points.
- 3. Basis.** The basis in a home is determined by how the taxpayer obtained the home. If the home was bought or built, the basis is its cost. If the home was obtained in some other way (inheritance, gift, etc.), the basis is either its fair market value when it was obtained or the adjusted basis of the person the taxpayer obtained it from.

The basis of inherited property is generally the fair market value of the property at the date of the decedent's death. However, this can vary if the personal representative of the estate elects to use an alternate valuation date. Alternate valuation issues can be complex and the taxpayer may need to seek the assistance of a paid tax preparer.

Determination of the adjusted basis of property received by a gift can be very complex. It is outside the scope of the Volunteer Return Preparation Program. Advise the taxpayer to seek the assistance of a paid tax preparer.

- 4. The adjusted basis.** The adjusted basis is the result of any adjustments (increases or decreases) made to the home's basis. Increases include additions or improvements to the home such as adding on additional rooms or finishing a basement. In order to be considered an increase, an addition or improvement must have a useful life of more than one year. Repairs that maintain the home in good condition are not considered improvements and should not be added to the basis of the property. Decreases to basis include deductible casualty losses.

Figuring the Gain

To determine whether a taxpayer has a gain or a loss on the sale of a home, compare the amount realized with the adjusted basis. If the amount realized is more than the adjusted basis, the difference is a gain and the taxpayer may be able to exclude all or part of it. If the amount realized is less than the adjusted basis, the difference is a loss. A loss on the sale of the taxpayer's main home cannot be deducted.

REPORTING REAL ESTATE PROCEEDS (FORM 1099-S)

If the taxpayer received Form 1099-S, Proceeds From Real Estate Transactions, use it to figure the selling price for the taxpayer's home. Box 1 shows the date of sale (closing) and box 2 shows the gross proceeds received from the sale of his or her main home. If the taxpayer can exclude the entire gain from a sale in 2005, the person responsible for closing the sale (for example, a real estate broker or settlement agent) generally will not have to report it on Form 1099-S. For taxpayers who did not receive a Form 1099-S, use sale documents and other records.

Example 6

Joe and Sarah Blackhawk bought their main home on September 3, 1993 and sold it on July 7, 2005. They will not be able to exclude the entire gain from income (they had an adjusted basis of \$226,000 for the home; their gain exceeds \$500,000). The Lincoln Title Company provided them with a Form 1099-S (Exhibit 1). The gain from the sale of their main home is reported in Part II of Schedule D (Exhibit 2).

Exhibit 1 - Blackhawk 1099-S

CORRECTED (if checked)

FILER'S name, street address, city, state, ZIP code, and telephone no. Lincoln Title Company 123 Lincoln Ave Your City, State Zip		1 Date of closing 07/07/2005	OMB No. 1545-0997 <div style="font-size: 2em; font-weight: bold; text-align: center;">2005</div>	Proceeds From Real Estate Transactions
FILER'S Federal identification number XX-XXXXXXX		2 Gross proceeds \$ 789,000	Form 1099-S	
TRANSFEROR'S identification number XXX-XX-XXXX	TRANSFEROR'S name Joe and Sarah Blackhawk Street address (including apt. no.) 91 Yale Dr City, state, and ZIP code Your City, State Zip	3 Address or legal description 84 Northeast St Your City, State Zip		Copy B For Transferor <small>This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported.</small>
Account or escrow number (see instructions)		4 Transferor received or will receive property or services as part of the consideration (if checked) <input type="checkbox"/>		
Account or escrow number (see instructions)		5 Buyer's part of real estate tax \$		

Form **1099-S** (keep for your records) Department of the Treasury - Internal Revenue Service

**SCHEDULE D
(Form 1040)**

Capital Gains and Losses

OMB No. 1545-0074

2005

Attachment
Sequence No. **12**

Department of the Treasury
Internal Revenue Service (99)

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule D (Form 1040).**
▶ **Use Schedule D-1 to list additional transactions for lines 1 and 8.**

Name(s) shown on Form 1040

Joe and Sarah Blackhawk

Your social security number

XXX XX XXXX

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1					
2 Enter your short-term totals, if any, from Schedule D-1, line 2					
3 Total short-term sales price amounts. Add lines 1 and 2 in column (d)					
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824					
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1					
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet on page D-6 of the instructions					()
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f)					

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8 Main Home	9/3/93	7/7/05	789,000	226,000	563,000
Section 121 Exclusion					(500,000)
9 Enter your long-term totals, if any, from Schedule D-1, line 9					
10 Total long-term sales price amounts. Add lines 8 and 9 in column (d)			789,000		
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824					
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1					
13 Capital gain distributions. See page D-1 of the instructions					
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet on page D-6 of the instructions					()
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Then go to Part III on the back					63,000

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2005

▶▶ SUMMING UP THIS LESSON ◀◀

In this lesson you learned, the simplified rules that apply to homeowners who sell their principal residence.

Taxpayers who have a gain from the sale of their main home may exclude up to \$250,000 of the gain from their taxable income (\$500,000 if Married Filing Jointly), if the eligibility requirements are met.

To qualify for the exclusion on the gain from the sale of a home, the taxpayer must meet the ownership and use tests during the five-year period ending on the date of the sale. The taxpayer must have:

- 1) Owned the home for at least two years (the ownership test), and
- 2) Lived in the home as his or her main home for at least two years (the use test)

A loss on the sale of a taxpayer's main home (principal residence) is not deductible.

STUDENT NOTES

Lined area for student notes.

FINISHING THE RETURN

Lesson 14

INTRODUCTION AND OBJECTIVES

In this lesson you will learn how to report federal income tax payments and figure the overpayment or balance due. You will also learn how to determine if estimated taxes should be paid. Additionally, you will learn how to finish the return and have the taxpayer sign the return.

After completing this lesson you should be able to:

- Calculate and report federal income tax withheld from all sources.
- Calculate and report estimated tax payments.
- Calculate the refund or amount due.
- Determine if estimated taxes should be paid.
- Determine who qualifies for an extension of time to file.
- Determine if changes to the taxpayer's W-4 or W-4P should be suggested.

This lesson will provide detailed information on how to finish the tax return. The following checklist is provided as a quick reference of the steps needed to finish the return.

CHECKLIST FOR FINISHING THE RETURN

Withholdings, Payments and Other Credits:

- Add all Federal Income Tax Withholding from Form W-2, box 2, (or other income statement(s)) and include on return.
- Add all Federal Income Tax Withholding from box 4 of Forms 1099R, 1099INT, 1099DIV and 1099G. Include in the payments section of the return.
- Include all estimated tax payments in the payment section.
- Include the amount of last year's refund that was applied to this year in the payment section. Note: If you need assistance with how to do this with TaxWise®, ask your site coordinator or computer specialist.

ALERT



This lesson contains tax law and information relating to all courses of training. Your course facilitator will only teach the information required to assist taxpayers you will serve.

POTENTIAL PITFALLS



Form W-2, box 4, shows social security tax withheld and box 6 shows Medicare tax withheld. These are not the same as federal income tax withheld. Do not report the amounts in box 4 and box 6 as federal income tax withheld.

POTENTIAL PITFALLS



When a taxpayer worked for more than one employer during the year, add up the amounts shown in box 4 of all Forms W-2. If the total in box 4 of all forms exceeds \$5,449.80 the taxpayers should claim a refund of excess social security tax withheld. Use the worksheet in Pub. 505, *Tax Withholding and Estimated Tax* to compute the refund.

- Calculate all of the refundable credits (covered in later lessons) that the taxpayer is entitled to and include them in the payments section of the return. Using TaxWise® software will help you determine what credits that the taxpayer is entitled to.
- Add all payments together and enter them on the total payments line. TaxWise® will do this step for you.
- Subtract the total payments from the total tax. TaxWise® will also complete this step for you.
- Record the account number and the routing number for taxpayers who want their refund direct deposited. Note: TaxWise® will ask you for this information on the Main Information screen and on the tax form. This is to help ensure that you have keyed in the correct information. Complete the line to apply part of the refund to next year, if the taxpayer wishes to use this option.

Paying Taxes or Adjusting Withholding Taxes if Balance Due:

- Explain the payment option (check, credit card, direct debit and installment agreement) to a taxpayer who owes money.
- Inform the taxpayer about the identifying information to include on payments made by check.
- Explain that interest and penalties continue to accrue on the unpaid balance even if the taxpayer has a valid installment agreement.
- Explain estimated taxes to taxpayers who expect to owe tax in 2006.
- Assist the taxpayer with completing form 1040ES for 2006. TaxWise® can do this for you. It will even print the vouchers for the payments. **See publication 4012, Volunteer Resource Guide for further guidelines.**
- Provide the taxpayer with the mailing address for the estimated payments. (Some sites provide unstamped envelopes for the taxpayers.)
- Encourage taxpayers to consider adjusting their withholding (on Form W-4 or W-4P) if they have a large refund or owe more than \$1,000 on the return.

Advance Earned Income Tax Credit (AEIC):

- Inform taxpayers about the Advance Earned Income Credit, if they were eligible for EIC this year and have at least one qualifying child. Be prepared to give the taxpayer a Form W-5, if they request it.

Name, Address, and Taxpayer Identification Section of Return:

- Complete the name and address section of the tax return. Use the taxpayer's label (if available) on a return prepared by hand. For computer generated returns, this section will be completed based on the information you entered in the Main Information section of the TaxWise® software.
- Make sure that you include the Taxpayer Identification Number for all taxpayers and dependents listed on the return. Note: If you are using TaxWise®, you will get an error when you run diagnostics if you have not included the identifying number. TaxWise® also has a diagnostic feature that helps you check the accuracy of the identifying number by comparing it to a database of information from the Social Security Administration. This does not guarantee that the name and social security number match. You should always look at the actual Social Security cards if possible. To validate the identity of the taxpayer you should also ask to see an official picture identification item.
- Mark the Presidential Election Campaign Box for the taxpayer. Note: If the taxpayer has a total tax of zero, the presidential campaign box should be marked no.

Return Assembly and Copy:

- Assemble the return. If filing a paper return for the taxpayer, forms should be in the order of the sequence number in the upper right corner. Procedures on assembling electronic returns may vary from site to site. Please ask your site coordinator for this information.
- Retain an electronic copy of all returns e-filed. Remember that you are not allowed to retain copies of the tax returns at your site past the end of the filing season. The retained copies should be forwarded to your local IRS territory office, where they will be retained until the end of the calendar year (as prescribed by the electronic filing regulations). For exception see Publication 4299, Privacy and Confidentiality.

Site Identification Number on Forms 1040, 1040A, & 1040EZ

Congress annually asks the IRS to provide the number of returns that were filed by volunteer tax assistance sites. For statistical purposes, the IRS requests that all Federal returns be identified with a Site Identification Number. The Site Identification Number is entered in the Paid Preparer's section of the tax return. The Internal Revenue Service Submission Processing Center will count each return processed using this data.

More about this topic is covered later in this lesson.

ALERT



If you receive questions regarding the Practitioner PIN please ask your site coordinator for additional information.

On Site Quality Review:

- Submit the completed return to the quality reviewer at your site. Note: Not all sites have enough volunteers to have a designated quality reviewer. In this case, ask another volunteer to review the form you prepared. Using TaxWise® is not a substitute for quality review. Use either the Quality Review Checklist, Form 8158, or Important Tax Records Envelope, Publication 730, to assure completeness and accuracy.

Signing the Return and Third Party Designation:

- Mark the area where the taxpayer should sign the return or Form 8453 U.S. Individual Tax Declaration for an IRS e-file Return.
- Complete the third party designation section of the return if the taxpayer wishes to allow someone else to discuss the return with the IRS. (**You cannot designate yourself.**)

Personal Identification Number (PIN) Guidelines

e-file sites can offer taxpayers all three signature options (Self-Select, Practitioner PINs, and Form 8453) available through IRS e-file:

Self-Select PIN— We encourage volunteers to actively promote the use of the self-select PIN which eliminates all paper signature documents.

Why? It eliminates the requirement for Form 8453, U.S. Individual Income Tax Declaration for an IRS e-file Return, making your e-filed return TRULY PAPERLESS!

Who? Any individual who filed Forms 1040, 1040A, and 1040EZ or used TeleFile the previous year is eligible, along with individuals who did not file a tax return in the previous year and are at least 16 years of age by December 31, 2005.

What? The Self-Select PIN method allows taxpayers to electronically sign their e-filed return by entering a five-digit PIN. A PIN consists of five numbers that a taxpayer chooses to enter as their electronic signature (it just can't be all zeros). If filing a joint return, a PIN is needed for the taxpayer and their spouse. The taxpayer does not need to: register the PIN with the IRS before filing; contact the IRS to get a PIN; or remember the PIN.

When/where? After the return is completed and reviewed, return to the Main Information Sheet and see if the return qualifies for Self-Select PIN. If the return qualifies and the taxpayer(s) agrees to the electronic signature, complete the information on the Main Information Sheet. The taxpayer will need to enter their date of birth and original Tax Year 2004 adjusted gross income (AGI) to verify their identity when using the PIN. Exceptions are provided under "Who cannot use the Self-Select PIN shown below. TaxWise software will indicate whether the return is eligible for Self-Select PIN.

Who cannot use Self-Select PIN?

- Primary Taxpayers under age 16 who have never filed a tax return.
- Secondary Taxpayers (spouse) under age 16 who did not file in the prior year.
- Taxpayers who filed Forms 1040-NR or 1040-SS in the prior tax year.
- Taxpayers whose returns require attachments other than W-2, W-2G, or 1099-R.
- Taxpayers required to file the following forms:
 - Form 8283, Non-Cash Charitable Contributions (if using Part B)
 - Form 8332, Release of Claim to Exemption for Children of Divorced or Separated Parents
 - Form 8885, Health Coverage Tax Credit

All of the above listed forms must be attached to Form 8453, U.S. Individual Income Tax Declaration for an IRS e-file Return.

Taxpayer Question:

- Ask the taxpayer if they have any additional questions.

Where to Mail Paper Returns:

- Tell the taxpayer where to mail the return (if filing by paper). Electronically filed returns are automatically transmitted to the correct IRS Processing Center. Paper tax returns must be mailed in by the taxpayer to the IRS processing Center for the area (state) where the taxpayer resides. Each tax package contains a pre-addressed envelope for a particular area based on the last address filed with the IRS. If the taxpayer has moved or does not have a pre-addressed envelope the address and other mailing information is located in the individual federal tax package and in your Volunteer Resource Guide, Publication 4012. Some sites provide unstamped pre-addressed envelope for their taxpayers. (You might be able to get the envelopes donated from a local office supply store. Your site receptionist could address the envelopes or you could print computer labels to use on them.

PAYMENTS

The federal government has a pay-as-you-earn tax system. The information for the payments section of the return has three sources: federal income tax withholdings, estimated tax, payments, and refundable credits.

Income tax withheld can appear on:

- Form W-2, *Wage and Tax Statement*, in box 2
- Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, in box 4
- Form 1099-INT, *Interest Income*, in box 4
- Form 1099-DIV, *Dividends and Distributions*, in box 4
- Form W-2G, *Certain Gambling Winnings*, in box 2
- Form 1099-G, *Certain Government and Qualified State Tuition Program Payments*, box 4
- SSA-1099, Social Security Benefits
- RRB-1099, Railroad Retirement Benefits Tier 1
- RRB-1099R, Railroad Retirement Benefits Tier 2
- Form 1099B, Proceeds from Broker and Barter Exchange Transactions


Example 1

Jessica has one Form W-2 (Exhibit 1).

The entry in Box 2 of Form W-2 goes on line 7, Form 1040EZ, line 39, Form 1040A, or line 63, Form 1040, is \$988.

Exhibit 1

Jessica's Form W-2

a Control number		OMB No. 1545-0008		Safe, accurate, FAST! Use 		Visit the IRS website at www.irs.gov/efile .				
b Employer identification number (EIN) XX-XXXXXXX				1 Wages, tips, other compensation 12,350.00	2 Federal income tax withheld 988.00					
c Employer's name, address, and ZIP code XYZ Associates 2112 Third Street Tampa, FL 33621				3 Social security wages 12,350.00	4 Social security tax withheld 765.70					
				5 Medicare wages and tips 12,350.00	6 Medicare tax withheld 179.08					
				7 Social security tips	8 Allocated tips					
d Employee's social security number XXX-XX-XXXX				9 Advance EIC payment		10 Dependent care benefits				
e Employee's first name and initial Last name Jessica A. Howard 134 Dawes Blvd. Tampa FL 33621				11 Nonqualified plans		12a See instructions for box 12				
				13 Statutory employee <input type="checkbox"/> Retirement plan <input type="checkbox"/> Third-party sick pay <input type="checkbox"/>	12b					
				14 Other		12c				
						12d				
f Employee's address and ZIP code				15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2 Wage and Tax Statement** **2005** Department of the Treasury—Internal Revenue Service
 Copy B—To Be Filed With Employee's FEDERAL Tax Return.
 This information is being furnished to the Internal Revenue Service.

Example 2

Anthony has a Form 1099-INT (Exhibit 2), a Form 1099-R (Exhibit 3), and a Form 1099-DIV (Exhibit 4). His total income tax withheld is entered on line 39, Form 1040A. It is \$1,247.

Exhibit 2

Anthony's Form 1099-INT

<input type="checkbox"/> CORRECTED (if checked)			
PAYER'S name, street address, city, state, ZIP code, and telephone no. Second Federal Bank 210 Miller Avenue Denver, CO 86011		Payer's RTN (optional)	OMB No. 1545-0112 2005 Form 1099-INT
PAYER'S Federal identification number XX-XXXXXXX	RECIPIENT'S identification number XXX-XX-XXXX	1 Interest income not included in box 3 \$ 935.00	
RECIPIENT'S name Anthony B. George Street address (including apt. no.) 1360 Shannon Avenue City, state, and ZIP code Denver, CO 86011 Account number (see instructions)		2 Early withdrawal penalty \$	3 Interest on U.S. Savings Bonds and Treas. obligations \$
		4 Federal income tax withheld \$ 187.00	5 Investment expenses \$
		6 Foreign tax paid \$	7 Foreign country or U.S. possession
Copy B For Recipient This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.			
Form 1099-INT		(keep for your records)	
Department of the Treasury - Internal Revenue Service			

Exhibit 3

Anthony's Form 1099-R

<input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED			
PAYER'S name, street address, city, state, and ZIP code APEX Triangles 213 Hickory Meadows Denver, CO 86011		1 Gross distribution \$ 12,000.00	OMB No. 1545-0119 2005 Form 1099-R
		2a Taxable amount \$ 12,000.00	Copy 1 For State, City, or Local Tax Department
		2b Taxable amount not determined <input type="checkbox"/> Total distribution <input type="checkbox"/>	
PAYER'S Federal identification number XX-XXXXXXX	RECIPIENT'S identification number XXX-XX-XXXX	3 Capital gain (included in box 2a) \$	4 Federal income tax withheld \$ 960.00
RECIPIENT'S name Anthony B. George Street address (including apt. no.) 1360 Shannon Avenue City, state, and ZIP code Denver, CO 86011 Account number (see instructions)		5 Employee contributions or insurance premiums \$	6 Net unrealized appreciation in employer's securities \$
		7 Distribution code(s) 7	8 Other \$ %
		9a Your percentage of total distribution %	9b Total employee contributions \$
		10 State tax withheld \$	11 State/Payer's state no.
		13 Local tax withheld \$	14 Name of locality
			12 State distribution \$
			15 Local distribution \$
Form 1099-R		Department of the Treasury - Internal Revenue Service	

<input type="checkbox"/> CORRECTED (if checked)				2005	Dividends and Distributions		
PAYER'S name, street address, city, state, ZIP code, and telephone no. Denver Sheet Metal 214 16th Street Denver, CO 86013		1a Total ordinary dividends \$ 500.00	OMB No. 1545-0110			Copy B For Recipient	
		1b Qualified dividends \$	Form 1099-DIV				
		2a Total capital gain distr. \$	2b Unrecap. Sec. 1250 gain \$				
PAYER'S Federal identification number XX-XXXXXXX	RECIPIENT'S identification number XXX-XX-XXXX			This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.			
RECIPIENT'S name Anthony B. George		2c Section 1202 gain \$	2d Collectibles (28%) gain \$				
Street address (including apt. no.) 1360 Shannon Avenue		3 Nondividend distributions \$	4 Federal income tax withheld \$ 100.00				
City, state, and ZIP code Denver, CO 86011							
Account number (see instructions)		5 Investment expenses \$	6 Foreign tax paid \$				
		7 Foreign country or U.S. possession	8 Cash liquidation distributions \$				
		9 Noncash liquidation distributions \$					
Form 1099-DIV (keep for your records) Department of the Treasury - Internal Revenue Service							

Estimated Tax Payments

Add all estimated tax payments made by the taxpayer for the year. Be sure to include:

- Payment made from last year's overpayment (see last year's tax return.)
- Quarterly payments made using the Form 1040ES, including the one made in January of the current tax year.

Record total estimated tax payments on Line 40 of Form 1040A or Line 65 of Form 1040.

Refundable Credits

Make sure that any refundable credits you have calculated are entered on the proper lines. The Earned Income Credit is reported on line 8 of the Form 1040 EZ, Line 41a of the Form 1040A, and Line 66a of the Form 1040. Any refundable Child Tax Credit is reported on Line 42 of the Form 1040A and Line 68 of the Form 1040. If excess Social Security deductions were made because of multiple employers, that amount is shown on Line 71 of the Form 1040.

Total Payments

Add the total of withholdings, estimated tax payments made, and refundable credits together. Enter this total on Line 9 of the Form 1040EZ, Line 43 of the Form 1040A, or Line 71 of the Form 1040.

Overpayments

If there have been more tax payments made than the amount of tax liability (line 10, Form 1040EZ, line 38, Form 1040A, or line 63, Form 1040), this is considered an overpayment. A taxpayer may wish to have a portion of the overpayment applied to next year's taxes. If so, then enter the amount to be applied to the following year on line 46 of the Form 1040A or line 74 of the Form 1040. Subtract this amount from the total overpayment and enter the remainder on line 45a of the Form 1040A or line 73a of the Form 1040.

Only a total refund can be entered on the Form 1040EZ, line 11a. Any overpayment on Form 1040EZ must be refunded; It cannot be applied to next year's taxes.

Example 3

Exhibit 5 shows Form 1040A, lines 28 through 46, for Jesse. His total tax is \$3,491. His total payments are \$5,000. Jesse overpaid and wants \$900 to be applied to his 2006 estimated tax. Note that line 45a plus line 46 equals the amount on line 44.

Exhibit 5

Jesse's 1040A, page 2

28	Tax , including any alternative minimum tax (see page 31).	28	3,491	00
29	Credit for child and dependent care expenses. Attach Schedule 2.	29		
30	Credit for the elderly or the disabled. Attach Schedule 3.	30		
31	Education credits. Attach Form 8863.	31		
32	Retirement savings contributions credit. Attach Form 8880.	32		
33	Child tax credit (see page 36). Attach Form 8901 if required.	33		
34	Adoption credit. Attach Form 8839.	34		
35	Add lines 29 through 34. These are your total credits .	35	0	00
36	Subtract line 35 from line 28. If line 35 is more than line 28, enter -0-.	36	3,491	00
37	Advance earned income credit payments from Form(s) W-2.	37		
38	Add lines 36 and 37. This is your total tax .	▶ 38	3,491	00
39	Federal income tax withheld from Forms W-2 and 1099.	39	2,600	00
40	2005 estimated tax payments and amount applied from 2004 return.	40	2,400	00
41a	Earned income credit (EIC) .	41a		
b	Nontaxable combat pay election.	41b		
42	Additional child tax credit. Attach Form 8812.	42		
43	Add lines 39, 40, 41a, and 42. These are your total payments .	▶ 43	5,000	00
44	If line 43 is more than line 38, subtract line 38 from line 43. This is the amount you overpaid .	44	1,509	00
45a	Amount of line 44 you want refunded to you .	▶ 45a	609	00
b	Routing number <input type="text"/>	c	Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings	
d	Account number <input type="text"/>			
46	Amount of line 44 you want applied to your 2006 estimated tax .	46	900	00
47	Amount you owe . Subtract line 43 from line 38. For details on how to pay, see page 51.	▶ 47	0	00
48	Estimated tax penalty (see page 51).	48		

Refunds

If the taxpayer wants an overpayment refunded, advise that a check should be mailed within 6-8 weeks after the return is filed. Remind the taxpayer of the availability to have the refund deposited directly into a financial account, such as a bank account.

Direct Deposit

Instead of getting a paper check, taxpayers may choose to have their refund deposited directly into their account at a bank or other financial institution such as a mutual fund, brokerage firm, or credit union.

To help IRS process the payment, the taxpayer should enter the amount on the right side of the check like this: \$XXX.XX. Do not use dashes or lines (for example, do not enter “\$XXX—” or “\$XXX^{xx}/₁₀₀”). Savings account deposit slips, in particular, are not a dependable source for routing numbers.

Note. Taxpayers should check with their financial institution to make sure their direct deposit will be accepted and to get the correct routing and account number.

Exhibit 6 shows the general location of the routing and account number on a sample check (reference lines from Form 1040). The routing number must be nine digits (the first two digits must begin with 01 through 12 or 21 through 32, otherwise the direct deposit will be rejected and a check sent instead). The account number can be up to 17 characters (both numbers and letters). It can include hyphens but not spaces or special symbols. The number should be entered from left to right with any unused boxes left blank.

Exhibit 6

The diagram shows a sample check with the following details:

- Payee:** LERON BROWN, RENA BROWN, 123 Main Street, Anyplace, CA 10000 (line 73b)
- Amount:** 1234 (line 73d)
- Bank:** ANYPLACE BANK, Anyplace, NY 10000 (line 70b)
- Routing Number:** 250250025 (line 70c)
- Account Number:** 202020 86 (line 70d)
- Check Number:** 1234
- Other:** A box for the amount in dollars is shown, and a note says "Do not include the check number".

The routing number is circled and labeled "Routing number (line 70b)". The account number is circled and labeled "Account number (line 70d)". A note says "Do not include the check number".

Tax Due

If there are less tax payments than the amount of tax liability, then there is tax due to be paid with the return. When this happens, remind the taxpayer to make the check or money order payable to the “United States Treasury.” Taxpayers can also pay by credit card or by authorizing a direct debit from their checking or savings account on the date they choose (anytime up to April 17, 2006). Encourage a 1040 filer to voluntarily send Form 1040-V, *Payment Voucher*, with his or her payment. The instructions for completing

the voucher appear on the 1040-V. The taxpayer should write his or her name, address, social security number, daytime telephone number, and “2005 Form 1040 (or 1040A or 1040EZ, whichever applies)” on the check or money order. The payment and Form 1040-V should be enclosed, but not attached to the tax return. Taxpayers should not mail cash with their returns.

Electronic Payment Options

If the taxpayer owes an amount on his or her return, he/she can make the payment electronically. To pay by credit card, the taxpayer must use one of the service providers listed in the instructions for Forms 1040, 1040A, or 1040EZ. The taxpayer can also pay by authorizing a direct debit out of his/her checking or savings account by April 15, 2006.

If the taxpayer cannot pay the full amount owed shown on his/her return, the taxpayer may ask permission to make monthly installment payments. To ask for an installment agreement, the taxpayer should file Form 9465, *Installment Agreement Request*, with the tax return.

Estimated Tax Penalty. If line 12, Form 1040EZ, line 47, Form 1040A, or line 75, Form 1040, is \$1,000 or more and it is more than 10 percent of the tax shown on the return, or if the taxpayer underpaid his or her 2005 estimated tax liability, the taxpayer can owe a penalty for underpayment of estimated tax. If so, report the penalty on line 48 for Form 1040A or line 76 of Form 1040. Line 47 or line 75 should include the amount owed with the return plus the penalty reported on line 48 of Form 1040A or line 76 of Form 1040, respectively.

Because the Form 2210, *Underpayment of Estimated Tax by Individuals, Estates, and Trusts*, used to compute estimated tax penalty is complicated, the IRS encourages taxpayers to let the IRS figure the penalty for them. The IRS will figure the penalty for underpayment of estimated tax and, if a penalty is owed, the taxpayer will be sent a bill. If taxpayers want the IRS to figure the penalty for them, the taxpayers should leave the penalty line on their return blank and **should not** complete Form 2210. As long as the taxpayer files the return by April 15, 2006, the IRS will not charge interest on the penalty if the bill is paid by the date specified on the bill.

ALERT



Preparation of Form 2210 is beyond the scope of VITA/TCE.

EXTENSIONS

Taxpayers can receive extensions of time to file their returns. Different rules apply to taxpayers who live in the United States and those who live outside the United States.

IRS will charge interest on taxes not paid by the due date, even if an extension of time to file is granted, unless the combat zone extension is applicable.

Within the United States

A taxpayer living in the United States can receive an automatic 6-month extension of time to file his or her federal tax return. To get the automatic extension, the taxpayer must file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, by the due date for the tax return.

The taxpayer is not required to pay any of the tax due when submitting the form. However, the taxpayer will owe interest on any tax that is owed but not paid by the due date. Interest will be charged from the due date to the date of payment. In addition, the taxpayer may be charged a late-payment penalty if the amount of tax paid before the due date (from withheld taxes or estimated tax payments) is less than 90% of the actual tax owed.

For more details on penalties, refer to filing information in Publication 17.

If Form 4868 is filed late, the request for an extension will be denied. The Internal Revenue Service will inform the taxpayer if the request is denied.

Taxpayers **cannot** use the automatic extension if they:

- Choose to have the IRS figure their tax, or
- Are under a court order to file their returns by the regular due date.

When the tax return is actually filed, any payment made with the application should be entered in line 69, Form 1040; added to the total on line 43, Form 1040A; or added to the total on line 9, Form 1040EZ.

The taxpayer can request an extension beyond this 4-month period by filing Form 2688, *Application for Additional Extension of Time To File U.S. Individual Income Tax Return*, or by letter. Except in undue hardship cases, this additional extension will not be granted unless Form 4868 has been filed first. Form 2688 or the taxpayer's letter will not be considered if filed after the extended due date.

Outside the United States and Puerto Rico

U.S. citizens and resident aliens who are living outside the United States and Puerto Rico on April 17 and whose main place of business or assigned tour of duty is outside the United States and Puerto Rico are allowed an automatic 2-month extension of time until June 17, 2006, to file a 2005 return. However, interest will be charged from the due date to the date the tax is paid.

Note: Traveling outside the United States and Puerto Rico on the due date does not qualify the taxpayer for an automatic 2-month extension.

Taxpayers using this automatic extension must attach a statement to their return stating that they were living outside the United States and Puerto Rico on the due date and that their main place of business or their assigned tour of duty is outside the United States and Puerto Rico.

POTENTIAL PITFALLS



When figuring estimated tax, be sure to include all taxes, such as tax on lump-sum distributions and self-employment tax.

Joint returns. For married persons who file jointly, only one spouse needs to meet the requirements to take advantage of the automatic extension to June 15.

Separate returns. For married persons who file separately, only the spouse who meets the requirements qualifies for the automatic extension. If both spouses meet the requirements, each may take advantage of the extension.

As discussed earlier, taxpayers who live outside the United States and Puerto Rico and whose main place of business or assigned tour of duty is outside the United States and Puerto Rico can also request an additional extension by filing Form 4868 by the automatic extension date of June 17 or by paying the tax due by credit card by April 17, 2006. The due date will then be extended to August 17. To obtain the additional extension, the taxpayer must file Form 4868 and write "Taxpayer Abroad" in the top margin of the form. If more time is needed, the taxpayer should file Form 2688.

FIGURING ESTIMATED TAX FOR NEXT YEAR

Estimated tax is the amount a taxpayer expects to owe for the year after deducting any tax credits or federal income tax withheld. In other words, it is the amount the taxpayer anticipates will be owed on his or her 2006 federal income tax return.

If a taxpayer is an employee, the taxpayer's employer generally must withhold income, Medicare, and social security taxes on the wages paid. Also, most payers of taxable pensions withhold income tax and pay it to the government. However, a taxpayer may receive many types of taxable income that are not subject to having tax withheld.

A taxpayer who receives interest, dividends, alimony, unemployment compensation, rent, gains from the sale of assets, prizes, or awards, generally will have no income tax withheld on the payments. As a result, the taxpayer may find that he or she owes estimated tax. Most self-employed taxpayers will also find they are required to pay estimated tax.

Who Must Pay Estimated Tax

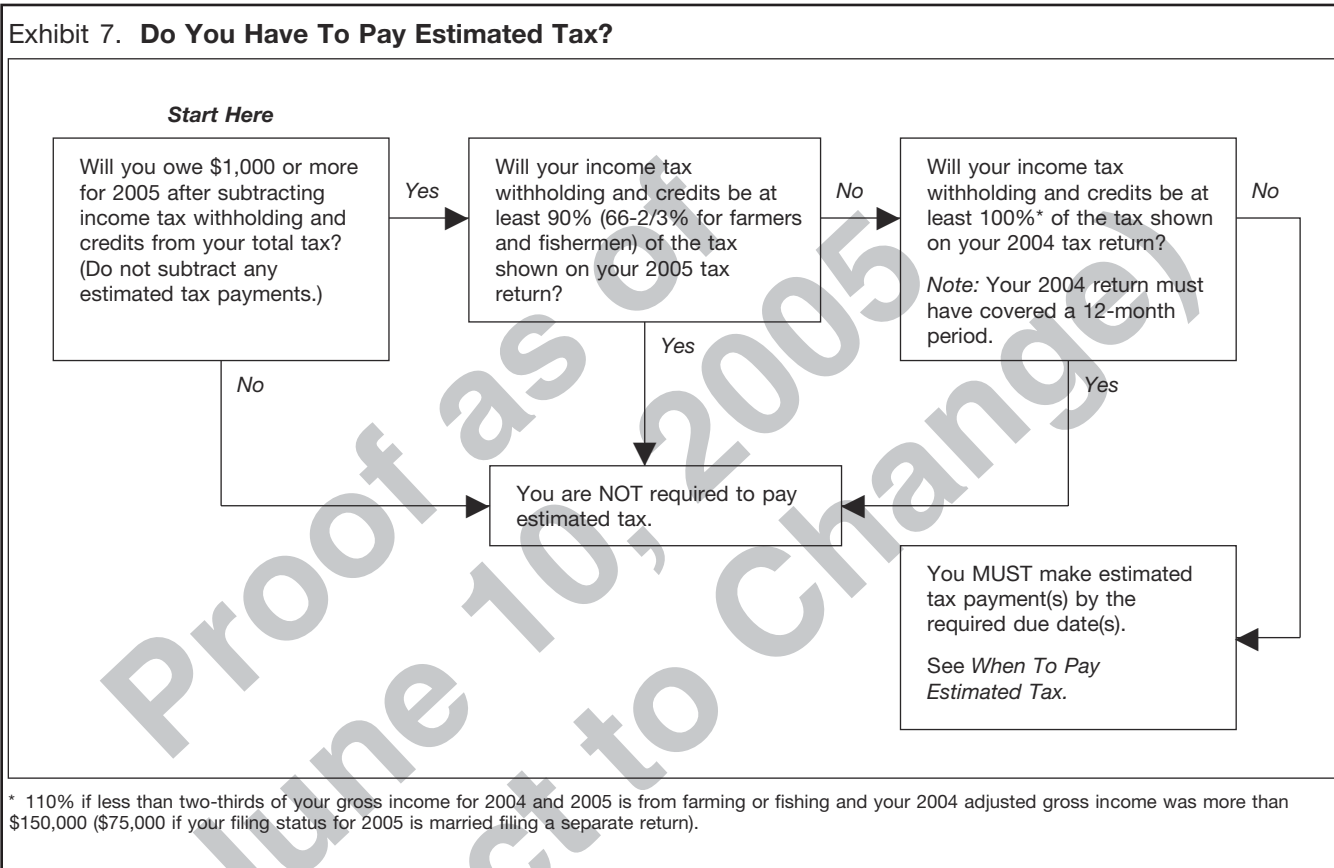
Estimated tax payments are required if certain conditions are met. Generally a taxpayer must make payments of estimated tax if:

1. He or she expects to owe \$1,000 or more in tax for 2005 after subtracting federal income tax withheld and credits from taxable income,

AND

2. He or she expects the 2006 tax withheld and credits to be less than the smaller of:
 - a) 90 percent of the tax to be shown on his or her 2006 tax return, or
 - b) 100 percent of the tax shown on his or her 2005 tax return. The return must cover all 12 months.

Married taxpayers can pay estimated tax either separately or jointly. How they pay their estimated tax will not affect their choice of filing a joint return or separate returns for the year. Joint estimated tax payments may be divided between the spouses if they later choose to file separate returns. Exhibit 7 illustrates when a taxpayer has to pay estimated taxes.



Example 4

Jayne is single and retired. She works part time as an usher in a movie theater. She estimates her 2006 income will be \$16,421, which includes \$3,500 of interest income from which there will be no tax withheld. Jayne calculates that she expects to owe \$1,008 (after taking into account her expected tax withheld and credits). Jayne meets condition 1 (mentioned earlier) and may have to pay estimated tax. Further checking tells Jayne that her expected 2006 tax withheld will be less than 100 percent of the tax shown on her 2005 return and less than 90 percent of the tax she will show on her 2006 tax return. Since Jayne also meets condition 2 (mentioned earlier), she is required to pay estimated tax.

Limit on the use of prior year's tax. Married taxpayers with joint AGI exceeding \$150,000 or \$75,000 if married filing separately cannot use 100% of their 2005 tax to figure their 2006 estimated tax payments.

For more information, see Publication 505, *Tax Withholding and Estimated Tax*.

How to Figure Estimated Tax

Estimated tax is paid by using Form 1040-ES, *Estimated Tax For Individuals*. Form 1040-ES also contains a worksheet that can be used in figuring a taxpayer's estimated tax. The taxpayer should keep the worksheet for his or her records.

To figure the estimated tax, the taxpayer must first figure his or her expected adjusted gross income, taxable income, taxes, and credits for 2006. All available facts that will affect those items during the year must be taken into account. Use the 2005 tax return as a starting point for estimating 2006 income, deductions, and credits. However, be careful to make adjustments both for anticipated changes in the taxpayer's situation and for recent changes in the tax law.

Form 1040-ES contains both the 2006 Tax Rate Schedules and the 2006 standard deduction and exemption amounts. Be sure to use the 2006 figures when figuring the estimated tax.

When to Pay Estimated Tax

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific due date. See Exhibit 8 to help determine when to pay estimated taxes.

Exhibit 8		If you first have income on which you must pay estimated tax:		
		Make a payment by:	Make later installments by:	
		Before Apr. 1	Apr. 15	June 15 Sept. 15 Jan. 15 next year*
		After Mar. 31 and before June 1	June 15	Sept. 15 Jan. 15 next year*
		After May 31 and before Sept. 1	Sept. 15	Jan. 15 next year*
		After Aug. 31	Jan. 15 next year*	(None)
For the period:	Due date:			
Jan. 1* through Mar. 31	Apr. 15			
April 1 through May 31	June 15			
June 1 through Aug. 31	Sept. 15			
Sept. 1 through Dec. 31	Jan. 15 next year**			

*See January payment, and Saturday, Sunday, holiday rule under *When To Pay Estimated Tax*, earlier.

**See January payment, later.

POTENTIAL PITFALLS

Advise the taxpayer to use the pre-addressed envelopes that came with his or her Form 1040-ES package, or mail payment vouchers to the address shown in the Form-ES instructions for the place where he or she lives. *Do not* use the address shown in the Form 1040 or Form 1040A instructions.

Most of the taxpayers that you assist will pay their estimated tax in four equal installments. However, a taxpayer does not have to make estimated tax payments until he or she has income on which tax is owed. The minimum payment due for the first period when the income is received between Jan. 1st and March 31 is 1/4 of

the total estimated payment for the year. If an additional income is received after the 1st period use Form 1040ES to figure out the amount of tax due for each remaining period. If a taxpayer receives income after one or more of the payment periods have passed, he or she will begin making payments during the period when the income is received.

The taxpayer also has the option of paying all the estimated tax at once. Instead of paying by installments, he or she may choose to pay the entire amount by the due date of the period during which the income is received.

Some taxpayers choose to pay all of their estimated tax with the first payment, April 17, 2006. It alleviates the need for them to remember to make the remaining payments.

Also, a taxpayer can apply all or part of an overpayment from his or her 2005 Form 1040 or Form 1040A to the estimated tax for 2006. The overpayment amount to be credited is entered on Form 1040, line 74, or Form 1040A, line 46. All of the credit can be applied to the first payment or it can be spread out among any or all of the payments.

If any due date falls on a Saturday, Sunday, or legal holiday, the payment is due on the next business day.

If a taxpayer files his or her 2006 Form 1040 or Form 1040A by January 31, 2007, and pays the entire amount of tax owed at that time, he or she is not required to make the estimated tax payment that would be due on January 16, 2007.

ALERT



If the taxpayer has a balance due, advise the taxpayer to carefully review estimated tax and withholding options using Form 1040ES or Form W-4.

How Much Estimated Tax to Pay

The computed estimated tax is based on expected income and deductions and should take into account all facts known at the time the estimate is made. If the taxpayer is unsure about the accuracy of the estimate, he or she may want to pay more than the required minimum 90 percent of the 2006 estimated tax. Taxpayers who do not pay enough tax by the due date of each payment period may be charged a penalty, even if the filed 2006 return shows a refund. Generally, the simplest and safest procedure is to make sure that the total of tax withheld plus the amount of estimated tax for each payment period during 2006 is at least one-fourth of the tax shown on the 2005 return. For more information, see Publication 505.

How to Pay Estimated Tax

Estimated tax payments can be sent electronically to the IRS by direct debit payment from the taxpayer's checking or savings account, by credit card, or can be sent along with a payment voucher from Form 1040-ES. Each voucher is inscribed with its due date. Be sure to use the correct voucher for each payment. For more information on electronic filing and payments, see Form 1040-ES instructions.

If the taxpayer paid estimated tax in 2005, he or she should have received a Form 1040-ES package containing preprinted vouchers. These vouchers show the taxpayer's preprinted name, address, and social security number. To use them, simply enter the amount of the payment on the appropriate line. If a taxpayer does not have the preprinted forms, use a set of blank vouchers from Form 1040-ES and enter the information on the appropriate lines. Advise the taxpayer to write his or her social security number and "2005 Form 1040-ES" on the check or money order (payable to the "United States Treasury") when paying estimated tax.

FORMS W-4 AND W-4P

An employer withholds tax based on wages paid and information the employee provides on Form W-4, *Employee's Withholding Allowance Certificate*. The employee uses his or her expected income, deductions, adjustments to income, and credits to figure the total withholding allowances to claim on Form W-4. In addition, an employee can claim extra allowances in certain situations.

A taxpayer who receives distributions from a pension, an annuity, an IRA, a stock bonus plan, or certain deferred compensation plans should use Form W-4P, *Withholding Certificate for Pension or Annuity Payments*, to notify the payer whether, and how much, income tax should be withheld.

Income, deductions, and credits should be estimated carefully. Taxpayers who do not have enough federal income tax withheld can be subject to interest and penalties. Taxpayers who have a very large refund or who owe should consider adjusting their withholding.

Some taxpayers want their withholding to be high enough to ensure that they receive a tax refund. They do not want to pay an additional amount when filing their tax return. If a taxpayer wishes, it is legal to claim fewer allowances than he or she is allowed. More tax than required will be withheld each pay period and, at the end of the year, the taxpayer should be eligible for a refund of overpaid taxes.

Forms W-4 and W-4P also contain:

- Instructions
- *Personal Allowances Worksheet*
- *Deductions and Adjustments Worksheet*
- *Two-Earner / Two-Job, Multiple Pension / More Than One Income Worksheets*
- Tables

ALERT



The IRS Withholding Calculator at <http://www.irs.gov/individuals/article/0,id=96196,00.html> is an excellent tool to use or recommend to the taxpayers to compute the correct withholding allowances.

The worksheets incorporate the number of allowances, adjustments, deductions, and credits that the employee expects on his or her 2006 income tax return. Some or all of these additional worksheets will then be used by the employee in completing the allowance certificate.

If an employee has a working spouse or income from two jobs, only one set of Form W-4 Worksheets should be completed. Complete the Form W-4 Worksheets using the combined expected income (from all sources and for both spouses if filing a joint return), adjustments, deductions, and exemptions. The number of total allowances from this Form W-4 can then be divided among all jobs. Withholding will usually be the most accurate when an employee claims zero allowances on all jobs except for the highest paying one. Reminder: A separate Form W-4 is needed for each job.

Certain events can occur during the year that can change an employee's marital status, exemptions, allowances, deductions or credits. When this happens, the employee may have to change his or her withholding allowances by submitting a new Form W-4 to the employer. The original Form W-4 remains in effect until the employee changes it.

For more information on withholding, refer to Publication 919, *How Do I Adjust My Tax Withholding?*

W-5, Advance Earned Income Credit (AEIC)

At this time, you as the preparer have the opportunity and the means to assist the taxpayer with the Form W-5, *Earned Income Credit Advance Payment Certificate*. The amount of the AEIC payments are based on wages by payroll cycle. Only persons with at least one qualifying child can get AEIC payments. If the taxpayer qualifies for the Earned Income Credit for 2005 refer them to Publication 596, *Earned Income Credit* or Form W-5 for additional information.

Completing and Assembling the Return

After all the decisions have been made regarding payments, overpayments, and estimated taxes, you should complete the taxpayer identification section, assemble the return, and submit it for quality review. When the review is completed, have the taxpayer sign the return and provide instructions on where and when to send it to the IRS. These steps are provided below.

ALERT



Before you complete any tax return you must request proof of identity. Follow guidelines in Lesson 1.

Taxpayer Identification Section

This section is completed after the rest of the return. Often, this saves time because after you begin preparing Form 1040A, you may discover that Form 1040EZ or Form 1040 is more appropriate. If this happens, you will not have to complete the taxpayer identification section twice.

Taxpayers who filed returns last year probably received a forms package by mail this year. The package includes a preaddressed label which shows the name and address of the taxpayer(s).

Peel the label off and place it in the address area of the return. Mark through any errors on the label, and print the correct information on the label. Be sure to enter the social security number(s) Individual Taxpayer Identification Number (ITIN) to the right of the label area.

If a taxpayer did not receive a forms package or does not have a pre-addressed label, PRINT the required information. Enter the taxpayer's name and social security number (or ITIN) on the first line. If married taxpayers are filing a joint return, enter one spouse's complete name and social security number (or ITIN) on the first line and the other spouse's complete name and social security number (or ITIN) on the second line. Be sure that each taxpayer's name and social security number (or ITIN) appear on one line, separate from the spouse's information. If you enter the husband's name and the wife's social security number (or ITIN) on the same line, there can be a considerable delay in processing the return.

Enter the address where any refund or notices should be sent. If the post office delivers mail to a post office box rather than to a street address, enter the P.O. box number on the line for the home address.

The Presidential Election Campaign Fund appears in the name and address area of Forms 1040EZ, 1040A, or 1040. Check *Yes* if the taxpayer wishes to have \$3 go to the Presidential Election Campaign Fund. Otherwise, check *No*. Checking *Yes* will not change the tax or reduce the refund. On a joint return, each taxpayer chooses whether or not \$3 should go to the fund.

Assembling the Return

Make sure that all forms, schedules, and attachments show the taxpayer's name and social security number. List the names in the same order that they appear on the front of the return and use the first social security (or ITIN) number that appears on the front of the return.

Attach forms and schedules behind Form 1040 according to the attachment sequence number shown in the upper right corner of the form or schedule. Items without an attachment sequence number should be placed at the end. For Form 1040A, attach any forms or schedules in order by number with Schedule EIC last.

Attach Form(s) W-2 to the left margin of the return. If any Form 1099 shows federal income tax withheld, include that amount in the payments section of the return.

When any Form 1099 shows federal income tax withheld, attach a copy to the return, along with any Form(s) W-2.

POTENTIAL PITFALLS

Using the pre-addressed label reduces processing time. However, to protect the taxpayer's privacy, the peel-off label that he or she received in the mail with the tax return booklet does not have his or her SSN (or that of his or her spouse if filing a joint return) printed on it. Therefore, *be sure* the taxpayer's SSN (and spouse's, if applicable) is entered in the space provided on the tax form (1040, 1040A, or 1040EZ).

Further, if the taxpayer filed a joint return for 2004 and is filing a joint return for 2005 with the same spouse, *be sure* the taxpayer's and spouse's names and SSNs are entered in the same order as on the 2004 tax return.

IDENTIFYING RETURNS

- If taxpayers ask about the site identification number designation at the bottom of the return in the paid preparer's section, explain that this is entered for statistical purposes. Inform the taxpayers that the site identification number does not affect the likelihood of an IRS examination (audit) of the return.
- If you prepare over 50 percent of the tax return and you are reasonably sure that the return will be filed as you prepared it, enter the site identification number at the bottom of the return in the Paid Preparer Section in the PTIN/SSN field.
- Most sites will have forms preprinted with the site identification number format entered in the Paid Preparer Section of the return. You must enter the number that has been assigned by the Territory Office for that site.
- If you do not have forms with the pre-printed site identification number format, print the appropriate site identification number for that site in the Paid Preparer Section of the return.
- The e-file administrator will set up computers to default the SIDN in the Paid Preparer section of the return (e-file administrators should refer to Publication 3189, e-file Administrator Guide for detailed instructions.)

ALERT



It is critical for you to enter the correct site identification number in the paid preparer's signature section of the return. The number goes in the designated area on the forms with the preprinted "S" followed by 8 digits or in the PTIN/SSN field of the return.

SITE IDENTIFICATION NUMBER

The Internal Revenue Service (IRS) will capture statistical information using the Individual Master File Report (IMF Report) and the Electronic Tax Administration (ETA) report.

The following procedures must be used when returns are prepared in a VITA or TCE site.

- The site identification number should be entered in the Paid Preparer Section of the return. (See Exhibit 7).
- The following procedures must be followed when returns are prepared in a VITA or TCE site.

1. Paper Returns

- All sites will enter the letter S followed by an 8 digit site identification number that is provided by the territory office. Sites should use the overprint form with the bold S format indicated in the Paid Preparer Section. Each of the numbers represent a certain area determined by the territory office. For instance, the fourth digit of the number will be 1 for VITA, 2 for Military VITA, 3 for Co-located site, 4 for TCE and 5 for AARP.
- If you use a return without the bold S format for the number enter the assigned number in the space provided in the Paid Preparer section of the return. Forms 1040EZ, 1040A, and 1040 with the bold "S" format are available from IRS and will be ordered by each site coordinator.

2. Electronically Filed Returns

- E-file administrators will set up computers to default to the proper location on the return where the number will already be entered. Ensure the default number has been entered for the site you are working.

Exhibit 9 illustrates a site identification number in the Paid Preparer's section of three tax forms, 1040EZ, 1040A, and 1040.

Exhibit 9 Site Identification Number

Paid preparer's use only		Preparer's signature ▶	Date	Site Identification Number ▶	Preparer's SSN or PTIN S10-05-1234
		Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN	
				Phone no. ()	
For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 23.			Cat. No. 11329W	Form 1040EZ (2005)	

Site Identification Number
Form 1040A

Paid preparer's use only		Preparer's signature ▶	Date	Site Identification Number ▶	Preparer's SSN or PTIN S10-05-1234
		Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN	
				Phone no. ()	
			Printed on recycled paper	Form 1040A (2005)	

Site Identification Number

Paid Preparer's Use Only		Preparer's signature ▶	Date	ChSite Identification selfNumber ▶	Preparer's SSN or PTIN S10-05-1234
		Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN	
				Phone no. ()	
				Form 1040 (2005)	

Site Identification Number

ALERT



When using computer software enter the SIDN without hyphens/dashes

The goal of the TCE and VITA Programs is to provide high quality service.

On-Site Quality Review Program

Every site must have a quality review program. Properly reviewed returns will help prevent taxpayers from receiving an error notice from the IRS. At larger sites, an experienced volunteer should be designated as the quality reviewer. At small sites, volunteers may review each other's work. During the actual tax return, preparation process and while conducting the quality review of the tax return, volunteers should ask probing questions to get complete and accurate information that reflects the taxpayers' circumstances. A Quality Review Checklist, Form 8158 may be used for this purpose. The checklist is also found on Publication 730, Tax Records envelope (not shown). Volunteers must review the tax return with the taxpayer before he/she leaves the site and make applicable changes or additions to the return. Volunteer Site Coordinators should become familiar with the quality review process as shown in Publication 1084, Volunteer Site Coordinator's Handbook. On-site quality review is a mandatory part of the VITA/TCE programs. See Quality Review Checklist in Exhibit 10.

Quality Review Checklist

Instructions: This form is designed for use by individuals responsible for confirming the accuracy of the taxpayer's return prior to obtaining the taxpayer(s)'s signature. **Check each box as the task is completed.**

The customer should sign the return after the information is verified and the return is reviewed.

All Returns

- Verified name and Social Security/ITIN number of the taxpayer(s), including a spouse and any dependents. (e.g. Social Security card, Social Security 1099 benefit statement, letter from Social Security, ITIN card or ITIN letter from IRS).
- Verified the correct address with your customer.
- Verified the filing status. (Use Publication 4012, *Volunteer Resource Guide*, decision tree/interview tips to check.)
- The total income includes all Forms W-2, 1099, and other taxable income sources.
- Withholding equals total from the W-2's, 1099's and other source documents.
- For refund returns, Direct Deposit information matches routing and account numbers from customer's check (or bank statement).
- For balance due returns, explained payment instructions.
- Form 13614, *Interview and Intake Sheet*, is signed to authorize retention of customer information.
- The Site Identification Number is entered on the return.

E-File Returns

- Document Control Number (DCN), Electronic Filing Identification Number (EFIN), and Site Identification Number (SIDN) are all correct on Form 8453.
- Customer(s) signed associated signature documents, as appropriate.

Paper Returns

- Copies of all 1099's showing withholding and all W-2's are attached to the return.
- Reminded customer of required signature(s) and mailing address.

Other IRS Quality Initiatives

IRS representatives may visit volunteer tax preparation sites to assist with any site coordination issues to identify areas of concern. The goal is to work closely with volunteers and site coordinators to help ensure the best customer service possible. Listed below is a brief description of the types of visits/reviews that will take place. See initiatives below:

- **Site Review, Form 6729.** The site review is pre-approved by the site coordinator and is a scheduled appointment by an IRS SPEC Relationship Manager to help determine the extent to which the volunteer preparation site adheres to standard operating procedures and guidelines as outlined in Publications 1084 and 3189 when performing their daily activities.
- **Shopping Review, Form 6729B.** A limited number of shopping reviews will be conducted by a neutral party (non-IRS) to measure the accuracy of return preparation provided by volunteers. Shoppers may be members of the American Institute of Certified Public Accountants (AICPA), the Armed Forces Tax Council (AFTC), or Treasury Inspector General for Tax Administration (TIGTA).
- **Return Review, Form 6729C.** While conducting the site review, the same Relationship Manager will review completed returns and cross check them against corresponding intake sheets to help determine the accuracy of return preparation. Return reviews are not designed to involve the taxpayer(s), so it is essential intake sheet has been completed and retained. If errors are identified, the return must not be filed until corrected. Procedures for notifying the taxpayer that the return has not been filed (see “Resubmission of Rejected Tax Returns”) and for signing a return that has been changed after the taxpayer’s signed Declaration of Taxpayer are in Publication 1045, Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns. For paper returns, the site coordinator should advise the taxpayer that an amended return, if needed, must be filed and that it be mailed to the submission processing center that handled the taxpayer’s paper return.

With quality tools and processes in place, volunteers can more effectively ensure that they have all the facts and information to accurately prepare the returns.

Signature Section

Make sure the taxpayer signs and dates the return before mailing. An unsigned return cannot be processed and may be sent back to the taxpayer. On a joint return, both spouses must sign, even if only one spouse had income. Also, make sure the occupation(s) of the taxpayer (or of both spouses, if married filing jointly) is/are entered.

If a taxpayer died before filing a return for 2005, the taxpayer's spouse or personal representative may have to file and sign a return for that taxpayer. A personal representative can be an executor, administrator, or anyone who is in charge of the deceased taxpayer's property. If the deceased taxpayer did not have to file a return but had tax withheld, a return must be filed to get a refund. The person who files the return should enter "DECEASED," the deceased taxpayer's name, and the date of death across the top of the return.

If the taxpayer's spouse died in 2005 and the taxpayer did not remarry in 2005, the taxpayer can file a joint return. (The taxpayer can also file a joint return if his or her spouse dies in 2006 before filing a 2005 return.) A joint return should show the taxpayer's spouse's 2005 income before death and the taxpayer's income for all of 2005. The taxpayer should enter "Filing as surviving spouse" in the area where the taxpayer signs the return. If someone else is the personal representative, he or she must also sign.

The surviving spouse or personal representative should promptly notify all payers of income, including financial institutions, of the taxpayer's death. This will ensure the proper reporting of income earned by the taxpayer's estate or heirs. A deceased taxpayer's social security number should not be used for tax years after the year of death, except for estate tax return purposes.

ALERT



Publication 4012, Volunteer Resource Guide, contains a section entitled Return Signature to assist you with completing the tax return.

Third-Party Designee

If the taxpayer wants to allow a friend, family member, or any other person he or she chooses to discuss his or her 2005 tax return with the IRS, the taxpayer should check the “Yes” box in the “Third party designee” area of the return. Also, the taxpayer should enter the designee’s name, phone number, and any five numbers the designee chooses as his or her personal identification number (PIN).

If the taxpayer checks the “Yes” box, he or she, and his or her spouse if filing a joint return, is authorizing the IRS to call the designee to answer any questions that may arise during the processing of the return. The taxpayer is also authorizing the designee to:

- Give the IRS any information that is missing from the return,
- Call the IRS for information about the processing of the return or the status of the taxpayer’s refund or payment(s), and
- Respond to certain IRS notices that the taxpayer has shared with the designee about math errors, offsets, and return preparation. The notices will not be sent to the designee.

The taxpayer is not authorizing the designee to receive any refund check, bind the taxpayer to anything (including any additional tax liability), or otherwise represent the taxpayer before the IRS. If the taxpayer wants to expand the designee’s authorization, he or she should see Publication 947, *Practice Before the IRS and Power of Attorney*.

The authorization cannot be revoked. However, the authorization will automatically end no later than the due date (without regard to extensions) for filing the taxpayer’s 2006 tax return. This is April 15, 2007, for most people.

As a volunteer preparer you may not be designated as a “Third Party Designee.”

Ending the Interview

Make sure the taxpayer keeps a copy of all Forms W-2 and 1099 with a copy of the tax return. Advise the taxpayer to keep these copies for at least three years. As the volunteer assistor, you should not keep a copy of the return. Listed below is a more detailed list of information to discuss with the taxpayer(s) prior to him/her leaving the site.

If an envelope has been provided for the taxpayer’s records place the copies into it. **Advise the taxpayer to bring the tax return and records back next year.**

Information to provide Customer prior to their departure from sites.

As a volunteer it is your job to insure that the customers leave the site with all the information they need. You should answer any questions that the customer has and advise them that a copy of their return is not kept at the site.

Here are some suggested items to give your customers:

- 1) Copy of return with attachments and reminder to bring to site next year
- 2) Pub 730 Important Tax Records envelope with the Quality Review Checklist completed
- 3) All documents given to volunteer to prepare return including Social Security cards and Photo identification
- 4) If e-filed:
 - Signed Forms 8453 for federal and state unless Self-Select PIN was used
 - Info on direct deposit vs. paper check
 - Explanation of the e-file process
 - Explanation that nothing needs mailing
- 5) If paper:
 - Signed return (with attached W-2's and 1099's if any withholding) for mailing for federal and state or knowledge of where to sign
 - Envelope or address to mail return
- 6) Contact information if problems with return
- 7) If refund:
 - Expected receipt date per Refund Cycle Chart
 - Contacts if refund not received: www.irs.gov; 1-800-829-1954; 1-800-829-4477
 - W-4 information if refund too high and not related to EITC
- 8) If balance due:
 - Form 1040V Payment Voucher if e-filed or if the client chooses to mail in the return
 - Address to send voucher
 - Information to show on check: payable to U.S. Treasury; SSN, daytime phone number, tax year and form number (1040, 1040EZ, 1040A)
 - Payment options: Refer to Pub 4012 or Pub 17
 - W-4 information if balance due to withholding
 - Information on estimated payments if balance not due to withholding
- 9) Information as to how long to keep records and what to retain

Exercise 1

- A.** Helen paid \$500 in estimated tax to the United States Treasury. Where is this reported on Form 1040A? _____

- B.** Shirley paid \$200, the amount owed on last year's income tax return. Is this \$200 in 2005 an estimated tax payment for this year's income tax return? _____
- C.** Elmer wants his refund deposited in his checking account. What information should you enter on line 45b of Form 1040A?

- D.** Jennifer had tax withheld from her wages on Form W-2. She also had some withholding on her Form 1099-R. Can these items be combined and listed on one line on her tax return?

Exercise 2

Look at the completed Form 1040EZ shown in Exhibit 11 and identify at least 3 areas that have not been properly completed.

Department of the Treasury—Internal Revenue Service
Income Tax Return for Single and Joint Filers With No Dependents (99) **2005**

OMB No. 1545-0675

Form **1040EZ**

<p>Label (See page 11.) Use the IRS label. Otherwise, please print or type.</p> <p>Presidential Election Campaign (page 11)</p>	L Your first name and initial Jorge	A Last name Mendez	Your social security number XXX XX XXXX	
	B If a joint return, spouse's first name and initial Lucinda	E Last name Mendez	Spouse's social security number	
	H Home address (number and street). If you have a P.O. box, see page 11. 1040 Main Street		Apt. no.	▲ You must enter your SSN(s) above. ▲
	E City, town or post office, state, and ZIP code. If you have a foreign address, see page 11. Anywhere USA 99999			

Checking a box below will not change your tax or refund.

Check here if you, or your spouse if a joint return, want \$3 to go to this fund? **You** **Spouse**

<p>Income</p> <p>Attach Form(s) W-2 here. Enclose, but do not attach, any payment.</p> <p>Note. You must check Yes or No.</p>	<p>1 Wages, salaries, and tips. This should be shown in box 1 of your Form(s) W-2. Attach your Form(s) W-2.</p>	1	14,900	00
	<p>2 Taxable interest. If the total is over \$1,500, you cannot use Form 1040EZ.</p>	2		2 00
	<p>3 Unemployment compensation and Alaska Permanent Fund dividends (see page 13).</p>	3		
	<p>4 Add lines 1, 2, and 3. This is your adjusted gross income.</p>	4		
	<p>5 Can your parents (or someone else) claim you on their return? Yes. Enter amount from worksheet on back. <input type="checkbox"/> No. If single, enter \$8,200. If married filing jointly, enter \$16,400. See back for explanation. <input type="checkbox"/></p>	5		
	<p>6 Subtract line 5 from line 4. If line 5 is larger than line 4, enter -0-. This is your taxable income.</p>	6	14,900	00

<p>Payments and tax</p>	<p>7 Federal income tax withheld from box 2 of your Form(s) W-2.</p>	7	1,700	00
	<p>8a Earned income credit (EIC).</p>	8a		
	<p>b Nontaxable combat pay election. 8b</p>			
	<p>9 Add lines 7 and 8a. These are your total payments.</p>	9	1,700	00
<p>10 Tax. Use the amount on line 6 above to find your tax in the tax table on pages 24–32 of the booklet. Then, enter the tax from the table on this line.</p>	10	1,490	00	

<p>Refund</p> <p>Have it directly deposited! See page 18 and fill in 11b, 11c, and 11d.</p>	<p>11a If line 9 is larger than line 10, subtract line 10 from line 9. This is your refund.</p>	11a	2	00	
	<p>b Routing number <input type="text"/></p>	<p>c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings</p>			
	<p>d Account number <input type="text"/></p>				

<p>Amount you owe</p>	<p>12 If line 10 is larger than line 9, subtract line 9 from line 10. This is the amount you owe. For details on how to pay, see page 19.</p>	12		
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Do you want to allow another person to discuss this return with the IRS (see page 19)? **Yes**. Complete the following. **No**

<p>Third party designee</p>	<p>Designee's name <input type="text"/></p>	<p>Phone no. <input type="text"/></p>	<p>Personal identification number (PIN) <input type="text"/></p>
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Sign here
Under penalties of perjury, I declare that I have examined this return, and to the best of my knowledge and belief, it is true, correct, and accurately lists all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.

<p>Joint return? See page 11. Keep a copy for your records.</p>	<p>Your signature <input type="text"/></p>	<p>Date <input type="text"/></p>	<p>Your occupation <input type="text"/></p>	<p>Daytime phone number () <input type="text"/></p>
	<p>Spouse's signature. If a joint return, both must sign. <input type="text"/></p>	<p>Date <input type="text"/></p>	<p>Spouse's occupation <input type="text"/></p>	

<p>Paid preparer's use only</p>	<p>Preparer's signature <input type="text"/></p>	<p>Date <input type="text"/></p>	<p>Check if self-employed <input type="checkbox"/></p>	<p>Preparer's SSN or PTIN <input type="text"/></p>
	<p>Firm's name (or yours if self-employed), address, and ZIP code <input type="text"/></p>	<p>EIN <input type="text"/></p>	<p>Phone no. () <input type="text"/></p>	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 23. Cat. No. 11329W Form **1040EZ** (2005)

▶▶ SUMMING UP THIS LESSON ◀◀

The information for the payment section of the return comes from these sources:

- ▶ Federal income tax withheld by the employer, and
- ▶ Forms 1099, and
- ▶ Estimated tax payments paid by the taxpayer (not reported on Form 1040EZ), and
- ▶ Refundable credits.

If the amount owed is \$1,000 or more, the taxpayer may have to pay an estimated tax penalty. If there is an overpayment, the taxpayer can take one of the following courses of action:

- ▶ Receive a complete refund,
- ▶ Apply the overpayment to the next year's estimated tax, or
- ▶ Receive a partial refund and apply the remainder of the overpayment to the next year's estimated tax.

Estimated tax payments must be made if a taxpayer:

- ▶ Expects to owe \$1,000 or more in tax for 2006 after subtracting income tax withheld and credits,

AND

- ▶ Expects his or her 2006 tax withheld and credits to be less than the smaller of: 90 percent of the tax to be shown on his or her 2006 tax return or, generally, 100 percent of the tax shown on his or her 2005 tax return.

Withholding allowances for employees are reported on Form W-4. Allowances for pension or annuity recipients are reported on Form W-4P. They are figured by taking into account:

- ▶ Expected income
- ▶ Deductions
- ▶ Credits
- ▶ Adjustments to income

**▶▶ SUMMING UP THIS LESSON ◀◀
(continued)**

To finish the return:

- ▶ Consider the taxpayer's possible eligibility for Advance Earned Income Credit.
- ▶ Complete the taxpayer's identification section after you have finished the rest of the return.
- ▶ Enter the site identification number in the paid preparer's section.
- ▶ Assemble the return correctly, attaching any Forms W-2 and Forms 1099 showing federal income tax withholding.
- ▶ Check each return for completeness and accuracy.
- ▶ Submit each return for on-site quality review.
- ▶ Have the taxpayer(s) sign and date the return.

Answers to Exercise 1

- (A) Line 40
- (B) No
- (C) The routing number for his bank account.
- (D) Yes

Answers to Exercise 2

- Wife's SSN is missing
- Husband's signature is missing
- The Site Identification Number is missing in the preparer's SSN/PTIN section of the form.
- Line 4 is blank
- Line 5 is blank
- Line 6 is incorrect
- Line 11a is incorrect
- Occupations are missing
- Spouse's signature is missing



Military/International students continue.

**All others complete problem and exercises in
Publication 678 W**

FINISHING AND FILING THE RETURN

Lesson 14
Military Segment

INTRODUCTION AND OBJECTIVES

General rules for filing returns may be found in the Basic segment of this lesson. This segment addresses special concerns of members of the Armed Forces and includes information for combat zone participants.

At the end of this lesson you should be able to:

- Determine where and when to file a federal tax return.
- Determine who qualifies for an extension of deadline.
- Identify special tax benefits that are available to persons who die in a combat zone or from a terrorist or military action.
- Explain how to file claims for tax forgiveness for these individuals.

TAXPAYER IDENTIFICATION

A member of the Armed Forces should include his or her name, social security number, and permanent home address on his or her return. A member who is due a refund and does not want it mailed to his or her permanent home address should enter a current address on the return. If the postal service does not deliver to the member's street address and the member has a post office box, he or she should enter the post office box number on the line for the present home address. A military person living overseas should use an APO or FPO address.

CHANGE OF ADDRESS

If a taxpayer changes his or her mailing address during the year, the taxpayer should notify the Internal Revenue Service of the change on Form 8822, *Change of Address*. However, if the taxpayer moves after filing a tax return, he or she should fill out and mail Form 8822 to the Internal Revenue Service Center where his or her returns were previously filed. Addresses for the service centers are listed on the back of the form.

WHERE TO FILE

Taxpayers should send their federal returns to the campus for the place where they reside. For example, Sgt. Keene, who is stationed in Maine but whose permanent home address is in California, should send her federal return to the campus in Maine. The tax form instructions give the addresses for the campuses, including the Philadelphia Campus for APO and FPO addresses.

WHEN TO FILE

Most individual tax returns cover a calendar year, January through December. Taxpayers who live in the United States or Puerto Rico and who use the calendar-year period should file their individual tax returns by April 15 of the following year. If April 15 falls on a Saturday, Sunday, or legal holiday, the due date is the next business day. (For 2005 tax returns, the due date is April 17, 2006.)

If a taxpayer has a balance due, they can pay by check, money order, direct debit (automatic withdrawal) or credit card. See Form 1040, 1040A, or 1040EZ instructions for complete details.

Taxpayers who cannot pay the tax due with their tax return should attach Form 9465, *Installment Agreement Request*. The Internal Revenue Service will try to arrange an installment payment agreement that reflects the taxpayer's ability to pay the tax owed. However, taxpayers should pay as much as possible with their return to reduce the amount of interest and penalties that will be charged on the unpaid balance.

EXTENSIONS

Taxpayers can receive extensions of time to file their returns. Different rules apply to taxpayers who live in the United States and those who live outside the United States. Deadline extensions are also available to members of the Armed Forces who served in a combat zone and Armed Forces on deployment outside the USA participating in a contingency operations operation.

IRS will charge interest on taxes not paid by the due date, even if an extension of time to file is granted, unless the combat zone extension is applicable.

Within the United States

A taxpayer living in the United States can receive an automatic 6-month extension of time to file his or her federal tax return. To get the automatic extension, the taxpayer must file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, by the due date for the tax return.

The taxpayer is not required to pay any of the tax due when submitting the form. However, the taxpayer will owe interest on any tax that is owed but not paid by the due date. Interest will be charged from the due date to the date of payment. In addition, the taxpayer may be charged a late-payment penalty if the amount of tax paid before the due date (from withheld taxes or estimated tax payments) is less than 90% of the actual tax owed.

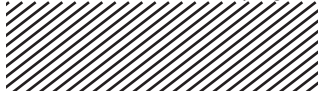
For more details on penalties, refer to filing information in Publication 17.

If Form 4868 is filed late, the request for an extension will be denied. The Internal Revenue Service will inform the taxpayer if the request is denied.

ALERT



Form 4868 is now used to obtain an automatic 6 month extension. Prior to this change it was used to receive a 4 month extension. Be sure to review the Form 4868 Instructions and Publication 17 for information on filing for an extension if the taxpayer is out of the country.



Taxpayers **cannot** use the automatic extension if they:

- Choose to have the IRS figure their tax, or
- Are under a court order to file their returns by the regular due date.

When the tax return is actually filed, any payment made with the application should be entered in line 69, Form 1040; added to the total on line 43, Form 1040A; or added to the total on line 9, Form 1040EZ.

Outside the United States and Puerto Rico

U.S. citizens and resident aliens who are living outside the United States and Puerto Rico on April 17 and whose main place of business or assigned tour of duty is outside the United States and Puerto Rico are allowed an automatic 2-month extension of time until June 17, 2006, to file a 2005 return. However, interest will be charged from the due date to the date the tax is paid.

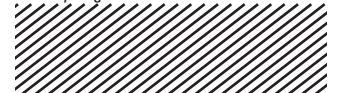
Note: Traveling outside the United States and Puerto Rico on the due date does not qualify the taxpayer for an automatic 2-month extension.

Taxpayers using this automatic extension must attach a statement to their return stating that they were living outside the United States and Puerto Rico on the due date and that their main place of business or their assigned tour of duty is outside the United States and Puerto Rico.

Joint returns. For married persons who file jointly, only one spouse needs to meet the requirements to take advantage of the automatic extension to June 15.

Separate returns. For married persons who file separately, only the spouse who meets the requirements qualifies for the automatic extension. If both spouses meet the requirements, each may take advantage of the extension.

As discussed earlier, taxpayers who live outside the United States and Puerto Rico and whose main place of business or assigned tour of duty is outside the United States and Puerto Rico can also request an additional extension by filing Form 4868 by the automatic extension date of June 17 or by paying the tax due by credit card by April 17, 2006. The due date will then be extended to October 17. To obtain the additional extension, the taxpayer must file Form 4868 and write "Taxpayer Abroad" in the top margin of the form.



Members of the Armed Forces who served in a combat zone are allowed additional time to take care of tax matters. This extension also applies to any individual who is deployed from his or her permanent duty station in support of operations in a qualified hazardous duty area, or performing qualifying service outside the qualified hazardous duty area. The law provides that certain periods of time are disregarded when determining whether certain tax matters have been taken care of on time. For ease of understanding, this publication refers to these provisions as “extensions of deadlines.” These deadline extensions should not be confused with other parts of the tax law that refer to extensions of time for performing acts.

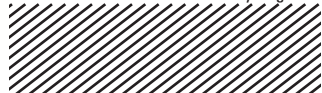
The deadline for filing tax returns, paying taxes, filing claims for refund, and taking other actions with the IRS is automatically extended if the taxpayer serves in the Armed Forces in a combat zone. The deadline for the IRS to take certain actions, such as collection and examination actions, is also extended.

Additionally, if members of the Armed Forces are deployed overseas away from their permanent duty station in support of operations in a qualified hazardous duty area, but outside the qualified hazardous duty area, they also receive these extensions (but not other combat zone benefits). The deadline for IRS to take certain actions, such as collection and examination actions, is also extended. See Lesson 3 for the beginning dates for the Afghanistan area combat zone, the Kosovo area combat zone, the Persian Gulf area combat zone, and the qualified hazardous duty areas.

The deadline for taking actions with the IRS is extended for 180 days after the later of:

1. The last day the taxpayer is in a combat zone/qualified hazardous duty area or have qualifying service outside of the combat zone/qualified hazardous duty area (or the last day the area qualifies as a combat zone or qualified hazardous duty area), or
2. The last day of any continuous qualified hospitalization (defined later) for injury from service in the combat zone/qualified hazardous duty area or while performing qualifying service outside of the combat zone/qualified hazardous duty area.

In addition to the 180 days, the deadline is also extended by the number of days remaining for the member to take the action with the IRS when he/she entered a combat zone/qualified hazardous duty area (or began performing qualifying service outside the combat zone/qualified hazardous duty area). If a taxpayer entered the combat zone/qualified hazardous duty area (or began performing qualifying service outside the combat zone/qualified hazardous duty area) before the period of time to take the action began, the deadline is extended by the entire period of time he/she has to take the action.



Example 1

Captain Kristina Jones entered a designated combat zone on December 1, 2003. She remained there through March 31, 2005, when she departed for the United States. She was not injured and did not return to the combat zone. The deadlines for filing Captain Jones' 2003, 2004, and 2005 returns are figured as follows.

- **The 2003 tax return.** The deadline is January 11, 2006. This deadline is 286 days (180 plus 106) after Captain Jones' last day in the combat zone (March 31, 2005). The 106 additional days are the number of days in the 3 1/2 month filing period that were left when she entered the combat zone (January 1 – April 15, 2004). **Note: 2004 was a Leap Year.**
- **The 2004 tax return.** The deadline is January 11, 2006. The deadline is 286 days (180 plus 106) after Capt. Jones' last day in the combat zone (March 31, 2005).
- **The 2005 tax return.** The deadline is not extended because the 180-day extension period after March 31, 2005, ends on September 27, 2005, which is before the start of the filing period for her 2005 return (January 1 – April 15, 2006).

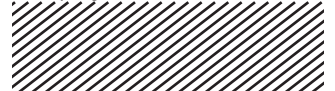
Example 2

Petty Officer Leonard Brown's ship entered the Persian Gulf on January 5, 2004. On February 15, 2004, Leonard was injured and was flown to a U. S. hospital. He remained in the hospital through April 20, 2005. The deadlines for filing Petty Officer Brown's 2003, 2004, and 2005 returns are figured as follows.

- **The 2003 tax return.** The deadline is January 27, 2006. Petty Officer Brown has 281 days (180 plus 101) after his last day in the hospital (April 20, 2005) to file his 2003 return. The 101 additional days are the number of days in the 3 1/2 month filing period that were left when he entered the combat zone (January 5 – April 15).
- **The 2004 tax return.** The deadline is January 31, 2006. Petty Officer Brown has 285 days (180 plus 105) after April 21, 2005, to file his 2004 tax return.
- **The 2005 tax return.** The deadline is not extended because the 180-day extension period after April 21, 2005, ends on October 18, 2005, which is before the start of the filing period for his 2005 return (January 1 – April 15, 2006).

Example 3

You generally have 3 years from April 15, 2002, to file a claim for refund against your timely filed 2001 tax return. This means that your claim normally must be filed by April 15, 2005. However, if you served in a combat zone from November 1, 2003, through March 23, 2005, and were not injured, your deadline for filing that claim is extended 347 days (180 plus 167) after you leave the combat zone. This extends your deadline to March 5, 2006. The 167 additional days are the number of days in the 3-year period for fil-



ing the refund claim that were left when you entered the combat zone on November 1 (November 1, 2003 - April 15, 2004). **Note: 2004 was a Leap Year.**

Missing status. Time in a missing status (missing in action or prisoner of war) counts as time in a combat zone or a qualified hazardous duty area.

Support personnel. The deadline extension provision also applies if a taxpayer is serving in a combat zone or a qualified hazardous duty area in support of the Armed Forces. This includes Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those forces.

Qualified hospitalization. The hospitalization must be the result of an injury received while serving in a combat zone or a qualified hazardous duty area. Qualified hospitalization means:

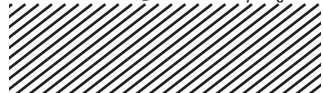
1. Any hospitalization outside the United States, and
2. Up to 5 years of hospitalization in the United States.

Actions Extended

The actions to which the deadline extension provision applies include:

- Filing any return of income, estate, or gift tax (except employment and withholding taxes),
- Paying any income, estate, or gift tax (except employment and withholding taxes),
- Filing a petition with the Tax Court for redetermination of a deficiency or for review of a Tax Court decision,
- Filing a claim for credit or refund of any tax,
- Bringing suit for any claim for credit or refund,
- Making a qualified retirement contribution to an IRA,
- Allowing a credit or refund of any tax by IRS,
- Assessment of any tax by the IRS,
- Giving or making any notice or demand by the IRS for the payment of any tax or for any liability for any tax,
- Collection by the IRS of any tax due, and
- Bringing suit by the United States for any tax due.

If the IRS takes any actions covered by these provisions or sends the taxpayer a notice of examination before learning that they are entitled to an extension of the deadline, the taxpayer should contact their legal assistance office. No penalties or interest will be imposed for failure to file a return or pay taxes during the extension period.



Spouses. Spouses of individuals who served in a combat zone are entitled to the same deadline extension with two exceptions.

1. The extension does not apply to a spouse for any tax year beginning more than 2 years after the date the area ceases to be a combat zone.
2. The extension does not apply to a spouse for any period the qualifying individual is hospitalized in the United States for injuries incurred in a combat zone.

Not in a combat zone. Reservists called to active duty or regular military members who are not in a combat zone may still qualify to defer the payment of back taxes. To qualify, these individuals must:

- Be serving their initial period of service and
- Show that their ability to pay the back taxes has been materially impaired.

Initial period of service. The initial period of service is defined as the period of active duty following recall to active duty from an inactive reserve or National Guard unit. For regular military personnel, it is the period following induction or first enlistment in the Armed Forces or the first period of reenlistment for a person who has been out of the service for a year or more. For an officer, the initial period of service is limited to two years of active service after one of the above occurrences.

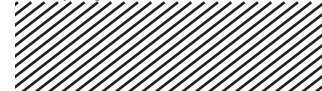
Material impairment. To indicate material impairment, the taxpayer must show that his or her income dropped as a result of going into military service.

Request for deferment. Military members who have a current payment agreement or who have received a notice requesting payment must make a written request for deferment to the IRS office where you have the agreement.

Information needed. The request for deferment must include the member's name, social security number, monthly income and source of income before military service, current monthly income, military rank, date of entry into the military service, and date the member is eligible for discharge. Enclosing a copy of the military orders is helpful.

The IRS will review each request and advise the taxpayer in writing of its decision. Should the taxpayer need further assistance, he/she can call the IRS at **1-800-829-1040** to discuss his/her situation. If the IRS grants the request for deferment, the taxpayer will be able to defer payment of back taxes until 6 months after the end of his/her initial period of service.

Third-Party Designee. If the taxpayer wants to allow a friend, family member, or any other person he or she chooses to discuss his or her 2005 tax return with the IRS, the taxpayer should check the



“Yes” box in the “Third part designee” area if the return. Also, the taxpayer should enter the designee’s name, phone number, and any five numbers the designee chooses as his or her personal identification number (PIN).

If the taxpayer checks the “Yes” box, he or she, and his or her spouse if filing a joint return, is authorizing the IRS to call the designee to answer any questions that may arise during the processing of the return. The taxpayer is also authorizing the designee to:

- Give the IRS any information that is missing from the return,
- Call the IRS for information about the processing of the return or the status of the taxpayer’s refund or payment(s), and
- Respond to certain IRS notices that the taxpayer has shared with the designee about math errors, offsets, and return preparation. The notices will not be sent to the designee.

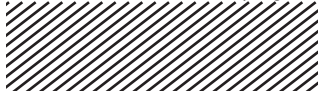
The taxpayer is not authorizing the designee to receive any refund check, bind the taxpayer to anything (including any additional tax liability), or otherwise represent the taxpayer before the IRS. If the taxpayer wants to expand the designee’s authorization, he or she should see Publication 947, *Practice Before the IRS and Power of Attorney*.

The authorization cannot be revoked. However, the authorization will automatically end no later than the due date (without regard to extensions) for filing the taxpayer’s 2005 tax return. This is April 17, 2006, for most people.

Power of Attorney. Use Form 2848, *Power of Attorney and Declaration of Representative*, to grant authority to an individual to represent you before the IRS and to receive tax information. If an individual is acting on behalf of a taxpayer serving in the combat zone and does not have a power of attorney specifying that he/she can handle federal tax matters, the IRS will accept a general power of attorney or other statement signed by the person for whom the individual is acting. The general power of attorney or statement must authorize the individual to act on the other person’s behalf even though federal tax matters are not specified. A copy must be attached to the tax return.

Signature. If it is not possible for the spouse of someone serving in the combat zone to obtain that person’s signature on a joint return, power of attorney, or other signed authorization to act on his or her behalf, the IRS will accept a written statement explaining that the husband or wife is serving in the combat zone.

The statement must be signed by the spouse filing the tax return and attached to the return.



Special tax forgiveness provisions apply to individuals who:

- Die while serving in a combat zone or from wounds, disease, or injury incurred while serving in a combat zone, or
- Die from wounds or injury incurred in a terrorist or military action while a U. S. employee.

Filing a Decedent Return

The personal representative (executor, administrator, or anyone who is in charge of the decedent's property) must file the final income tax return (Form 1040) of the decedent for the year of death and any returns not filed for preceding years. A surviving spouse, under certain circumstances, may have to file the returns for the decedent. See *Joint Return*, later.

Return for preceding year. If an individual died after the close of the tax year, but before the return for that year was filed, the return for the year just closed will not be the final return. The return for that year will be a regular return and the personal representative must file it.

Example 4

Samantha Smith died on March 21, 2005, before filing her 2004 tax return. Her personal representative must file her 2004 return by April 15, 2005. Her final tax return is due April 17, 2006.

When and Where To File

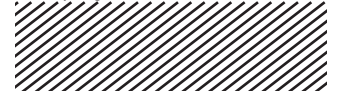
The final income tax return is due at the same time the decedent's return would have been due had death not occurred. A final return for a decedent who was a calendar year taxpayer is generally due on April 15 following the year of death, regardless of when during that year death occurred.

The tax return must be prepared on a form for the year of death regardless of when during the year death occurred.

Generally, you must file the final income tax return of the decedent with the Internal Revenue Service center for the place where you live.

Combat Zone Forgiveness

Federal income tax liability is forgiven for U. S. military personnel who die while serving in a combat zone or as a result of wounds, disease, or injury incurred while so serving. The forgiveness of tax applies for the year of death and for any prior year ending on or after the first day that the individual served in a combat zone in active service. Any forgiven tax liability that has already been paid will be refunded, and any unpaid tax liability at the date of death will be forgiven.



This forgiveness provision also applies to a member of the Armed Forces serving outside the combat zone if the service:

1. Was in direct support of military operations in the zone, and
2. Qualified the member for special military pay for duty subject to hostile fire or imminent danger.

Missing status. The date of death for a member of the Armed Forces who was in a missing status (missing in action or prisoner of war) is the date his or her name is removed from missing status for military pay purposes. This is true even if death actually occurred earlier.

Tax Forgiveness for Deaths Due to Military or Terroristic Actions

A decedent's income tax liability may be forgiven if his or her death was due to service in a combat zone or to military or terroristic actions.

The Victims of Terrorism Tax Relief Act of 2001 provides tax relief for those injured or killed as a result of terrorist attacks, certain survivors of those killed as a result of terrorist attacks, and others who were affected by terrorist attacks. For information on that Act, see Publication 3920.

Military or Terroristic Actions

The decedent's income tax liability is forgiven if, at death, he or she was a military or civilian employee of the United States who died because of wounds or injury incurred:

- While a U. S. employee, and
- In a military or terroristic action.

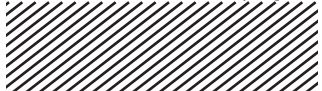
For tax years ending after September 10, 2001, tax liability is forgiven for an individual who dies from wounds or injury incurred while a U. S. employee in a terroristic or military action regardless of where the action occurred.

The forgiveness applies to the tax year in which death occurred and for any prior tax year in the period beginning with the year before the year in which the wounds or injury occurred.

Military or terroristic action defined. A military or terroristic action means the following.

- Any terroristic activity that most of the evidence indicates was directed against the United States or any of its allies.
- Any military action involving the U. S. Armed Forces and resulting from violence or aggression against the United States or any of its allies, or the threat of such violence or aggression.

Military action does not include training exercises. Any multinational force in which the United States is participating is treated as an ally of the United States.



Claims for Credit or Refund

If any of these tax-forgiveness situations applies to a prior year tax, any tax paid for which the period for filing a claim has not ended will be credited or refunded. If any tax is still due, it will be canceled. The normal period for filing a claim for credit or refund is 3 years after the return was filed or 2 years after the tax was paid, whichever is later.

If death occurred in a combat zone or from wounds, disease, or injury incurred in a combat zone, the period for filing the claim is extended by:

- The amount of time served in the combat zone (including any period in which the individual was in missing status), plus
- The period of continuous qualified hospitalization for injury from service in the combat zone, if any, plus
- The next 180 days.
- Qualified hospitalization means any hospitalization outside the United States and any hospitalization in the United States of not more than 5 years.

Filing a claim. Use the following procedures to file a claim.

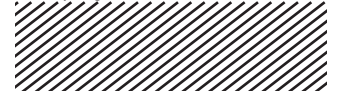
- File Form 1040, 1040A, or 1040EZ if an income tax return has not been filed for the tax year. Form W-2, *Wage and Tax Statement*, must accompany all returns.
- File Form 1040X if an income tax return has been filed. A separate Form 1040X must be filed for each year in question.

These returns and claims must be filed with the Internal Revenue Service, P. O. Box 4053, Woburn, MA 01888.

All returns and claims must be identified by writing “Enduring Freedom—KIA,” “Kosovo Operation—KIA,” “Desert Storm—KIA,” or “Former Yugoslavia—KIA” in bold letters on the top of page 1 of the return or claim. On Forms 1040 and 1040X, the phrase “Enduring Freedom—KIA,” “Kosovo Operation — KIA,” “Desert Storm—KIA,” or “Former Yugoslavia—KIA” must be written on the line for total tax. If the individual was killed in a terroristic or military action, put “KITA” on the front of the return and on the line for total tax.

An attachment should accompany any return or claim that includes a computation of the decedent’s tax liability before any amount is forgiven and the amount that is to be forgiven. For joint returns, see *Joint returns*, later.

Necessary documents. The following documents must accompany all returns and claims for refund. For returns and claims relating to individuals who died as a result of a terrorist attack, see Publication 3920.



- Form 1310, *Statement of Person Claiming Refund Due a Deceased Taxpayer*.
- A certification from the Department of Defense or the Department of State that the death was due to a military or terroristic action.

For military and civilian employees of the Department of Defense, certification must be made by that department on Form DOD 1300, *Report of Casualty*. For other civilian employees who die as a result of wounds or injury incurred outside the United States, certification must be a letter signed by the Director General of the Foreign Service, Department of State, or his/her delegate. The certification must include the individual's name and social security number, the date of injury, the date of death, and a statement that the individual died as the result of a military or terroristic action outside the United States and was an employee of the United States at the date of injury and at the date of death.

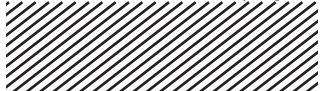
If the certification has been received, but you do not have enough tax information to file a timely claim for refund, file Form 1040X. Attach Form 1310 and a statement that an amended claim will be filed as soon as the required tax information is available.

Joint returns. Only the decedent's part of the joint income tax liability is eligible for the refund or tax forgiveness. To determine the part for the decedent, the person filing the claim must complete the following steps:

1. Figure the income tax for which the decedent would have been liable if a separate return had been filed.
2. Figure the income tax for which the spouse would have been liable as if a separate return had been filed.
3. Multiply the joint tax liability by a fraction. The top number of the fraction is the amount in (1) above. The bottom number of the fraction is the total of (1) and (2).

The amount in (3) is the decedent's tax liability that is eligible for the refund or tax forgiveness. If a taxpayer is unable to complete this process, he or she should attach a statement of all income and deductions indicating the part that belongs to each spouse. The IRS will make the proper allocation.

Residents of community property states. If the member of the Armed Forces was domiciled in a community property state and the spouse reported half the military pay on a separate return, the spouse can get a refund of taxes paid on his or her share of the pay for the years involved. The forgiveness of unpaid tax on the military pay would also apply to the half owed by the spouse for the years involved.



Calendar for year 2005

January 2005

Su	Mo	Tu	We	Th	Fr	Sa
						1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	29
30	31					

February 2005

Su	Mo	Tu	We	Th	Fr	Sa
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28					

March 2005

Su	Mo	Tu	We	Th	Fr	Sa
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30	31		

April 2005

Su	Mo	Tu	We	Th	Fr	Sa
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30

May 2005

Su	Mo	Tu	We	Th	Fr	Sa
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30	31		

June 2005

Su	Mo	Tu	We	Th	Fr	Sa
				1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	29	30	

July 2005

Su	Mo	Tu	We	Th	Fr	Sa
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

August 2005

Su	Mo	Tu	We	Th	Fr	Sa
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30	31		

September 2005

Su	Mo	Tu	We	Th	Fr	Sa
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30

October 2005

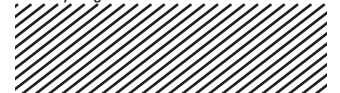
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9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	29
30	31					

November 2005

Su	Mo	Tu	We	Th	Fr	Sa
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30			

December 2005

Su	Mo	Tu	We	Th	Fr	Sa
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						



The Julian Calendar may also be used in the calculation of “extension of deadlines.”

January						
Sun	Mon	Tue	Wed	Thu	Fri	Sat
						1
						1
2	3	4	5	6	7	8
2	3	4	5	6	7	8
9	10	11	12	13	14	15
9	10	11	12	13	14	15
16	17	18	19	20	21	22
16	17	18	19	20	21	22
23	24	25	26	27	28	29
23	24	25	26	27	28	29
30	31					
30	31					

February						
Sun	Mon	Tue	Wed	Thu	Fri	Sat
		1	2	3	4	5
		32	33	34	35	36
6	7	8	9	10	11	12
37	38	39	40	41	42	43
13	14	15	16	17	18	19
44	45	46	47	48	49	50
20	21	22	23	24	25	26
51	52	53	54	55	56	57
27	28					
58	59					

March						
Sun	Mon	Tue	Wed	Thu	Fri	Sat
		1	2	3	4	5
		60	61	62	63	64
6	7	8	9	10	11	12
65	66	67	68	69	70	71
13	14	15	16	17	18	19
72	73	74	75	76	77	78
20	21	22	23	24	25	26
79	80	81	82	83	84	85
27	28	29	30	31		
86	87	88	89	90		

April						
Sun	Mon	Tue	Wed	Thu	Fri	Sat
					1	2
					91	92
3	4	5	6	7	8	9
93	94	95	96	97	98	99
10	11	12	13	14	15	16
100	101	102	103	104	105	106
17	18	19	20	21	22	23
107	108	109	110	111	112	113
24	25	26	27	28	29	30
114	115	116	117	118	119	120

May						
Sun	Mon	Tue	Wed	Thu	Fri	Sat
1	2	3	4	5	6	7
12	122	123	124	125	126	127
8	9	10	11	12	13	14
128	129	130	131	132	133	134
15	16	17	18	19	20	21
135	136	137	138	139	140	141
22	23	24	25	26	27	28
142	143	144	145	146	147	148
29	30	31				
149	150	151				

June						
Sun	Mon	Tue	Wed	Thu	Fri	Sat
			1	2	3	4
			152	153	154	155
5	6	7	8	9	10	11
156	157	158	159	160	161	162
12	13	14	15	16	17	18
163	164	165	166	167	168	169
19	20	21	22	23	24	25
170	171	172	173	174	175	176
26	27	28	29	30		
177	178	179	180	181		

July						
Sun	Mon	Tue	Wed	Thu	Fri	Sat
					1	2
					182	183
3	4	5	6	7	8	9
184	185	186	187	188	189	190
10	11	12	13	14	15	16
191	192	193	194	195	196	197
17	18	19	20	21	22	23
198	199	200	201	202	203	204
24	25	26	27	28	29	30
205	206	207	208	209	210	211
31						
212						

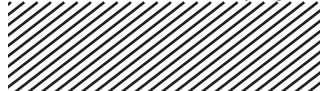
August						
Sun	Mon	Tue	Wed	Thu	Fri	Sat
	1	2	3	4	5	6
	213	214	215	216	217	218
7	8	9	10	11	12	13
219	220	221	222	223	224	225
14	15	16	17	18	19	20
226	227	228	229	230	231	232
21	22	23	24	25	26	27
233	234	235	236	237	238	239
28	29	30	31			
240	241	242	243			

September						
Sun	Mon	Tue	Wed	Thu	Fri	Sat
				1	2	3
				244	245	246
4	5	6	7	8	9	10
247	248	249	250	251	252	253
11	12	13	14	15	16	17
254	255	256	257	258	259	260
18	19	20	21	22	23	24
261	262	263	264	265	266	267
25	26	27	28	29	30	
268	269	270	271	272	273	

October						
Sun	Mon	Tue	Wed	Thu	Fri	Sat
						1
						274
2	3	4	5	6	7	8
275	276	277	278	279	280	281
9	10	11	12	13	14	15
282	283	284	285	286	287	288
16	17	18	19	20	21	22
289	290	291	292	293	294	295
23	24	25	26	27	28	29
296	297	298	299	300	301	302
30	31					
303	304					

November						
Sun	Mon	Tue	Wed	Thu	Fri	Sat
		1	2	3	4	5
		305	306	307	308	309
6	7	8	9	10	11	12
310	311	312	313	314	315	316
13	14	15	16	17	18	19
317	318	319	320	321	322	323
20	21	22	23	24	25	26
324	325	326	327	328	329	330
27	28	29	30			
331	332	333	334			

December						
Sun	Mon	Tue	Wed	Thu	Fri	Sat
				1	2	3
				335	336	337
4	5	6	7	8	9	10
338	339	340	341	342	343	344
11	12	13	14	15	16	17
345	346	347	348	349	350	351
18	19	20	21	22	23	24
352	353	354	355	356	357	358
25	26	27	28	29	30	31
359	360	361	362	363	364	365



Exercise 1

Pvt. Franklin, a U.S. citizen, is a calendar-year taxpayer. What would be the due date for him to file a return if his assigned tour of duty were in the following places?

A. Puerto Rico

Answer _____

B. Germany

Answer _____

C. United States

Answer _____

Exercise 2

Capt. Regis is stationed in England on April 17. He is concerned about when he should file his federal tax return. Answer the following questions for Capt. Regis.

A. What extensions of time are available to him?

Answer _____

B. How can he get those extensions?

Answer _____

Exercise 3

Major Joe Wells entered Afghanistan on 6 January 2005. He remained there through 7 April 2005, when he departed for the United States. He was not injured and did not return to the combat zone.

What is the deadline for filing Major Wells' 2004 tax return?

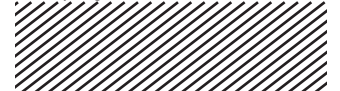
Answer _____

Exercise 4

Mr. Tim Morris, a civilian employee of the United States, died in 2006 as a result of injuries he suffered during a terrorist attack in 2004.

What years are Mr. Morris' income liabilities forgiven?

Answer _____



▶▶ SUMMING UP THIS SEGMENT ◀◀

In this lesson you have learned:

- ▶ Where members of the Armed forces should file their returns.
- ▶ When the returns are due for taxpayers who live both inside and outside the United States and Puerto Rico and how extensions can affect the due date.
- ▶ The deadline for filing tax returns, paying taxes, and taking other actions with the Internal Revenue Service is automatically extended if an individual serves in a combat zone.
- ▶ The income tax liability of a member of the Armed Forces is forgiven if a member dies as a result of service in a combat zone or from a terrorist or military action outside the United States.
- ▶ The terrorist or military action forgiveness also applies to an individual who is a U.S. employee at death and dies from wounds or injury incurred while a U.S. employee in a terrorist or military action regardless of where the action occurred.



1.
 - a. April 17
 - b. June 17 if he attached a statement to his return indicating that he was on an assigned tour of duty in Germany on the due date.
 - c. April 17
2.
 - a. An automatic 2-month extension of time to June 17 and an additional 2-month extension to August 17 (for a total of 4 months).
 - b. Captain Regis can obtain the automatic 2-month extension by attaching a statement to his tax return indicating that he was on an assigned tour of duty outside the United States and Puerto Rico on April 17. If Captain Regis needs an additional extension of time, he should file Form 4868 by the automatic extension date of June 17 and write "Taxpayer Abroad" in the top margin of the form. If he still needs additional time, he should request it before the extended due date of August 17 by filing Form 2688, or by letter.
3. 12 January 2006. The deadline is 280 days (180 plus 100) after Major West's last day in the combat zone (7 April 2005). The 100 additional days are the number of days in the 3 1/2 month filing period that were left when entered the combat zone (6 January–7 April 2005).
4. 2003, 2004, 2005, and 2006



Complete problem and exercises in Publication 678-W.

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Lined area for student notes.



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STUDENT NOTES

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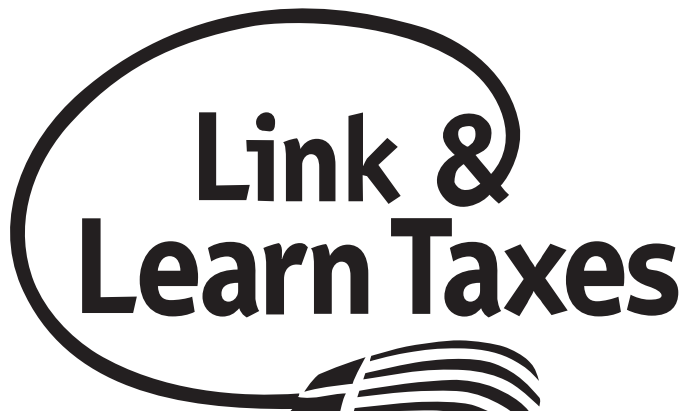


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