Tax-Aide Version Rel. 2

Click here for the latest version of this publication

Click here for the release notes of the latest version

IRS

4491

VITA/TCE Training Guide

Volunteer Income Tax Assistance (VITA) / Tax Counseling for the Elderly (TCE)

2024 RETURNS

– FOR USE BY AARP FOUNDATION TAX-AIDE VOLUNTEERS ONLY –

How to Get Technical Updates?

Updates to the volunteer training materials will be contained in Publication 4491-X, VITA/TCE Training Supplement. The most recent version can be downloaded at: **www.irs.gov/pub/irs-pdf/p4491x.pdf**

Volunteer Standards of Conduct

Volunteer Income Tax Assistance / Tax Counseling for the Elderly (VITA/TCE) Programs

The mission of the VITA/TCE return preparation programs is to assist eligible taxpayers in satisfying their tax responsibilities by providing free tax return preparation. To establish the greatest degree of public trust, volunteers are required to maintain the highest standards of ethical conduct and provide quality service.

Annually all VITA/TCE volunteers must pass the Volunteer Standards of Conduct (VSC) certification test and agree that they will adhere to the VSC by signing and dating Form 13615, Volunteer Standards of Conduct Agreement, prior to volunteering at a VITA/TCE site. In addition, return preparers, quality reviewers, coordinators, client facilitators and tax law instructors must certify in Intake/Interview and Quality Review. Volunteers who answer tax law questions, instruct tax law classes, prepare or correct tax returns, or conduct quality reviews of completed returns must also certify in tax law prior to signing the form. Form 13615 is not valid until the site coordinator, sponsoring partner, instructor, or IRS contact confirms the volunteer's identity, name and address, and signs and dates the form. Volunteers' names and addresses in Link & Learn Taxes must match their government issued photo identification. Advise volunteers to update their My Account page in Link & Learn Taxes with their valid name and address.

As a volunteer in the VITA/TCE programs, you must adhere to the following Volunteer Standards of Conduct:

VSC #1 - Follow all Quality Site Requirements (QSR).

VSC #2 - Do not accept payment, ask for donations, or accept refund payments for federal or state tax return preparation from customers.

VSC #3 - Do not solicit business from taxpayers you assist or use the information you gained about them (taxpayer information) for any direct or indirect personal benefit for yourself, any other specific individual or organization.

VSC #4 - Do not knowingly prepare false returns.

VSC #5 - Do not engage in criminal, infamous, dishonest, notoriously disgraceful conduct, or any other conduct considered to have a negative effect on the VITA/TCE programs.

VSC #6 - Treat all taxpayers in a professional, courteous, and respectful manner.

Failure to comply with these standards could result in, but is not limited to, the following:

- Your removal from all VITA/TCE programs;
- Inclusion in the IRS Volunteer Registry to bar future VITA/TCE activity indefinitely;
- Deactivation of your sponsoring partner's site VITA/TCE EFIN electronic filing identification number (EFIN);
- Removal of all IRS products, supplies, loaned equipment, and taxpayer information from your site;
- Termination of your sponsoring organization's partnership with the IRS;
- Termination of grant funds from the IRS to your sponsoring partner; and
- Referral of your conduct for potential TIGTA and criminal investigations.

TaxSlayer® is a copyrighted software program owned by Rhodes Computer Services. All screen shots that appear throughout the official Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) training materials are used with the permission of Rhodes Computer Services.

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.

4491 Table of Contents

Director's Letter vii
Important Changes for 2024 viii
Due Dates viii
Tax Form Changes viii
Tax Law Changes viii
Annual Inflation Adjustments ix
1 Course Introduction 1-1
Responsibilities as a Tax-Aide volunteer 1-4
Taxpayer civil rights 1-7
The Taxpayer Advocate Service is here to help 1-8
What are the materials available to assist me? 1-8
2 Introduction to Federal Tax Law 2-1
3 Filing Basics 3-1
Who must file? 3-1
Who should file? 3-3
How do I verify taxpayer identity? 3-4
Identity protection PIN (IP PIN) program 3-6
How do I file a return? 3-7
Presidential election campaign fund 3-7
Other taxpayer questions 3-7
What potential pitfalls should I keep in mind? 3-7
4 Filing Status 4-1
What are the five filing statuses? 4-1
Requirements for each filing status 4-2
How do I determine the correct filing status? 4-8
5 Personal Exemptions 5-1
What are exemptions? 5-1
6 Dependents 6-1
Who are dependents? 6-1
Who are NOT dependents? 6-1
How do I apply the dependency tests? 6-1
What tests must be met for all dependents? 6-2
What are the tests for a qualifying child? 6-3
Qualifying child of more than one person 6-5
What are the tests for a qualifying relative? 6-6
7 Unique Filing Situations 7-1
How do I apply tax law to nonresident aliens? 7-1
What are the filing status options? 7-5
Family members qualifying as dependents 7-6
8 Income – Wages, Interest, Etc. 8-1
Part I: Wages, salaries, tips, etc. 8-3
Part II: Interest income 8-9
Part III: Dividend income 8-13
Part IV: Alimony income 8-15
9 Income – Business 9-1
What is a business? 9-1
Overview of business income and expenses 9-3
Where do I get business income information? 9-5
Business expenses 9-7
How do I complete Schedule C? 9-10
10 Income – Capital Gain or Loss 10-1
Reporting a capital gain or loss 10-1
What is the basis of stock? 10-2
How do I determine the holding period? 10-4
Bonds 10-5
Worthless securities 10-5
1099-B or broker information 10-5
Reporting capital gains and losses 10-6
What about capital losses? 10-6
Sale of home 10-8
11 Income – Retirement 11-1
What is retirement income? 11-1
Retirement income interview 11-1
Forms reporting retirement income 11-1
Taxable portion already calculated 11-2
Taxable portion not calculated 11-2
Retirement income distributions 11-2
Individual Retirement Accounts 11-4
How are IRA distributions reported? 11-5
Transfers, rollovers, and conversions 11-6

Qualified charitable distributions 11-8
Employer retirement plans 11-10
Other retirement income issues 11-14
What is a loss on termination of annuity? 11-16
Special retirement distribution provisions 11-16
When to adjust withholding 11-18
12 Income – Sch K-1, Royalties, and Land Rents 12-1
Sch K-1 income, deductions, credits, etc. 12-1
Royalties reported on 1099-MISC or Sch K-1 . 12-2
How do I handle land rents? 12-2
13 Income – Governmental Payments 13-1
What are state or local income tax refunds? ... 13-1
What is unemployment compensation? 13-2
Reporting amounts on Form 1099-G 13-2
14 Income – Social Security Benefits 14-1
Social Security benefits 14-1
Railroad retirement benefits (RRBs) 14-1
When are benefits taxable? 14-2
Lump-sum Social Security benefit payments ... 14-3
15 Income – Other 15-1
Part I: Other income 15-1
Gambling winnings 15-1
Medical trial participation pay 15-2
Cash for keys program 15-2
Qualified Medicaid waiver payments 15-2
Strike benefits 15-2
Election or poll workers 15-2
Form 1099-K reporting nontaxable proceeds .. 15-3
Health savings account distributions 15-3
ABLE account distributions 15-4
Educational savings account distributions 15-5
Long-term care benefits 15-5
Disaster payments 15-5
Olympic and other prize money 15-5
Expense recoveries 15-6
Cancellation of debt income (CODI) 15-6
CODI – principal residence 15-9
Part II: Worldwide income 15-17
Foreign income exclusions or deductions 15-19
What income qualifies for exclusion? 15-22
16 Income – Military Members 16-1
What are the types of military income? 16-1
Main home suspension period 16-5
Qualified plan repayments 16-5
Residential rental 16-6
17 Adjustments to Income 17-1
Possible adjustments to income 17-1
How do I handle educator expenses? 17-1
Self-employment tax 17-3
Self-employed health insurance (SEHI) 17-3
Early withdrawal of savings penalty 17-4
How do I handle alimony paid? 17-4
How do I handle IRA contributions? 17-5
Health savings accounts contributions? 17-9
How do I handle student loan interest? 17-12
Is pay for jury duty an adjustment to income? 17-14
Nontaxable Olympic and other prizes 17-14
What is W-2 box 12 code H? 17-15
How do I determine adjusted gross income? . 17-15
18 Military Adjustments to Income 18-1
Employee business expenses 18-1
Temporary active-duty reservists' expenses 18-1
Moving expense deduction 18-2
Military reimbursements 18-3
When to claim the moving deduction 18-4
Special qualified plan provisions 18-5
19 Deductions 19-1
Standard deduction or itemized deductions 19-1
Standard deduction 19-2
Itemized deductions 19-4
Which deduction is best for the taxpayer 19-16
Qualified business income (QBI) deduction ... 19-16
20 Taxable Income and Tax Calculation 20-1
How is taxable income determined? 20-1
How is tax determined? 20-1

The kiddie tax 20-1
21 Child and Dependent Care Credit 21-1
What is the child and dependent care credit? .. 21-1
What are dependent care benefits? 21-2
How do I determine if a taxpayer is eligible? ... 21-2
What is the qualifying person test? 21-2
What is the earned income test? 21-3
What is the work-related expense test? 21-4
What is the joint return test? 21-6
What is the provider identification test? 21-6
What limits apply to this credit? 21-8
22 Education Credits 22-1
What are education credits? 22-1
Who can take an education credit? 22-1
What is an eligible institution? 22-2
What are qualifying expenses? 22-2
What rules apply to each credit? 22-4
What education benefits are possible? 22-6
How do I approach an education credit? 22-7
Which education benefit is better? 22-8
How can I avoid common errors? 22-8
AOC disallowed in a prior year 22-8
23 Foreign Tax Credit 23-1
What is the foreign tax credit? 23-1
Part I: Simplified foreign tax credit 23-2
Part II: Foreign tax credit on Form 1116 23-3
What qualifies taxpayers for the credit? 23-3
When is income from a foreign country? 23-4
What is “economic benefit”? 23-5
FTC restrictions 23-5
In scope FTC categories of income 23-6
What is high-taxed income? 23-7
How do I complete Form 1116? 23-7
24 Child Tax Credit & Credit for Other Dependents 24-1
Child tax credit and additional child tax credit .. 24-1
Who can claim the CTC or ACTC? 24-1
Eligibility for the CTC or ACTC 24-2
What is the amount of the credit? 24-3
What is the ACTC? 24-3
What is the credit for other dependents? 24-5
How do I avoid common errors? 24-5
Credits were disallowed in a prior year 24-5
25 Miscellaneous Credits 25-1
What is a nonrefundable credit? 25-1
Retirement savings contributions credit 25-1
What are residential energy credits? 25-4
Credit for the elderly or the disabled 25-6
What is the mortgage interest credit? 25-7
26 Premium Tax Credit 26-1
What is the Affordable Care Act? 26-1
Did the taxpayer receive Form 1095-A? 26-1
Who is allowed PTC? 26-1
Coverage other than individual market coverage 26-2
How is PTC calculated? 26-4
What else do I need to know about PTC? 26-6
Terms You May Need to Know 26-9
27 Other Taxes 27-1
What are other taxes? 27-1
What is self-employment tax? 27-1
What about taxes on unreported tip income? .. 27-2
Taxes on IRAs and retirement plans 27-4
Additional tax on taxable HSA distributions 27-6
Repayment of the first-time homebuyer credit . 27-6
28 Payments and Miscellaneous Refundable Credits 28-1
How do I report federal income tax withheld? .. 28-1
Estimated tax payments 28-2
Extension payments? 28-3
Excess Social Security and tier 1 RRTA tax withholding 28-3
Repayments of previously taxed income 28-4
29 Earned Income Credit 29-1
What is the EIC? 29-1
How does a taxpayer qualify for the EIC? 29-2
What rules apply to everyone? 29-2

Rules for taxpayers with qualifying children..... 29-4
Rules for taxpayers without qualifying children 29-5
EIC disallowed in a prior year..... 29-6
How is the correct EIC amount calculated?..... 29-6
30 Refund and Amount of Tax Owed 30-1
What if the taxpayer is due a refund?..... 30-1
What if an amount is owed?..... 30-4
What is the estimated tax penalty?..... 30-6
Correcting the amount of tax withheld 30-7
Are estimated tax payments needed? 30-8
How can I avoid common errors?..... 30-8
31 Completing the Return 31-1
What if a taxpayer moves?..... 31-1
When should taxpayers file their returns? 31-1
What is the third party designee?..... 31-3
Rules for filing a return for decedents..... 31-3
What is the global carryforward consent form? 31-3
Preparing the taxpayer's copy of the return..... 31-3
Who keeps the records? 31-4
Does the taxpayer have to do anything else?.. 31-4
How do I close the contact? 31-5
32 Military Finishing and Filing the Return ... 32-1
Filing Armed Forces returns 32-1
Extensions – taxpayers outside the U.S. and Puerto Rico and members of the military..... 32-2
Notifying the IRS about combat zone service.. 32-3
Tax options for combat zone participants 32-3
Tax options for combat zone participants 32-4
When can taxes be deferred? 32-4
Can other parties assist with a tax return? 32-5
Tax forgiveness for military decedents 32-5
Rules for filing a return for decedents..... 32-6
33 Amended and Prior Year Returns..... 33-1
When is an amended return needed? 33-1
How do I start?..... 33-2
What is Form 1040-X? 33-2
Time limits to file amended returns for refunds 33-3
Amended return with a tax refund 33-3
Amended return with an amount owed..... 33-4
How do I assemble and submit Form 1040-X? 33-4
Who can prepare prior year returns?..... 33-4
Index 1

Director's Letter

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

October 1, 2024

Greetings Volunteers,

I am excited to welcome you to another Tax Filing Season! ***Thank you*** for supporting the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs. Your service continues to be needed to help taxpayers and enhance their federal tax return experience through these programs.

As returning volunteers, your ongoing dedication to the VITA and TCE programs is appreciated. You've shown extraordinary fortitude, perseverance, kindness and dedication this past year in carrying out our cause.

As new volunteers, I encourage you to embrace each opportunity to help taxpayers through these vital programs. The success of each filing season is attributed to your continued commitment to the VITA and TCE programs.

Each year offers unique challenges and opportunities to help many taxpayers. To ensure that all volunteers are equipped and prepared for the filing season, we have taken extensive steps to provide the training materials and software you will need.

As we continue through this filing season, I look forward to hearing good news stories on how volunteers have embraced our cause to serve more taxpayers and touch more lives. I welcome your suggestions for improving your experience, as well as that of the taxpayers you serve. Feel free to email your feedback to specdirect@irs.gov.

Your support is sincerely appreciated. I look forward to another successful filing season.

Gwen Garren
Director, Stakeholder Partnerships,
Education and Communication

Important Changes for 2024

Due Dates

The due date for filing 2024 individual income tax returns is April 15, 2025.

Estimated tax payment due dates for tax year 2025 are:

1st payment ..... April 15, 2025

2nd payment ..... June 16, 2025

3rd payment ..... Sept. 15, 2025

4th payment ..... Jan. 15, 2026

Tax Form Changes

- Form 1040, U.S. Individual Income Tax Return, includes a checkbox and entry field in the Filing Status section that allows taxpayers to elect to treat a nonresident alien spouse or dual-status alien spouse as a resident.
- Form 1040, Schedule 1, Additional Income and Adjustments to Income, includes an entry field for taxpayers who had amounts reported on a Form 1099-K in error or for personal items sold at a loss.
- Form W-2, Wage and Tax Statement, includes a new Box 12 code II for Medicaid waiver payments excluded from income under Notice 2014-7.
- Taxpayers will receive Form 1099-K, Payment Card and Third Party Network Transactions, when reportable proceeds exceed $5,000 for 2024, although they may receive the form at a lower amount. This threshold applies to third party settlement organizations.
- Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, adds two new codes for the exceptions to the additional tax on early distributions for domestic abuse victims and emergency personal expense distributions, effective for distributions made after 12/31/2023.
- Form 8888, Allocation of Refund, is now only used to split a direct deposit refund between 2 or more accounts or to split a refund between a direct deposit and a paper check. The program allowing for depositing refunds into a TreasuryDirect® account to buy savings bonds, as well as the ability to buy paper bonds with refunds, has been discontinued.
- Publication 1244, Employee's Daily Record of Tips and Report of Tips to Employer, is obsolete.
- Publication 531, Reporting Tip Income, will no longer be updated annually. It is changed to continuous use.

Tax Law Changes

Refer to the respective lessons for details.

What provisions are new or noteworthy?

- Waiver of the 10% additional tax on early distributions for emergency personal expense distribution of as much as $1,000 beginning in 2024. The distribution may be repaid within three years from the date of distribution.
- Beginning in 2024, domestic abuse victims may distribute the lesser of $10,000 or 50% of accrued benefit from an eligible retirement plan without the 10% early distribution additional tax. The distribution may be repaid within three years from the date of distribution.
- Qualified tuition plan rollovers can be made to fund Roth IRAs beginning in 2024, subject to limitations.

- Starting 2024, an employer retirement plan may provide for Roth nonelective or matching contributions. These amounts are taxable to the employee and will be reported on Form 1099-R using code G in box 7; the amount of the taxable distribution (box 2a) will be the same as the gross distribution (box 1).
- Required minimum distributions to certain designated beneficiaries from inherited accounts of a decedent who died in 2020 through 2023 and whose retirement account was in payout mode have been waived for 2021 through 2024 (previously 2021 through 2023).
- The first-time homebuyer credit 15-year repayment period for homes purchased in 2008 began in 2010 and ends in 2024.

Annual Inflation Adjustments

Personal exemption amount

The deduction for all personal exemptions is suspended (reduced to zero), effective for tax years 2018 through 2025. For 2024, the gross income limitation for a qualifying relative is $5,050 ($350 increase).

Standard deduction

The standard deduction for taxpayers who do not itemize deductions on Sch A (Form 1040) has increased. The standard deduction amounts for 2024 are:

- $29,200 – Married filing jointly or qualified surviving spouse (increase of $1,500)
- $21,900 – Head of household (increase of $1,100)
- $14,600 – Single or married filing separately (increase of $750)

Taxpayers who are 65 and older or are blind

For 2024, the additional standard deduction amounts for taxpayers who are 65 and older or blind are:

- $1,950 for single or head of household (increase of $100)
- $1,550 for married taxpayers or qualified surviving spouse (increase of $50)

Dependents

For 2024, the standard deduction amount for an individual who may be claimed as a dependent by another taxpayer cannot exceed the greater of (1) $1,300, or (2) the sum of $450 and the individual's earned income.

Qualified charitable distributions

For 2024, the maximum amount of qualified charitable distributions that are not includible in gross income is $105,000 (an increase of $5,000). The maximum amount applies to each spouse if filing jointly.

Foreign earned income exclusion

For 2024, the maximum foreign earned income exclusion is $126,500.

Certain expenses of elementary and secondary school teachers

The amount of the deduction allowed that consists of expenses paid or incurred by an eligible educator for use in the classroom is $300 (no change).

IRA deduction amount and modified AGI (MAGI) limits for traditional and Roth IRA contributions

For 2024, the maximum combined traditional IRA deduction or Roth contribution is $7,000 ($8,000 if age 50 or older). For taxpayers who are covered by a retirement plan at work, the deduction for contributions to a traditional IRA is reduced (phased out) if the MAGI is:

- more than $123,000 but less than $143,000 for a married couple filing a joint return or a qualifying surviving spouse.
- more than $77,000 but less than $87,000 for an individual filing as single, head of household, or married filing separately and did not live with the spouse at any time during 2024.

- less than $10,000 for a married individual filing a separate return who lived with the spouse at any time during 2024.

For an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered (and the spouses live together or file a joint return), the deduction is phased out if the couple's MAGI is between $230,000 and $240,000.

For 2024, maximum Roth IRA contributions phase out based on MAGI as follows:

- Married filing jointly or qualifying surviving spouse with MAGI between $230,000 and $240,000
- Single, head of household, or married filing separately and didn't live with the spouse at any time in 2024 with MAGI between $146,000 and $161,000
- Married filing separately, lived with the spouse at any time during the year, and MAGI is between $0 and $10,000

Standard mileage rate

For 2024, the following rates are in effect:

- 67 cents per mile for business miles driven
- 21 cents per mile driven for medical or moving purposes
- 14 cents per mile driven in service of charitable organizations

Student loan interest deduction

The deduction begins to phase out for taxpayers with MAGI more than $80,000 ($165,000 for joint returns) and is completely phased out for taxpayers with MAGI of $95,000 or more ($195,000 or more for joint returns).

Health savings account (HSA) deduction

For 2024, the annual contribution limits on deductions for HSAs for individuals with self-only coverage is $4,150 (increase of $300) and $8,300 for family coverage (increase of $550). There is an additional contribution amount of $1,000 for taxpayers who are age 55 or older.

Long-term care insurance

The deductible amount of qualified long-term care insurance premiums for itemized deductions purposes or for calculating the self-employed health insurance deduction is limited for 2024: (each amount is per person)

- Age 40 or under: $470 (reduction of $10)
- Age 41 to 50: $880 (reduction of $10)
- Age 51 to 60: $1,760 (reduction of $30)
- Age 61 to 70: $4,710 (reduction of $60)
- Age 71 and over: $5,880 (reduction of $80)

For calendar year 2024, gross income includes the amount received under a long-term care policy in excess of the per-diem amount of $410 (reduction of $10) or the actual cost of long-term care services, if more.

Deduction for qualified business income

For 2024, the threshold amount is $383,900 for married filing joint returns and $191,950 for all other returns.

Household employee

An employer isn't required to provide a Form W-2 if they paid wages of less than $2,700 in 2024 (increase of $100).

Kiddie tax

To be subject to the kiddie tax, the individual must have unearned income of at least $2,600 in 2024.

Retirement savings contribution credit

To claim this credit in 2024, the taxpayer's modified adjusted gross income (MAGI) must not be more than

- $38,250 for single, married filing separately, or qualifying surviving spouse (increase of $1,750)
- $57,375 for head of household (increase of $2,625)
- $76,500 for married filing jointly (increase of $3,500)

Earned income credit (EIC)

For 2024, the maximum credit increases to:

- $7,830 with three or more children
- $6,960 with two children
- $4,213 with one child
- $632 with no children

Earned income and AGI amounts increased for EIC

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

- $59,899 ($66,819 if married filing jointly) with three or more qualifying children
- $55,768 ($62,688 if married filing jointly) with two qualifying children
- $49,084 ($56,004 if married filing jointly) with one qualifying child
- $18,591 ($25,511 if married filing jointly) with no qualifying child

Investment Income for EIC

Taxpayers whose investment income is more than $11,600 in 2024 cannot claim the EIC.

Child tax credit/additional child tax credit

The maximum refundable amount of the credit is $1,700 per child for 2024.

Premium tax credit

Advance Premium Tax Credit (APTC) repayment caps for 2024 are:

Income (as a % of federal poverty line)	Taxpayers filing as Single	Taxpayers using other filing statuses
Less than 200%	$375	$750
At least 200% but less than 300%	$950	$1,900
At least 300% but less than 400%	$1,575	$3,150
400% and above	No cap (full repayment)	No cap (full repayment)

The federal poverty line tables are adjusted for inflation.

Through 2025, taxpayers with household income that exceeds 400 percent of the federal poverty line for their family size may be allowed a premium tax credit (PTC).

Congress may enact additional legislation that will affect taxpayers after this publication is released. Click on the link on the front cover for the latest edition.

Course Introduction

Welcome

We're glad you decided to take advantage of this challenging, yet rewarding, experience and hope you have fun being a part of Tax-Aide.

Our Tax-Aide program is primarily supported by the AARP Foundation. Tax-Aide also qualifies for Volunteer Income Tax Assistance and Tax Counseling for the Elderly (VITA/TCE) grants from the Internal Revenue Service (IRS). For over 50 years, we have been working closely with the IRS to help taxpayers meet their tax filing responsibilities with an accurate tax return.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Internet access (optional but highly recommended to access linked materials)

Objectives

This lesson will introduce you to the major components of the Tax-Aide program. At the end of this lesson, you will be able to understand:

- the various course levels and certification process.
- the responsibilities of a VITA/TCE volunteer, including due diligence.
- the critical steps involved in the return preparation process.
- the resources available to assist you.

Your Instructor will guide you to the training materials that are appropriate for your chosen course of training.

Unlike most classes, there is no need to memorize a lot of information. The material in this training guide will give you a good understanding of the tax law that applies to tax returns that are in scope. You can always come back here to review a particular subject.

Once you get used to looking up a certain topic, you will have all the resources you need to serve the taxpayers you assist. At the completion of your course of study, you will fully understand how to apply critical aspects of each component of the process and be able to complete an accurate return for each taxpayer you assist.

If you wish to review any of the referenced forms, schedules (sch), form instructions, and publications (pubs) as you go through this training guide, they can be viewed or downloaded by clicking on the link or at www.irs.gov.

Thank you for volunteering with Tax-Aide to deliver free, high-quality tax service and helping the IRS achieve its mission of providing America's taxpayers with top quality service by helping them understand their tax responsibilities and by applying the tax law with integrity and fairness to all.

Let's get started!

How is this training guide structured?

This training guide supports the Advanced certification path that is required to be a Tax-Aide Counselor. There is a Basic certification used by VITA/TCE but not used by Tax-Aide. There are two optional specialty courses presented in this publication indicated by the following icons:

Military covers topics applicable to members of the Armed Forces, Reserve, and National Guard.

International covers topics applicable to military and non-military taxpayers living outside the United States or with income from sources outside the United States.

If either of these icons appears at the start of a lesson or a section, that lesson or section is devoted solely to that certification path. Only if you are certified in Military or International are you able to assist taxpayers with those tax issues. Volunteers wishing to certify in Military or International must complete the Advanced certification test first.

There are two other specialty courses that are not covered in this guide but are instead covered in separate pubs: Pub 5876 for foreign students and scholars and Pub 4696 for Puerto Rico taxpayers.

You will see icons throughout the text. They are used to emphasize specific types of information that are important for your learning experience:

Caution

Tip

Example

Note

Exercises

Tax Law Application

TaxSlayer Software Hint

Additional resources are listed at the end of each lesson, which you might wish to investigate for a deeper dive into the particular topic. Experienced Counselors may wish to use these handy links to expand their tax law understanding of specific areas of interest.

What is the training approach?

Each course uses an approach that combines tax law and tax software training to help you prepare an accurate return. In each lesson of this publication, you will find yourself using:

- The Tax-Aide Intake Booklet. At your site, you will use it to interview the taxpayer to establish the right filing status and dependency; to identify items income, deductions, and credits; to validate information provided during the interview; to determine whether all necessary documents and information are present; and to confirm that the tax return is within the scope of the program. All are essential to preparing an accurate return.
- Reference materials, such as Tax-Aide tools, NTTC 4012, and IRS form instructions and publications, to better understand the tax rules that are essential for an accurate return.

NTTC 4012 is the Tax-Aide version of the IRS's Pub 4012, Volunteer Resource Guide. It is available in digital form only and is kept up to date throughout the tax return filing season. You will find yourself using it extensively while at your tax site to help you through the multitude of tax forms and properly entering data into the tax return software.

You may use the Practice Lab found at vita.taxslayerpro.com/IRSTraining/en/Account/Access to complete exercises, practice returns, and test scenarios using the same tax software that you will use at your tax site. Your Instructor will guide through setting up your account and introduce you to the software.

You can find detailed instructions for entering data into the software, completing relevant tax forms, and filing the return in the NTTC 4012.

What happens after I complete this course?

After completing this course, you will have an understanding of tax law and research tools needed to prepare an accurate return. You will have also practiced preparing various tax returns from the Tax-Aide Workbook as your Instructor will have assigned. The next step will be to complete the required certification tests and any optional certifications chosen as shown in the following table. Your Instructor will help you determine whether you should certify in any of the optional areas.

Required Test	Client Facilitators	Tax Counselors	Local Coordinators Shift Supervisors
Volunteer Standards of Conduct	✓	✓	✓
Intake/Interview and Quality Review	✓	✓	✓
Advanced Test		✓	
Site Coordinator Test			✓
Military		Optional	
International		Optional	
Foreign Student or Scholar		Optional	
Puerto Rico		Optional	

Throughout this Training Guide, we will refer to Local Coordinators and Shift Supervisors as "Coordinators." The Coordinator is the individual responsible for the smooth operation of your site and the person with whom to check if you have operational or other questions.

How does certification work?

Your Instructor will guide you through how and when to take each test. You will need to register on Link & Learn Taxes (L&LT) and take the tests online using the Advanced certification path. Online testing is fast and efficient; it provides test results immediately. There is no time limit and you may consult this guide and other tax materials while taking the test. Volunteers who prefer to complete the test on paper first, using the test questions in Form 6744, must then transcribe their answers to the online test in L&LT. The passing score for each test is 80%, and volunteers who do not pass a test first time may review the course material and try again, this time using the retest questions. Any volunteer who does not pass the retest is encouraged to participate in the program in another capacity such as greeter, client facilitator, communication specialist, or technical support.

For more information on registering in L&LT and taking the tests, you can refer to the Taking the IRS Tests Online document.

You must pass the Volunteer Standards of Conduct and Intake/Interview and Quality Review tests before you can access the Advanced certification test. You do not have to take the Basic Certification test.

When you're done with all the tests in your course of study, you will have an opportunity to electronically sign your copy of Form 13615, Volunteer Standards of Conduct. That form shows all the tests that you have passed to date. Ask your Coordinator or Instructor if you should send Form 13615 (in pdf format) to them each time you pass a test, or only when you have completed all your tests.

What types of returns can I prepare?

It is important that you assist only with returns, supporting schedules, and forms for which you have been trained and certified. You are protected by the federal Volunteer Protection Act of 1997 (discussed below) as long as you are only preparing returns within the scope of the Tax-Aide program. Refer taxpayers with tax situations outside your scope of training and certification to your Coordinator. The training resources and tools discussed in this guide support the completion of a Form 1040 and associated tax forms within Tax-Aide scope. Some common out-of-scope topics are mentioned in each lesson of this Training Guide for awareness so you will know what not to do. A complete list of what is within the scope of the Tax-Aide program can be found in the Tax-Aide Scope Manual. Do not prepare returns that fall outside the scope of the Tax-Aide program or your own training and certification.

If any element in a return falls outside the scope of the Tax-Aide program, then the entire return is out of scope and should not be prepared, even if it seems unlikely that it will affect the total tax due or refund amount.

You may prepare, amend, or review returns for a prior year only if you completed the appropriate certification for that year.

Am I legally liable for returns I prepare?

VITA/TCE program volunteers are not considered paid preparers; therefore, you are not legally liable under federal law for the return you prepare. You are protected by the federal Volunteer Protection Act of 1997, as long as all of the following conditions are true:

- You do not accept payment of any kind for preparing a federal tax return or for providing any other tax-related assistance.
- You are acting within the scope of your volunteer responsibilities in the Tax-Aide program.
- You completed the appropriate level of training and certification required for preparing tax returns at your site.
- The harm was not caused by willful, criminal, reckless, grossly negligent, or conscious, flagrantly indifferent acts.

How does the IRS identify volunteer-prepared returns?

Each return is identified with a site identification number (SIDN) in the paid preparer box of the return to ensure it is readily identifiable by the IRS. Your Coordinator will assure that your site's SIDN 8-digit number is reflected on all returns prepared at your site.

Responsibilities as a Tax-Aide volunteer

As a Tax-Aide program volunteer, you have a responsibility to provide quality service and to uphold the ethical standards of the program. Before you start working as a volunteer, you will be asked to sign the Volunteer Standards of Conduct Agreement (Form 13615), which states that you will adhere to these standards:

- Follow the Quality Site Requirements (QSR)
- Do not accept payment, ask for donations, or accept refund payments for federal or state tax return preparation from taxpayers
- Do not solicit business from taxpayers you help or use the information you gained about them (their information) for any direct or indirect personal benefit for yourself, any other specific individual, or organization
- Do not knowingly prepare false returns
- Do not engage in criminal, infamous, dishonest, notoriously disgraceful conduct, or any other conduct considered to have a negative effect on the Tax-Aide program
- Treat all taxpayers in a professional, courteous, and respectful manner

As a certified Counselor, follow these standards for return preparation for every return: diligently use the Tax-Aide Intake Booklet, follow the quality review process, use reference materials to ensure an accurate return, complete the steps to electronically file tax returns, and adhere to the privacy and confidentiality guidelines.

What is due diligence?

Due diligence means doing your part to ensure tax returns are correct. As an IRS-certified volunteer, you ensure the information on the return you are preparing or reviewing is correct and complete.

Doing your part includes:

- Confirming a taxpayer's (and spouse's if married filing jointly) identity

- Providing top-quality service by helping the taxpayer understand and meet their tax responsibilities
- Clarifying information that may appear to be inconsistent or incomplete

Generally, IRS-certified volunteers may rely in good faith on information from a taxpayer without requiring documentation as verification. However, part of due diligence requires volunteers to ask a taxpayer to clarify information that may appear to be inconsistent or incomplete. When reviewing information for its accuracy, you need to ask yourself if the information is unusual or questionable. If at any time you become uncomfortable with the information provided by the taxpayer, you should not prepare the tax return.

When in doubt, make an effort to find the answer

- Refer to your research publications (i.e. NTTC 4012, Pub 17, etc.)
- Seek assistance from your Coordinator
- Seek assistance from a Counselor with more experience
- Research www.irs.gov including the Interactive Tax Assistance (ITA)
- Call the VITA/TCE Hotline at 1-800-829-VITA (8482)

However, resist giving information that is not tax-related. Taxpayers should seek counsel from their own experts on nontax matters or matters that are out of scope.

The following examples illustrate unusual or questionable situations that call for more information from the taxpayer.

Larry goes to a Tax-Aide site to have his taxes prepared. Larry tells the tax preparer:

- *His filing status is head of household*
- *He wants to claim his 2-year-old nephew for the earned income credit*
- *He has no child care expenses*
- *He earned $19,000 in wages*
- *He is 26 years old*

Larry's information regarding his qualifying child and filing status is questionable. Further inquiries are needed to determine:

- *Why the uncle is claiming the child and not the parents?*
- *Why aren't there child care expenses and who cares for the child while the taxpayer works?*
- *Is there anyone else in Larry's household that contributes?*
- *Is there anyone else eligible to claim the child?*
- *Do the tie-breaker rules apply?*
- *If asked, could Larry provide proof that the qualifying child lived with him for more than half of the year?*

Steven goes to a Tax-Aide site to have his taxes prepared. Steven tells the tax preparer:

- *He is 22 years old*
- *He has two sons, ages 10 and 11*
- *He has Social Security cards for both boys and himself*
- *His W-2 wage indicates earnings of $20,000*

Steven's age and the age of the qualifying children appear to be inconsistent. Further inquiries are needed to determine:

- *Are the boys his sons by birth, foster sons, adopted sons, step-sons?*

- *Is anyone else eligible to claim the boys as qualifying children?*
- *Do the tie-breaker rules apply?*
- *If asked, could Stephen provide proof that the qualifying children lived with him for more than half of the year?*

As a certified volunteer, remember due diligence and take reasonable steps to ensure the tax return is correct:

- Ask enough questions to determine if allowable expenses were incurred and that income reported is correct.
- Include all taxable income in the tax return.
- If an item is questionable and/or unallowable, do not claim the deduction or credit on the tax return. Make a note of the decision to alert the reviewer to this on Tax-Aide Intake Booklet.
- If you are uncomfortable with the information and/or documentation provided by a taxpayer, check with your Coordinator.
- If the taxpayer wishes to take a position on their return that is contrary to your training, you should not prepare the return.

Tax return integrity means volunteers must take reasonable steps to ensure the tax return is correct, which includes:

- Verifying that all Social Security numbers (SSN) and individual taxpayer identification numbers (ITIN) presented by the taxpayer match the numbers listed on the tax return.
- Not preparing out-of-scope returns.
- Not preparing returns for which you have not been certified.
- Explaining to the taxpayer what income is taxable and why a deduction or credit can or cannot be included on their return. Use IRS reference materials to support your statements.
- Having a second certified volunteer quality review the completed return and discuss it with the taxpayer.
- Not making changes or corrections to the tax return after the taxpayer leaves the site without notifying the taxpayer and providing them with a corrected copy.

In conclusion, as an IRS-certified volunteer preparer, you have the responsibility to perform adequate due diligence on EVERY return. The goal is not to prepare as many tax returns as possible; the goal is to accurately report taxpayer income and deductions.

How do I maintain the taxpayer's trust?

You are key to the integrity of the Tax-Aide program. 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 your service.
- Do not openly discuss taxpayers by name in the presence of other volunteers or taxpayers. You may discuss tax situations with other volunteers. For example, you may ask for or give advice about the appropriate tax treatment for a specific situation without identifying the taxpayer.
- In the usual face-to-face preparation process, do not retain taxpayers' documents for a follow-up visit. If you cannot fully complete the taxpayer's return at the time of service, return all documents to the taxpayer.
- Do not take taxpayers' information for preparation of the return outside the presence of the taxpayer, unless virtual or drop-off preparation procedures are being used.
- Do not prepare a tax return when you suspect an individual is not providing truthful information.
- Do not exclude any of the taxpayer's relevant income or expenses, regardless of whether they increase or decrease the amount of tax due or refund.

Having the taxpayer present in the tax preparer's site is not always possible. In these cases, virtual or drop-off processes can be used to prepare returns without the taxpayer being in-person. Certified volunteers may interview taxpayers over the phone or other approved method while preparing their return. The alternative process used to prepare returns must be approved by the responsible IRS Territory Manager prior to the start of the filing season to ensure all procedures are in place as described in the Quality Site Requirements (QSR). Most importantly, the taxpayer's and government's interests must be properly protected. In some cases, the taxpayer information must be left at the site to be prepared and mailed to the taxpayer. Your Coordinator will instruct you on security and privacy procedures to ensure taxpayer records are properly safeguarded.

Some individuals may attempt to defraud the government by filing false tax returns. If you have any question about the validity of information provided by a taxpayer, or are uncomfortable with a taxpayer situation, discuss your concern with your Coordinator.

If you or a taxpayer have a concern or issue regarding unethical behavior at a site, e-mail wi.voltax@irs.gov. The email notification should include your name, contact number, site name, and a detailed description of the incident including the individual's full name, date the incident occurred, and the number of taxpayer's affected by the violation if applicable. Also, refer to the information on the Tax-Aide Important Tax Records Envelope or the Tax-Aide program poster (D143).

Taxpayer civil rights

In accordance with federal law and the Department of the Treasury – Internal Revenue Service policy, discrimination against taxpayers on the basis of race, color, national origin (including Limited English Proficiency), disability, sex (in education programs or activities), age or reprisal is prohibited in programs and activities receiving federal financial assistance.

Persons with disabilities and/or limited English proficiency should be able to participate in or benefit from programs and services that IRS supports. Taxpayers with a disability may request a reasonable accommodation and taxpayers with limited English proficiency may request language assistance to access services. For additional information refer to Publication 4053, Your Civil Rights Are Protected, for reasonable accommodations.

If a taxpayer believes that they have been discriminated against, a written complaint should be sent to:

Operations Director,
Civil Rights Unit, Room 2413
1111 Constitution Avenue, NW
Washington, DC 20224

For all questions about taxpayer civil rights, contact the Civil Rights Division at the above address, or by e-mail at edi.civil.rights.division@irs.gov.

Do not send tax returns, payments, or other non-civil rights information to this address.

What resources are available if the taxpayer has an unresolved tax issue from prior years?

When talking with the taxpayer, a volunteer may discover that the taxpayer has other unresolved tax issues. It may be more likely that the taxpayer is experiencing difficulties with the IRS when the taxpayer indicates any of the following during the interview:

- Having been a victim of tax-related identity theft or been issued an Identity Protection PIN
- Having had a credit card, student loan, or mortgage debt canceled/forgiven by a lender or have a home foreclosed
- Having had an earned income credit, child tax credit, or American opportunity credit disallowed in a prior year
- A letter or bill from the IRS that they do not understand

If it appears that there are unresolved issues for the taxpayer that cannot be addressed in preparing the tax return, you can assist the taxpayer by providing them with a referral to a local Low Income Taxpayer Clinic (LITC) that may be able to help. LITCs:

- Are independent from the IRS and the Taxpayer Advocate Service.
- Assist taxpayers whose income is below a certain level and who need to resolve tax problems with the IRS.
- Provide education, outreach, and information on taxpayer rights to individuals who speak English as a second language.
- Represent taxpayers in disputes before the IRS and in court and help taxpayers respond to IRS notices and correct account problems.
- Services are offered for free or a small fee.

For more information or to find an LITC, see the LITC page at www.TaxpayerAdvocate.irs.gov/litc, download IRS Pub 4134, Low Income Taxpayer Clinic List, also available in Spanish at https://ww.irs.gov, or call the IRS at 1-800-829-3676.

The Taxpayer Advocate Service is here to help

The Taxpayer Advocate Service (TAS) is an independent organization within the IRS, led by the National Taxpayer Advocate, that helps taxpayers and protects taxpayer rights. TAS offers free help to taxpayers when a tax problem is causing a financial difficulty, when they've tried and been unable to resolve their issue with the IRS, or when they believe an IRS system, process, or procedure just isn't working as it should. TAS strives to ensure that every taxpayer is treated fairly and knows and understands their rights under the Taxpayer Bill of Rights.

TAS has offices in every state, the District of Columbia, and Puerto Rico. To find your local advocate's number:

- Visit www.TaxpayerAdvocate.irs.gov/contact-us
- Check your local directory
- Call TAS toll-free at 877-777-4778

The Taxpayer Advocate Service's website, www.TaxpayerAdvocate.irs.gov, is a resource for all taxpayers. It covers a variety of tax-related concepts and problems, breaking each down to describe what taxpayers should know, what they should do, and where they can get more help if needed. Taxpayers can also learn about their taxpayer rights.

What is the Taxpayer Bill of Rights?

The Taxpayer Bill of Rights groups rights from the Internal Revenue Code into ten fundamental taxpayer rights. IRS employees are responsible for knowing and following these rights. For more information, see Pub 1, Your Rights as a Taxpayer, or visit www.TaxpayerAdvocate.irs.gov/ taxpayer-rights.

How else does the Taxpayer Advocate Service help taxpayers?

TAS works to resolve large-scale problems that affect many taxpayers. Please report systemic issues at www.irs.gov/sams. (Be sure not to include any personal identifiable information)

What are the materials available to assist me?

A tax return is accurate when tax law is applied correctly and it is free from error. The VITA/TCE certification and return preparation process consists of several critical components:

- Your thorough interview of the taxpayer and review of the taxpayer's supporting documentation as documented in a completed Tax-Aide Intake Booklet
- VITA/TCE Volunteer Standards of Conduct – Ethics Training is in Pub 4961
- Tax law training – understanding and applying tax law is the primary role for this Training Guide

- Intake/Interview and Quality Review training is in Pub 5101 and the handbook is Pub 5838
- Tax return preparation using the IRS-provided tax software is addressed in NTTC 4012
- Local Coordinator training for volunteers acting in this role is in the Tax-Aide Portal Library > Tax-Aide: Position Information > Local Coordinator > Local Coordinator Guide
- Optional training for the Foreign Student and Scholar certification (Pub 5876)
- Optional training for Puerto Rico certification (Pub 4696)

When you're ready to complete the appropriate tests, you'll find them in Form 6744 Volunteer Assistor's Test/Retest and on L&LT.

IRS produces numerous publications, some of which are referenced in this publication if you wish to learn more about a particular subject. You will see many references to the NTTC 4012, which is available in digital form only. The National Tax Training Committee (NTTC) modifies the IRS version of Pub 4012, Volunteer Resource Guide, to enhance areas as needed and to add subject matter that is in scope for Tax-Aide but not in scope for other VITA/TCE volunteers. You are encouraged to practice using the NTTC 4012 as it will be the main "go-to" resource you will use while preparing a return at your tax site.

While at your tax preparation site, your Tax-Aide computer will give you access to tax forms, publications, and worksheets. Your Coordinator will also provide some paper worksheets or instructions to help you assist taxpayers.

You may always come back here to this Training Guide to reinforce your knowledge of tax law or by accessing other online training materials from Tax-Aide or L&LT, found at apps.irs.gov/app/vita/.

A toll-free tax information hotline is available for volunteer use only and is readily found on the last page of NTTC 4012. If you have a tax law question and cannot get the answer from your Coordinator or your reference material, call 1-800-829-8482 (1-800-TAX-VITA). **Do not give this phone number to taxpayers.** The volunteer hotline is generally available from February 1 until the filing deadline.

For inquiries about refund offsets, taxpayers can call the Treasury Offset Program toll-free at 1-800-304-3107. Other helpful contact information can be found near the back of the NTTC 4012.

How do I get started using the tax software?

The online tax software, TaxSlayer Pro, is used to prepare returns and includes a help feature to assist in understanding the application of tax law. Your Instructor or Coordinator will provide you with the information, user names, and passwords required for logging into the program for training and tax preparation purposes.

Where do I find information about the tax software?

The NTTC 4012 contains step-by-step guidance for electronic return preparation and helpful hints for using the tax software within each applicable tax law topic.

Summary

Welcome to the Tax-Aide program. Remember:

- Make sure you have the resources and support you need to provide each taxpayer with high-quality service and an accurate tax return.
- A tax return is considered accurate when tax law is applied correctly and the completed return is free from error based on the taxpayer's interview and supporting documentation, and a completed Tax-Aide Intake Booklet.
- Know your roles and responsibilities, adhere to the Volunteer Standards of Conduct, and exercise due diligence.
- Prepare returns that are:
  - within the scope of the Tax-Aide program.

    - within your certification level.
- Use Tax-Aide equipment and supplies (including hardware and software) for their intended purposes.

Where to find more information

Pub 4961, VITA/TCE – Volunteer Standards of Conduct – Ethics Training

Pub 5101, Intake/Interview and Quality Review Training

Pub 5838, VITA/TCE Intake/Interview and Quality Review Handbook

Form 6744, VITA/TCE Volunteer Assistor's Test/Retest

Pub 4299, Privacy, Confidentiality, and Civil Rights

Pub 1546, The Taxpayer Advocate Service Is Your Voice at the IRS

Pub 4134, Low Income Taxpayer Clinic List

Pub 1, Your Rights as a Taxpayer

Pub 5876, VITA/TCE Foreign Student and Scholar Volunteer Training Guide6

Pub 4696 (PR), VITA/TCE Puerto Rico Resource Guide

Introduction to Federal Tax Law

Introduction

This lesson provides an overview of our federal tax system. It also provides an overview of the structure of a federal tax return. Many states that impose a state income tax start with the completed federal return. Your local instructor team will guide you through your state's tax return process.

Objectives

At the end of this short lesson, you will have a good overview of our federal tax laws and the IRS-provided process to comply with our federal tax laws.

Basics of federal income tax law

Our federal tax laws contained in the Internal Revenue Code can be generally summarized to say:

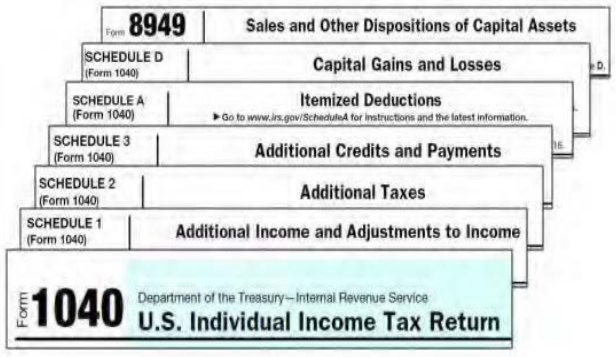
1. All income is taxable – unless there is a provision to say it is not.
2. No deduction or credit is allowable – unless there is a provision for it.

U.S. citizens and residents are taxable on their worldwide income, regardless of where they live. All taxable or reportable amounts must be stated in U.S. dollars. These subjects are discussed later.

The U.S. Department of the Treasury, through its IRS enforcement arm, has primary responsibility for enforcing the income tax laws.

Federal income tax compliance

The IRS provides tax forms that enable taxpayers to comply with our federal tax laws. These forms are arranged as a main summary form with additional forms as necessary to provide details or to make a calculation. The main form for individuals is Form 1040 (or Form 1040-SR for seniors) and is structured to capture income, deductions, and tax credits to arrive at their total tax liability.



Income tax is imposed on **taxable income** computed as:

	Gross Income
Minus	Adjustments (also known as above-the-line deductions)
Equals	Adjusted Gross Income ("AGI")
Minus	Deductions
Equals	Taxable Income

The tax rates used to compute the tax depend on the filing status claimed by the taxpayer, which may depend on whether the taxpayer can claim a dependent or other individual for a more favorable filing status. Filing

statuses are discussed in the Filing Status lesson 4. Other taxes may apply, depending on the taxpayer's specific facts.

Income tax credits can reduce the amount of tax due or even result in a net refund. When total taxes exceed total credits, it is a net tax liability. When credits and payments exceed total taxes, there is an overpayment.

Taxpayers must generally prepay their net tax liability throughout the year through withholding tax or by making estimated tax payments. If there is a balance remaining after prepayments, it must be paid on time to avoid interest and possibly penalties. If there is an overpayment, the taxpayer will receive a refund or can apply some or all of the overpayment to their next year's taxes.

Income tax return preparation

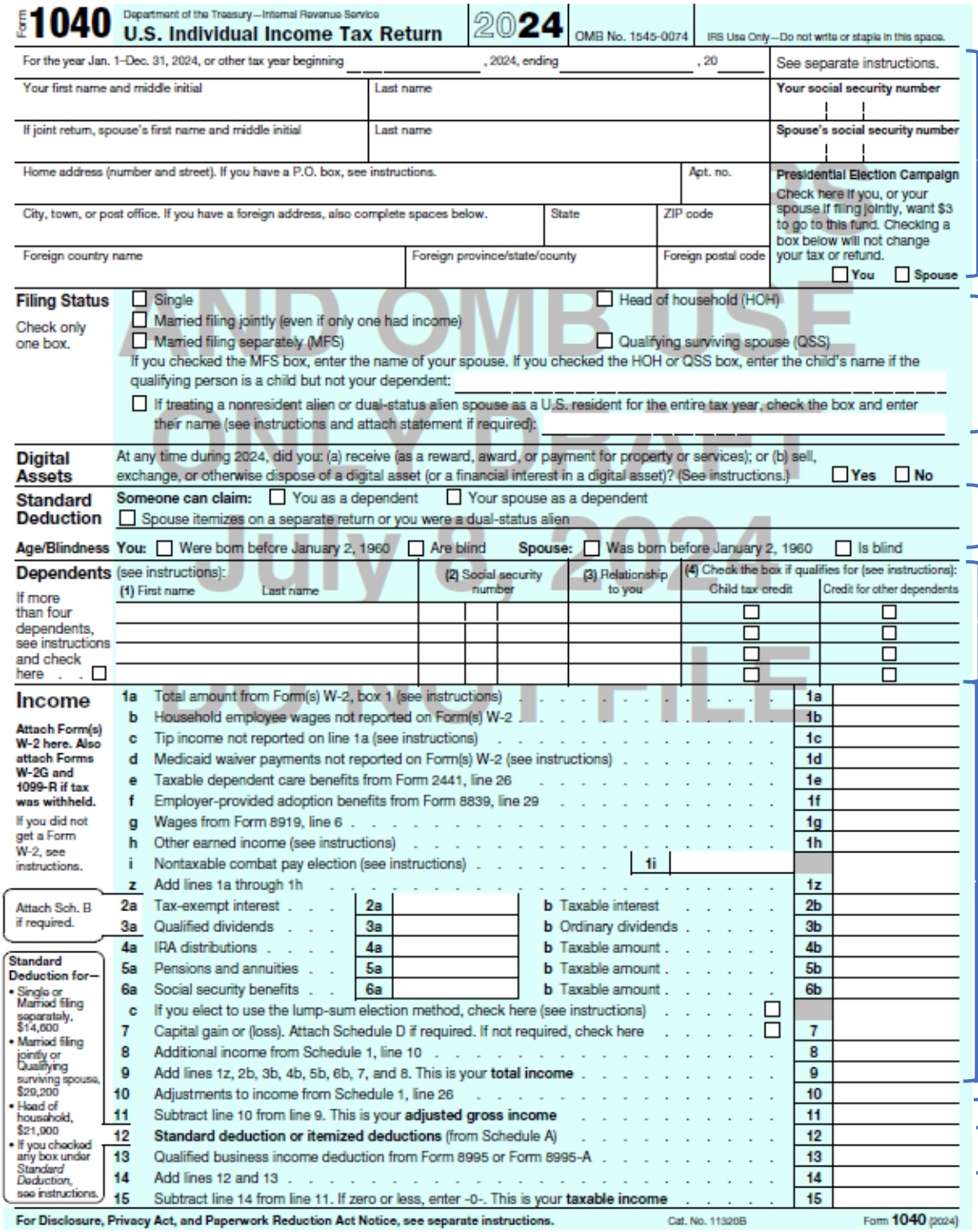
Tax-Aide provides laptops for all Counselors to use for tax return preparation. All online resources are easily available. The IRS provides the Tax-Aide and VITA/TCE programs with tax software to complete individual income tax returns. That software greatly simplifies the preparation of an accurate return and prevents mathematical errors. The software is also used to electronically transmit returns (e-file) to avoid having to mail paper returns.

Tax-Aide policies and procedures require that the Tax-Aide Intake Booklet is used by the taxpayer and the Counselors for each and every tax return. Additionally, each return must be quality reviewed by an experienced Counselor other than the Counselor that prepared the return or conducted the intake interview.

Scope of service

This training guide covers all the items of income, deduction, additional tax, or credit that are in scope for Tax-Aide as part of the VITA/TCE Programs. Each lesson identifies issues that fall outside of our scope. You do not need to memorize all of these issues, though you should have a general understanding of major limitations. Items in scope or out of scope are listed by tax form number in the Tax-Aide Scope Manual. Staying within the scope of the program is critical and cannot be overemphasized.

Here is a roadmap of Form 1040 to the respective lessons in this training guide:



Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** 2024 OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2024, or other tax year beginning , 2024, ending , 20 — See separate instructions.

Your first name and middle initial | Last name | Your social security number

If joint return, spouse's first name and middle initial | Last name | Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions. | Apt. no.

City, town, or post office. If you have a foreign address, also complete spaces below. | State | ZIP code

Foreign country name | Foreign province/state/county | Foreign postal code

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

Lesson 3

Filing Status Check only one box.

☐ Single ☐ Head of household (HOH)
☐ Married filing jointly (even if only one had income)
☐ Married filing separately (MFS) ☐ Qualifying surviving spouse (QSS)
If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QSS box, enter the child's name if the qualifying person is a child but not your dependent:
☐ If treating a nonresident alien or dual-status alien spouse as a U.S. resident for the entire tax year, check the box and enter their name (see instructions and attach statement if required):

Lessons 4 and 7

Digital Assets At any time during 2024, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) ☐ Yes ☐ No

Standard Deduction **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness **You:** ☐ Were born before January 2, 1960 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1960 ☐ Is blind

Lesson 19

Dependents (see instructions): If more than four dependents, see instructions and check here ☐

(1) First name Last name	(2) Social security number	(3) Relationship to you	(4) Check the box if qualifies for (see instructions): Child tax credit	Credit for other dependents
			☐	☐
			☐	☐
			☐	☐
			☐	☐

Lesson 6

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 Form W-2, see instructions.

1a	Total amount from Form(s) W-2, box 1 (see instructions)			1a
b	Household employee wages not reported on Form(s) W-2			1b
c	Tip income not reported on line 1a (see instructions)			1c
d	Medicaid waiver payments not reported on Form(s) W-2 (see instructions)			1d
e	Taxable dependent care benefits from Form 2441, line 26			1e
f	Employer-provided adoption benefits from Form 8839, line 29			1f
g	Wages from Form 8919, line 6			1g
h	Other earned income (see instructions)			1h
i	Nontaxable combat pay election (see instructions)	1i		
z	Add lines 1a through 1h			1z
2a	Tax-exempt interest	2a	b Taxable interest	2b
3a	Qualified dividends	3a	b Ordinary dividends	3b
4a	IRA distributions	4a	b Taxable amount	4b
5a	Pensions and annuities	5a	b Taxable amount	5b
6a	Social security benefits	6a	b Taxable amount	6b
c	If you elect to use the lump-sum election method, check here (see instructions) ☐			
7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ☐			7
8	Additional income from Schedule 1, line 10			8
9	Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income**			9
10	Adjustments to income from Schedule 1, line 26			10
11	Subtract line 10 from line 9. This is your **adjusted gross income**			11
12	**Standard deduction or itemized deductions** (from Schedule A)			12
13	Qualified business income deduction from Form 8995 or Form 8995-A			13
14	Add lines 12 and 13			14
15	Subtract line 14 from line 11. If zero or less, enter -0-. This is your **taxable income**			15

Attach Sch. B if required.

Standard Deduction for—
- Single or Married filing separately, $14,600
- Married filing jointly or Qualifying surviving spouse, $29,200
- Head of household, $21,900
- If you checked any box under Standard Deduction, see instructions.

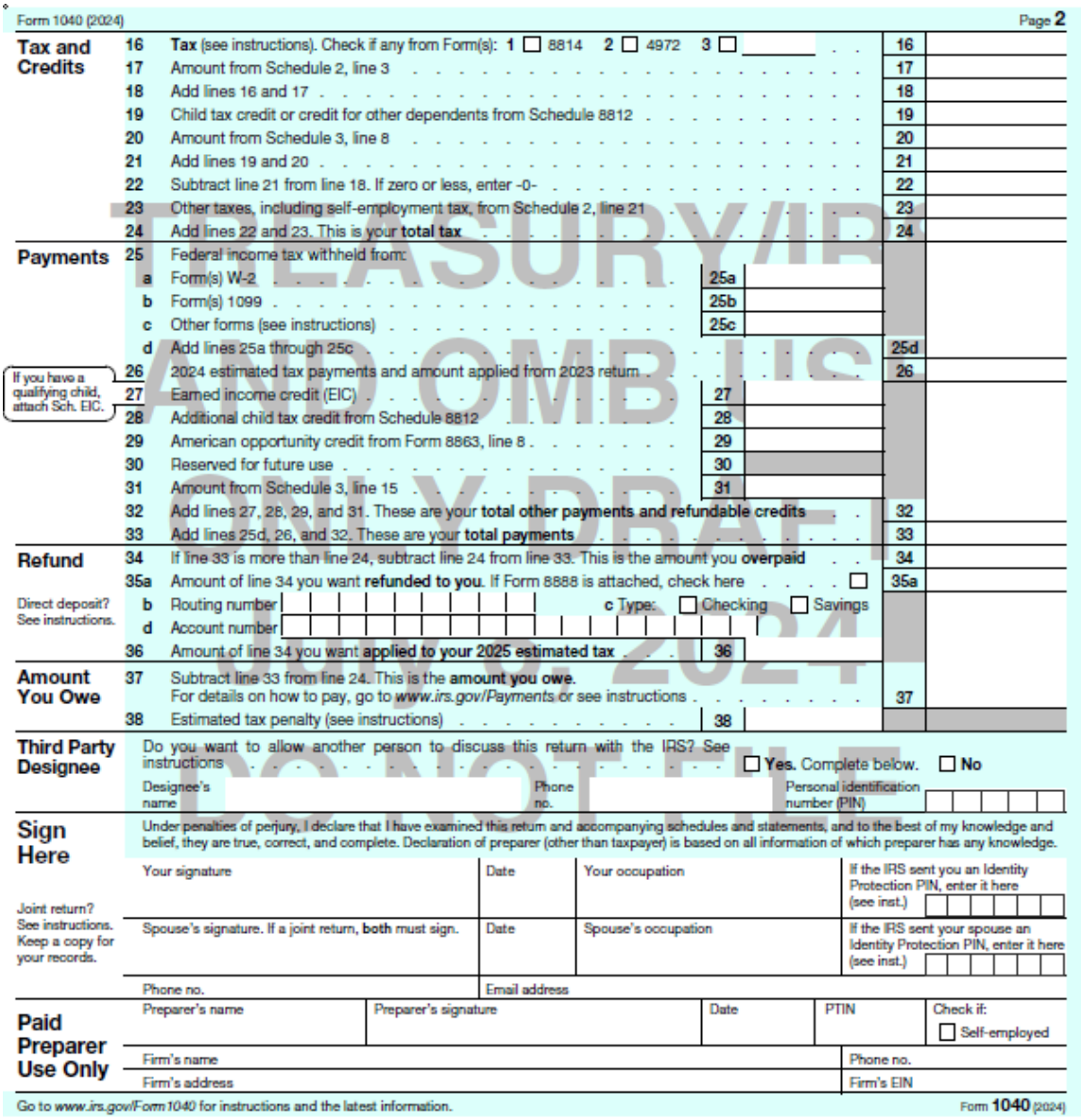
Lessons 8-16

Lessons 17and 18

Lesson 19

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2024)

DO NOT USE OR FILE
DRAFT
July 8, 2024



Form 1040 (2024) Page 2

Tax and Credits	16	Tax (see instructions). Check if any from Form(s): 1 ☐ 8814 2 ☐ 4972 3 ☐	16	
	17	Amount from Schedule 2, line 3	17	
	18	Add lines 16 and 17	18	
	19	Child tax credit or credit for other dependents from Schedule 8812	19	
	20	Amount from Schedule 3, line 8	20	
	21	Add lines 19 and 20	21	
	22	Subtract line 21 from line 18. If zero or less, enter -0-	22	
	23	Other taxes, including self-employment tax, from Schedule 2, line 21	23	
	24	Add lines 22 and 23. This is your **total tax**	24	
Payments	25	Federal income tax withheld from:		
	a	Form(s) W-2 — 25a		
	b	Form(s) 1099 — 25b		
	c	Other forms (see instructions) — 25c		
	d	Add lines 25a through 25c	25d	
If you have a qualifying child, attach Sch. EIC.	26	2024 estimated tax payments and amount applied from 2023 return	26	
	27	Earned income credit (EIC) — 27		
	28	Additional child tax credit from Schedule 8812 — 28		
	29	American opportunity credit from Form 8863, line 8 — 29		
	30	Reserved for future use — 30		
	31	Amount from Schedule 3, line 15 — 31		
	32	Add lines 27, 28, 29, and 31. These are your **total other payments and refundable credits**	32	
	33	Add lines 25d, 26, and 32. These are your **total payments**	33	
Refund	34	If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you **overpaid**	34	
	35a	Amount of line 34 you want **refunded to you**. If Form 8888 is attached, check here ☐	35a	
Direct deposit? See instructions.	b	Routing number c Type: ☐ Checking ☐ Savings		
	d	Account number		
	36	Amount of line 34 you want **applied to your 2025 estimated tax** — 36		
Amount You Owe	37	Subtract line 33 from line 24. This is the **amount you owe**. For details on how to pay, go to *www.irs.gov/Payments* or see instructions	37	
	38	Estimated tax penalty (see instructions) — 38		

Third Party Designee — Do you want to allow another person to discuss this return with the IRS? See instructions ☐ **Yes.** Complete below. ☐ **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.

Your signature | Date | Your occupation | If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Joint return? See instructions. Keep a copy for your records.
Spouse's signature. If a joint return, **both** must sign. | Date | Spouse's occupation | If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.)

Phone no. | Email address

Paid Preparer Use Only — Preparer's name | Preparer's signature | Date | PTIN | Check if: ☐ Self-employed
Firm's name | Phone no.
Firm's address | Firm's EIN

Go to *www.irs.gov/Form1040* for instructions and the latest information. Form **1040** (2024)

TREASURY/IRS AND OMB IRS ONLY DRAFT NOT FINAL UNTIL 2024 NOT FOR FILE

Lessons 20 and 26

Lessons 21-25

Lesson 27

Lessons 22, 24, 26, 28, and 29

Lesson 30

Lessons 31-32

IP PIN Lesson 3

Summary

You now have a good understanding of how the income tax laws work and how an income tax return is structured. The lessons in this Training Guide will cover the income, deductions, additional taxes, and tax credits that are in scope for Tax-Aide. Additional information is just a link away in the various pubs and form instructions referenced in each lesson.

Where to find more information

Tax-Aide Scope Manual

Tax-Aide Policy and Procedures Manual

Pub 17, Your Federal Income Tax

IRS.gov for current year forms, instructions, and publications

Filing Basics

Introduction

This lesson will help you determine which taxpayers must or should file a tax return. You will also find information on verifying a taxpayer's identity and using an identity protection PIN (IP PIN) issued by the IRS.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1040 Instructions

Objectives

At the end of this lesson, using your reference materials, you will be able to:

- Determine who *must* file a tax return
- Determine who *should* file a tax return
- Verify the taxpayer's identity
- Assist taxpayers who have been issued an IP-PIN by the IRS
- Determine how to file the return

Who must file?

U.S. citizens or residents of the United States must file a return based on three factors. There are special rules for dependents, surviving spouses, U.S. citizens and residents living outside the U.S., residents of Puerto Rico, and individuals with income from U.S. possessions.

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

- Age
- Gross income
- Filing status

Where do I get information on the taxpayer's age?

Look at the Tax-Aide Intake Booklet for the taxpayer's date of birth. You can confirm this date during the interview with the taxpayer's government-issued photo ID.

Where do I get information on the taxpayer's gross income?

An approximation of gross income is enough to see if a taxpayer must file a return. Gross income is **all** the income the taxpayer received during the tax year in the form of money, goods, property, and services that is not exempt from tax. It includes both earned and unearned income.

The Income section of the NTTC 4012 lists the sources of income that should be included or excluded in determining a person's gross income. You can also refer to the income lessons in this training guide.

To approximate gross income:

- Add the amounts from all the taxpayer's Form(s) W-2, Box 1
- Add taxable amounts reported on any Form 1099
- Using the Tax-Aide Intake Booklet, review the income questions with the taxpayer to see if there was any additional income not reported on Form W-2 or Form 1099 and determine each amount

Total the above amounts to determine the taxpayer's approximate gross income.

A decedent's income received by a beneficiary after the decedent's death is generally taxable to the beneficiary. Too often, a surviving spouse or a beneficiary does not change the decedent's SSN with the payer on a timely basis. Even if the income is reported using the decedent's SSN, the beneficiary who receives the income and is entitled to it needs to report it on their tax return.

If there is an estate that will file an estate income tax return (Form 1041), income received and kept by the estate is taxed to the estate. The estate or trust may be able to distribute the income it receives to the beneficiaries, in which case the taxpayer will receive Form 1041, Sch K-1 (discussed in a later lesson).

Do not include Social Security benefits when determining filing requirement unless the taxpayer is married, is filing a separate return, and lived with their spouse at any time during the tax year.

Where do I get information on the taxpayer's filing status?

Taxpayers may or may not know which filing status to use. For the purpose of determining whether a person must file a return, narrowing the choices down to the most likely filing status(es) is adequate in most cases.

Check the first page of the Tax-Aide Intake Booklet for:

- The taxpayer's marital status.
- Whether the taxpayer can be claimed as a dependent on someone else's tax return.
- The taxpayer's potential dependents.

Use the NTTC 4012's Determination of Filing Status decision tree and the Interview Tips in Tab B, Starting a Return and Filing Status, for helpful probing questions.

Who is legally required to file a federal tax return?

To determine whether a taxpayer is legally required to file a return, start with the NTTC 4012, Tab A, Who Must File. Use those charts to review these examples.

Lucy is 36 years old, single, has no dependents, and her gross income is $20,000. She must file a tax return since her income exceeds the amount for her age and filing status.

Henrietta and Javier are married and plan to file a joint return. Henrietta is 67 and had a gross income of $11,000 for the tax year. Javier is 66. His gross income was $5,000 for the year. Since their combined gross income is less than the minimum amount for their ages and filing status, they do not have to file a return.

What are special situations that require a taxpayer to file?

If the Who Must File charts show that an individual is not required to file a return, then continue to Chart C – Other Situations When You Must File in the NTTC 4012 to see if any of the special conditions require the person to file.

The most common special situations when individuals are legally required to file a return are:

- Self-employed with net earnings of $400 or more
- Taxpayers who received advanced payments of the premium tax credit (APTC) for themselves, their spouse, or a dependent
- Taxpayers who received the 2008 first-time homebuyer credit are required to file a return to repay a portion of the credit.
- Taxpayers who owe special taxes – see the Other Taxes lesson 27.

Taxpayers may wish to file a return even if it is not required and they are not claiming a refund. Sometimes, that return will have $0 AGI. A tax return with $0 AGI cannot be e-filed. To e-file that return you will need to add $1 as interest income.

Exercises

Refer to the Who Must File section of the NTTC 4012 to answer these questions. Answers are at the end of the lesson.

Question 1: Bob is 27 years old and single. His gross income was $17,000 during the tax year. Based only on this information, is he required to file a tax return?

a. Yes
b. No

Question 2: Janet and Harry are married, file jointly, and lived together all year. During the tax year, she turned 66 and he turned 64. Their gross income was $19,800. Based only on this information, are they required to file a tax return?

a. Yes
b. No

Question 3: Juanita has a dependent child and can file as a qualified surviving spouse. She is 47 years old. Her gross income was $30,000. Based only on this information, is she required to file a tax return?

a. Yes
b. No

Who should file?

Even if individuals are not required to file a tax return, they should file a return if they qualify for certain credits or a refund. The complete list is in the NTTC 4012, Tab A, Chart D – Who Should File. These are the more common situations where an individual should file a return if they are eligible to claim:

- A refund of withheld taxes or estimated taxes paid in
- The earned income credit
- The additional child tax credit
- The American opportunity credit
- Premium tax credit

Individuals who are not required to file a federal return may benefit by filing for state purposes.

How do I find out if a taxpayer is eligible to claim a refund or refundable credit?

The taxpayer may qualify for a tax refund, earned income credit, additional child tax credit, premium tax credit, or American opportunity credit if:

- Federal or state income tax was withheld on any income form
- The taxpayer made estimated tax payments
- The taxpayer had earned income
- The taxpayer has a qualifying child
- The taxpayer or their dependent paid higher education expenses
- The taxpayer purchased health coverage through the marketplace.

If a taxpayer is not required to file a tax return, and you are uncertain if they will benefit from filing, begin a return to determine if filing a tax return would benefit the taxpayer. Tax-Aide recommends e-filing a return even if not required to detect or deter identity theft. A zero AGI return cannot be e-filed so you need to add $1 as interest income.

How do I verify taxpayer identity?

As the first step in the interview process, you should verify the taxpayer's or taxpayers' identity, address, and the spelling of names entered on the taxpayer's Tax-Aide Intake Booklet.

What documents do I use to verify identity?

Ask to see an original photo identification such as:

- Valid driver's license (U.S.)
- State ID (U.S.)
- Visa
- Military ID
- Passport
- National ID
- Employer ID
- School ID

Judgment should be used in accepting any other valid form of identification. IRS-tax-law certified volunteers preparing tax returns are required to confirm the identity of the taxpayer to avoid identity theft, tax fraud, and to validate the correct name and SSN. If a taxpayer cannot prove their identity, or if the volunteer is uncomfortable accepting the items presented as proof of identity, the taxpayer should be advised to return with an acceptable form of identification.

Exceptions to requiring a photo ID should only be made under extreme circumstances and should be approved by the Coordinator. For example, there may be limited situations where an exception may apply to a person with a disability, the elderly, or other unique circumstances. Additionally, the Coordinator has discretion to approve exceptions to verification of taxpayer identity rules. Refer to Pub 4299, Privacy, Confidentiality, and Civil Rights for additional information.

A spouse who is married filing separately is not required to provide the Social Security card for the other spouse, although the return cannot be e-filed without the spouse's SSN.

In addition to photo identification for taxpayers, they must also present proof of taxpayer identification numbers (TIN) for themselves and all persons listed on their tax return. (TIN is explained in the next section.) Exceptions to this rule should be rare and only the Coordinator has discretion to approve an exception.

Taxpayers must be able to prove their identity to be assisted by Tax-Aide; if not, their return is out of scope.

What about taxpayers filing for decedents?

If you are assisting someone who is filing a return for a decedent:

- Be aware that volunteers need to take steps to protect a taxpayer's identity and avoid possible identity theft.
- Ask to see the surviving spouse's identification or a copy of the death certificate.
- A personal representative may be filing the return for the deceased taxpayer. Verify the identity of the person who is filing for the decedent and ask if they have court documents or other documentation authorizing them to file the tax return.

Representatives or surviving spouses who do not have the necessary documentation with them should be advised to return once they have the information. If they cannot provide the information, the return is out of scope.

You will find more information about tax returns for decedents and their surviving spouse (if any) throughout this guide.

What are taxpayer identification numbers?

IRS regulations require that each person listed on a U.S. federal income tax return have a valid taxpayer identification number (TIN). The types of TINs are:

- Social Security number (SSN)
- Individual taxpayer identification number (ITIN)

- Adoption taxpayer identification number (ATIN)

Who has a Social Security number?

Any individual who is legally eligible for employment in the United States must have a SSN. All cards issued by the Social Security Administration are valid for income tax purposes. “Valid for work only with DHS authorization” is marked on the card for people lawfully admitted to the U.S. on a temporary basis who have DHS authorization to work. That is, they are valid for work. “Not valid for employment” is marked on the card for people who are either lawfully admitted without work authorization or because they are required to have a SSN to get a benefit or service.

Taxpayer, spouse, or dependent name and Social Security number mismatches are some of the most frequent errors in processing a tax return.

Some Canadians have both U.S. and Canadian Social Security numbers. Never use the Canadian number on a U.S. tax return.

Who has an individual taxpayer identification number?

Some individuals who need to file tax returns do not have SSNs. The IRS issues ITINs to nonresidents and others living in the U.S. who are required to have a TIN but who are not eligible to obtain an SSN.

The ITIN contains nine digits and is formatted like an SSN (XXX-XX-XXXX), but begins with the number 9 and has a specified range of numbers as the fourth and fifth digits. Generally, you should enter the ITIN on the return wherever the SSN is requested.

Taxpayers who cannot obtain an SSN must apply for an ITIN if they file a U.S. tax return or are listed on a tax return as a spouse or dependent. These taxpayers must file Form W-7, Application for Individual Taxpayer Identification Number and supply documentation that will establish foreign status and true identity. A federal tax return must be associated with all Form W-7 applications with exceptions as noted in the Form W-7 Instructions.

Taxpayers with an ITIN are able to file their returns but are not eligible for certain tax credits, such as the earned income credit. This and other issues are covered in later lessons.

Under the Protecting Americans from Tax Hikes (PATH) Act, ITINs that have not been used on a federal tax return at least once in the last three consecutive years will expire at the end of the year. Taxpayers who expect to file a tax return must submit a renewal application if their ITIN has expired.

Who has an adoption taxpayer identification number?

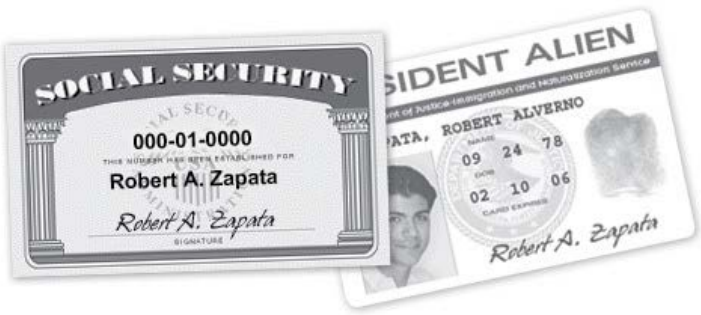
Taxpayers who are in the process of adopting a child and who are able to claim the child as their dependent or are able to claim the child and dependent care credit need an ATIN for their adoptive child. The IRS issues an ATIN for the child while a final domestic adoption is pending, and the adopting taxpayers do not have the child’s SSN.

Like an ITIN, the nine-digit ATIN begins with the number 9. Generally, you should enter the ATIN on the return wherever the child’s SSN is requested.

What are acceptable documents if the taxpayer does not have a Social Security card?

For individuals who do not bring their original or a copy of their Social Security card, you may accept either of the following:

- Form SSA-1099 benefit statement or a letter from the Social Security Administration
- An ITIN card or letter
- Birth certificate or death certificate



The previous year's prepared tax return may also be used if the number is consistent with other tax documents, and if the taxpayer presents an acceptable government issued photo ID.

Driver's licenses and passports are not acceptable substitutes for Social Security or ITIN cards.

What if the taxpayer does not have an SSN or ITIN?

If an individual does not have a TIN, explain that they must have a taxpayer identification number before you can assist them. Direct them to the Social Security Administration and advise them to complete Form SS-5, Social Security Number Application.

If the individual is not eligible for an SSN, they will need to complete Form W-7, Application for IRS Individual Taxpayer Identification Number. If taxpayers need assistance completing Form W-7, refer them to an IRS Taxpayer Assistance Center unless a volunteer and a reviewer at your site have been trained in the completion of Form W-7 or a Certifying Acceptance Agent (CAA) is available.

When preparing a return that will include a Form W-7 application, refer to the instructions in the NTTC 4012, Tab L, Resident/NR Alien, Creating a Temporary ITIN.

Exercises (continued)

Question 4: It is your responsibility as a volunteer tax preparer to enter each SSN correctly on the tax return.

a. True
b. False

Identity protection PIN (IP PIN) program

Identity theft continues to grow at an alarming rate nationwide. The IRS developed a strategy to address the problem of identity theft-related tax administration issues. The IRS strategy continues to evolve, but is focused on three priorities that are fundamental to addressing this challenge: victim assistance, outreach, and prevention.

- Victim assistance: The IRS is working to speed up case resolution and provide more training for employees who assist victims of identity theft.
- Outreach: The IRS is educating taxpayers so they can prevent and resolve tax-related identity theft issues quickly.
- Prevention: The IRS is implementing new processes for handling returns, new filters to detect fraud, new initiatives to partner with stakeholders, and a continued commitment to investigate the criminals who perpetrate these crimes.

As an additional security measure, IRS may mail a notice letter to a taxpayer to verify their identity according to the instructions in the letter. The taxpayer's return will not be processed until their identity is verified.

How to assist taxpayers who may be victims of identity theft at your site

Being sensitive towards victims of identity theft is critical to assisting taxpayers through a confusing and frustrating situation. Remember victims of identity theft are:

- Victimized by identity thieves – mostly through no fault of their own and
- Trying to comply with tax laws – file tax returns and pay their fair share of taxes

After the taxpayer has proven their identity using Form 14039, Identity Theft Affidavit, IRS will assign an IP-PIN. Every December, the IRS mails Notice CP01A to taxpayers previously identified as identity theft victims. The notice includes a 6-digit Identity Protection Personal Identification Number (IP PIN) to be entered on the

tax return. Taxpayers are mailed Notice CP01A every year as long as the identity theft indicator remains on their account (usually 3 years).

An IP PIN is also available to all taxpayers that wish to have one, not just those who have been tax identity theft victims. The taxpayer must apply online and retrieve their IP PIN online. No letter is sent to them.

Use the most recent IP PIN regardless of the tax year.

For the IP PIN to be accepted, all six digits must be input on Form 1040. The IP PIN may begin with a zero.

Lost, misplaced, or non-receipt of IP PIN

If a taxpayer did not receive a new IP PIN or the taxpayer misplaced it, the taxpayer has two options:

1. Register and create a user profile to get a current IP PIN. The registration process will require the taxpayer to provide specific personal information and answer a series of questions to validate his/her identity. Use key words “IP PIN” in the search window at irs.gov to access the Retrieve Your Identity Protection PIN (IP PIN) application.
2. Contact the IRS at 1-800-908-4490 to request the IP PIN be reissued by mail if the taxpayer is unable or unwilling to create an account on irs.gov.

Refer to Tab P, Partner Resources, in the NTTC 4012, for further information and guidance.

IRS’ Identity Theft Central is an online resource that provides information on how to report identity theft, how taxpayers can protect themselves against phishing, online scams, and more.

How do I file a return?

As you enter the taxpayer’s data, the tax software will automatically add all the needed forms and schedules.

Detailed instructions for completing and filing the return are covered in the NTTC 4012.

All returns are filed electronically using IRS e-file unless it is not possible to e-file the return. In that case, a paper return is needed and the taxpayer will need to mail it.

With e-filing, taxpayers receive their refund in half the usual time, and even faster with direct deposit. As a fraud-prevention measure, IRS will not issue a refund for an overpayment to a taxpayer before February 15 if the taxpayer claims a refundable credit, such as the earned income credit, on the tax return.

Presidential election campaign fund

This fund helps pay for presidential election campaigns. The fund also helps pay for pediatric medical research. The taxpayer and spouse, if filing jointly, can each have $3 go to the fund. Checking the box will not change the taxpayer’s tax or refund.

Other taxpayer questions

Questions such as “How can I get a copy of my prior year’s return” or “How can I get an IRS form or publication” can be answered by researching your reference materials.

Turn to the “Frequent Taxpayer Inquiries” located in the NTTC 4012, Tab P, Partner Resources, and review this helpful information. For a list of helpful phone numbers, refer to “Information for Volunteers,” located on the back of the NTTC 4012. Your Coordinator and fellow volunteers are also good resources.

What potential pitfalls should I keep in mind?

To avoid any difficulties when preparing tax returns:

- Always treat the information used to prepare an individual’s income tax return as confidential.

- Canadians have a number that is like a U.S. Social Security number, but it is for their Canadian old age pension. Do not use this number on a U.S. tax return. Canadians often have both a U.S. and a Canadian Social Security number.
- Be alert to the following possible indications of fraudulent activity:
  - A Form W-2 that is typed, handwritten, or has noticeable corrections
  - A Form W-2 that looks different from other Forms W-2 issued by the same company
  - A suspicious person accompanying the taxpayer and observed on other occasions
  - Multiple refunds directed to the same address or P.O. box
  - Employment or earnings, which 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)
- Notify your Coordinator if you suspect any fraudulent or unusual activity.

Summary

Who must file?

To determine whether an individual is required to file a federal tax return:

- Obtain the person's age
- Calculate the person's approximate gross income
- Determine the person's likely filing status

Use the table and guidelines in the NTTC 4012, Who Must File section

How do I verify a taxpayer's identity?

An initial step in the interview process is to verify the identity of the taxpayer(s), the accuracy of each SSN or ITIN, and spelling of names with the appropriate documents.

What is an IP-PIN?

An IP-PIN is issued to an individual who has been the victim of identity theft for tax purposes and to any individual who requests an IP-PIN for their income tax filing requirements. It must be entered on the return to avoid a reject or delayed processing

Filing the return

E-filing is the safest, fastest, and easiest way to file a tax return. With e-file, taxpayers can generally expect their refund in less than 21 calendar days after the receipt of their tax return.

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Tax returns for individuals with inconsistent or incomplete information that cannot be adequately resolved
- Tax returns for individuals who present potentially fraudulent information
- Tax returns for individuals who cannot prove their identity

Where to find more information

Pub 559, Survivors, Executors and Administrators

Pub 17, Your Federal Income Tax

Pub 4299, Privacy, Confidentiality, and Civil Rights

VITA sites that offer CAA services

IRS Identity Theft Central

Exercise answers

Answer 1: a, Yes, Bob is required to file a return.

Answer 2: b, No, Janet and Harry are not required to file.

Answer 3: a, Yes, Juanita must file.

Answer 4: a, True. To prevent processing delays, check the accuracy of each SSN you enter on the return, as well as the spelling of the name associated with the number.

Filing Status

Introduction

This lesson will help you determine the most advantageous (and allowable) filing status for the taxpayer. Selecting and entering the correct filing status is a critical component of completing the taxpayer's return.

See Tab B, Starting a Return and Filing Status, in the NTTC 4012 for filing status interview tips with helpful probing questions to use in your interview with the taxpayer.

What do I need?

- Tax-Aide Intake Booklet
- Qualifying Child or Relative Resource Tool
- NTTC 4012

Optional:

- Form 1040
- Form 2120 (multiple support)
- Form 8379 (injured spouse)

Objective

At the end of this lesson, using your resource materials, you will be able to determine the most beneficial filing status allowed for the taxpayer.

What are the five filing statuses?

Taxpayers must use one of five filing statuses. Filing status impacts the calculation of income tax, affects the amount of the standard deduction, and determines allowance or limitation of certain credits and deductions. The following list is in order from the most beneficial to the least beneficial to the taxpayer.

- Married filing jointly
- Qualifying surviving spouse
- Head of household
- Single
- Married filing separately

Most nonresident aliens and dual status aliens have different filing requirements and may have to file Form 1040-NR. In this case, the return is out of scope, except for foreign students or scholars if the preparer and reviewer have the required certification.

Taxpayers may qualify for more than one filing status. Choose the filing status that results in the lowest tax for the taxpayer.

You will need to verify the best filing status for a taxpayer before you start entering data into the tax software. Use your Qualifying Child or Relative Resource Tool (QC/R Tool) to identify possible dependents / qualifying persons and to help you determine the best filing status.

How does marital status affect filing status?

The first step in determining taxpayers' filing status is to confirm their marital status on the last day of the tax year. Avoid using information from the prior year, as it may have changed.

Generally, taxpayers are considered to be **unmarried** for the entire year if, on the last day of the tax year, they were:

- Unmarried.
- Legally separated from their spouse under a divorce or separate maintenance decree. State law governs whether taxpayers are married or legally separated under a divorce or separate maintenance decree.

Taxpayers are considered to be **married** for the entire year if:

- They were married on the last day of the tax year, **or**

- The spouse died **during** the year and the surviving spouse has not remarried

Requirements for each filing status

Who is considered single?

Taxpayers can use the single filing status if, on the last day of the tax year, they were:

- Not married
- Legally separated or divorced, or
- Widowed **before the beginning** of the tax year and did not remarry

A marriage that has been legally annulled is treated as never having existed, even if it is annulled in a later year.

Can single taxpayers qualify for another status?

Some unmarried taxpayers qualify for head of household or for qualifying surviving spouse status, which can mean a lower tax. These statuses will be discussed later in this lesson.

What is married filing jointly?

Married taxpayers who choose to file a joint return will use one return to report their combined income and to deduct combined allowable expenses. Married taxpayers can select this status even if one of the spouses did not have any income or any deductions. The married filing jointly status can be claimed by taxpayers who, on the last day of the tax year:

- Were married and lived together.
- Were married and living apart (for reasons such as medical reasons or Military separation), but were not legally separated under a divorce or separate maintenance decree. State law governs whether taxpayers are married or legally separated under a divorce or separate maintenance decree.
- Were common law married pursuant to the laws of the state in which they live (or in the state where the common law marriage began) and the marriage has not been dissolved, such as by death or divorce.
- Are the surviving spouse who did not remarry before the end of the tax year (the surviving taxpayer can file a joint return with a spouse who died during the tax year).

Taxpayers who file a joint return can't choose to file separate returns for that year after the due date of the return. See the Amended and Prior Years Returns lesson 33 for an exception for executors.

A citizen or resident alien married to a nonresident alien may be able to choose from more than one filing status. More information can be found in the Unique Filing Situations lesson 7.

Filing a joint return for a common law marriage applies to the federal return only. Volunteers must check state or local laws before completing a state return. Volunteers are not responsible for determining whether a couple is in a common law marriage. If taxpayers are not certain, the return is out of scope.

What are the responsibilities of each taxpayer on a joint return?

Both taxpayers must include all worldwide income on their joint return. They each may be held responsible for all the tax and for any interest or penalty due, even if all the income was earned by only one spouse. A subsequent divorce usually does not relieve either spouse of the liability associated with the joint return.

In some cases, a spouse may be relieved of joint liability. Information is available in Pub 971, Innocent Spouse Relief, however, this topic is beyond the scope of the Tax-Aide program.

When a joint return is filed and only one spouse owes a past-due amount, the other spouse may be considered an injured spouse and able to claim their portion of a joint refund. This is discussed later in this lesson.

IRS uses the term "you" throughout its form instructions and publications to refer to the taxpayer. On a joint return, both spouses are taxpayers.

What is married filing separately?

The married filing separately status is for taxpayers who are married, and either:

- Choose to file separate returns, or
- Cannot agree to file a joint return

Taxpayers who file as married filing separately in non-community property states each report their own income and deductions on separate returns. Reporting is more complex in community property states. More information on community property is provided later in this lesson.

Taxpayers can change their filing status from a separate return to a joint return by filing an amended return using Form 1040-X.

Can married filing separately taxpayers qualify for another status?

Some married taxpayers may be considered unmarried even if they are not divorced or legally separated. Such taxpayers may be able to use the head of household filing status, which may result in a lower tax than married filing separately. Refer to the topic "Can married taxpayers ever file as head of household?" in this lesson to see if the "considered unmarried" definition applies.

Why are taxes usually higher for married filing separately?

Special rules apply to married filing separately taxpayers, which generally result in a higher tax. For example, when filing separately:

- The tax rate is generally higher than on a joint return.
- Taxpayers cannot take the child and dependent care credit, education credits, and certain other benefits and credits.
- Some credits and deductions, such as the child tax credit and the retirement savings contributions credit, are reduced at income levels that are half those for a joint return.
- If a taxpayer is married filing separately and the spouse itemizes deductions on their return, the taxpayer must itemize and cannot take the standard deduction.

For married filing separately taxpayers, enter the spouse's name and SSN or ITIN on the tax return. If the taxpayer does not know the spouse's SSN, refer to the NTTC 4012, Tab B, Starting a Return and Filing Status, Entering Basic Information (continued). The return will need to be paper filed.

Whether or not a spouse is itemizing is only a concern for married filing separately status. Married taxpayers who qualify to file as head of household can take the standard deduction even if their spouse is itemizing.

For the complete list of special rules, see Pub 17, Filing Status.

Are there special rules for taxpayers who live in community property states?

The income of taxpayers who lived in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin during the tax year and who choose to file separate returns may be considered separate income or community income for tax purposes. The states of Tennessee and South Dakota have passed elective Community Property Laws. Each state has its own community property laws, which may affect the amount of tax owed by taxpayers. See Pub 555, Community Property, for more information.

Some Tax-Aide sites have determined that community property tax laws for taxpayers who are or were married at any time during the tax year and who want to file married filing separately or who are eligible to file as head of household as too complex and out of scope. This issue occurs when either spouse was domiciled in a community property state. Your Instructor or Coordinator will let you know.

If a married taxpayer is in one of the community property states and files a separate return from the spouse, Form 8958, Allocation of Tax Amounts Between Certain Individuals in Community Property States, must be completed in order to e-file the return.

If filing jointly generally results in the lowest total tax, why would a married taxpayer want to file separately?

Married taxpayers sometimes choose to file separate returns when one spouse does not want to be responsible for the other spouse's tax obligations, or because filing separately may result in a lower total tax. For example, if one spouse has high medical expenses, separate returns may result in lower total taxes because a lower adjusted gross income allows more expenses to be deducted.

Another common reason taxpayers file as married filing separately is to avoid an offset of their refund against their spouse's outstanding debts. This includes past due child support, past due student loans, or a tax liability the spouse incurred before they were married. If married taxpayers want to file separately, and a potential refund offset is the reason, suggest that they file a joint return with Form 8379, Injured Spouse Allocation. Another approach is to file separately, then file an amended to elect filing jointly — any additional refund will likely be offset, but the outstanding debt causing the offset will be reduced.

Who is considered to be an injured spouse?

When a joint return is filed and only one spouse owes a past-due amount, the other spouse can be considered an injured spouse. Injured spouses may file Form 8379 to receive their share of the refund shown on the joint return. The injured spouse:

1. Must not be legally obligated to pay the past-due amount, and
2. Must have made and reported tax payments (such as federal income tax withheld from wages or estimated tax payments), or claimed a refundable tax credit (see the credits listed in Pub 17 under Who Should File?).

Both of these conditions must apply unless the injured spouse lived in a community property state at any time during the tax year. In community property states, the injured spouse must meet only the first condition. If the taxpayer meets these requirements, Form 8379 can be e-filed with the joint return.

Taxpayers may not realize the cost of filing separately when Form 8379 could be used instead. Emphasizing the loss of credits, such as the earned income or education credits, may be helpful.

If a taxpayer already filed a joint return and the refund was offset, Form 8379 can be filed by itself. When filed after the offset, it can take up to eight weeks or longer for the taxpayer to receive a refund. Do not attach the previously filed tax return, but do include copies of all Forms W-2 and W-2G for both spouses and any Forms 1099 that show income tax withheld. The processing of Form 8379 may be delayed if these forms are not attached. A separate Form 8379 must be filed for each tax year to be considered.

An injured spouse claim is different from an innocent spouse relief request. Form 8379 allows an injured spouse to request the division of the tax overpayment attributed to each spouse. An innocent spouse uses Form 8857, Request for Innocent Spouse Relief, to request relief from joint liability for tax, interest, and penalties on a joint return for items of the other spouse (or former spouse) that were incorrectly reported on the joint return. Form 8857 is out of scope.

What if a spouse died during the tax year?

Remember, taxpayers whose spouses died during the tax year are considered married for the entire year, provided they did not remarry. The surviving spouse is eligible to file as married filing jointly or married filing separately.

Surviving spouses who have remarried must file with the new spouse, either jointly or separately. The deceased spouse's filing status becomes married filing separately.

Surviving spouses who have an eligible child may be able to use the qualified surviving spouse status in the two tax years following the year of the spouse's death. This is discussed later in this lesson.

When preparing a return for a deceased taxpayer, refer to the NTTC 4012, Tab B, Starting a Return and Filing Status, for instructions on entering basic information in the software.

Who is head of household?

Taxpayers may qualify for the head of household filing status, if they:

- Are unmarried or "considered unmarried" on the last day of the tax year, and
- Paid more than half the cost of keeping up a home for the required period of time, and
- Had a qualifying person living in their home for more than half the year (except for temporary absences, such as school)

A qualifying person who is the taxpayer's dependent parent does not have to live with the taxpayer. However, the parent(s) must qualify as the taxpayer's dependent(s) for the taxpayer to qualify as head of household without using the multiple support provision (Form 2120, Multiple Support Declaration).

For a married taxpayer to be "considered unmarried," there are special rules, discussed later in this topic.

What are the costs of keeping up a home?

The costs of keeping up a home include expenses such as rent, mortgage interest, real estate taxes, insurance on the home, repairs, utilities, and food eaten in the home. Under proposed regulations, a taxpayer may treat a home's fair market rental value as a cost of maintaining a household instead of the sum of payments for mortgage interest, property taxes, and insurance.

What is the required period of time?

If a new household is established during the taxpayer's taxable year (for example, if spouses separate and one moves out of the family home with the child), the cost of maintaining the new household for the year is the cost of maintaining that household beginning with the date the new household is established. If one spouse and the child remain in the family home and the other parent moves out of the home, the cost of maintaining the household for the year is the cost of maintaining the household beginning with the date the other spouse moves out.

What about a shared residence?

If two or more taxpayers not filing a joint return reside in the same living quarters, each taxpayer may be treated as maintaining a separate household if each provides more than one-half of the cost of maintaining their separate household. For this purpose, two households in the same living quarters are not considered separate households if any individual in one household is the spouse of any individual in the other household, or if any individual in one household may claim, or would have priority under the tiebreaker rules to claim, any individual in the other household as a dependent.

Two sisters and their respective children reside in the same living quarters. Neither sister may claim the other sister as a dependent. Each sister pays more than one-half of the expenses for herself and her children, and each sister claims each of her own children as a dependent. Because neither sister may claim the other sister as a dependent, and because neither sister would have priority to claim any of the other sister's children as a qualifying child under the tiebreaker rules, each sister is treated as maintaining a separate household.

Grandparent, Parent, and Child live together and Child meets the definition of a qualifying child for both Parent and Grandparent. Both Parent and Grandparent pay their respective expenses, and both contribute to paying Child's expenses. Neither Parent nor Grandparent may claim the other as a dependent.

Under the tiebreaker rules, Parent would have priority over Grandparent to claim Child as a qualifying child. Therefore, Grandparent may not be treated as maintaining a household for Grandparent and Child separate from the household of Parent. However, Parent may be treated as maintaining a household for Parent and Child separate from the household of Grandparent.

Who is a qualifying person for head of household status?

Use your QC/R Tool to identify who is or is not a qualifying person for head of household status (or refer to Tab B of the NTTC 4012). A qualifying person for head of household is:

- A qualifying child who is single (whether or not the child can be claimed as a dependent)
- A married child who can be claimed as a dependent
- A dependent parent
- A qualifying relative who lived with the taxpayer more than half the year, *and* is one of the relatives listed on the chart, *and* can be claimed as a dependent by the taxpayer

As more fully discussed in the Dependent lesson 6, an individual who is claimed as a dependent only because of a multiple support agreement is not a qualifying person for head of household status.

A person may be a qualifying relative dependent, but not qualify the taxpayer for head of household filing status. For example, a companion or friend who lives with the taxpayer all year may be the taxpayer's dependent but not a qualifying person for head of household filing status.

Refer to the QC/R Tool (or the NTTC 4012, Tab B) when reviewing these examples. You will learn more about who can be claimed as a dependent in a later lesson.

Kate's unmarried 16-year-old daughter, Shelby, lived with her all year. Kate is single, provided all of Shelby's support, and paid all the costs of keeping up the home. Shelby is Kate's qualifying child dependent and is Kate's qualifying person for head of household filing status.

Michael provided all the costs of keeping up his home for the year. Michael's son Justin lived with him the entire year. Justin is 22 and was not a full-time student during the tax year, so he cannot be Michael's qualifying child. Although Justin only worked part-time, his income is greater than the gross income threshold amount for Michael to claim him as a qualifying relative dependent. Therefore, Michael cannot file head of household because he does not have a qualifying person.

Jane and Todd are not married. Their daughter, Amanda, lived all year with Jane in an apartment. Todd lived alone. Todd earns more than Jane, and provides for some of her living expenses. He paid over half the cost of Jane's rent and utilities. He also gave Jane extra money for groceries. Even though Todd paid over half the cost of providing a home for Jane and Amanda, he cannot file head of household because Amanda did not live with him over half the year. Jane cannot be head of household either because she did not provide more than half the cost of keeping up the home for her daughter.

Nancy is single and lives alone. Nancy's mother, Maxine, lives alone in another city. Maxine receives Social Security payments, but has no other income. Nancy pays all of the costs of keeping up the home her mother lives in and provides over half her support. Even though Maxine did not live with her, Maxine is Nancy's qualifying person for head of household filing status because Nancy can claim her mother as a dependent under the rules for qualifying relative.

Exercises

Answers are at the end of the lesson.

Question 1: Alexandra's younger brother, Sebastian, is seventeen years old. Sebastian lived with his grandparents for the first two months of the year. From March through July, he lived with Alexandra. On August 1, Sebastian moved in with some friends and stayed there for the rest of the year. Since Sebastian did not have a job, Alexandra gave him money every month. Assuming Alexandra had no other dependents, can she file as head of household?

a. Yes

b. No

Since her spouse died five years ago, Joan has lived with her friend, Mary Ann, who is also a widow. Joan is a U.S. citizen, is single, and lived with Mary Ann all year. Joan had no income and received all of her support from Mary Ann. Joan is Mary Ann's qualifying relative because she lived with Mary Ann all year as a member of her household. Mary Ann can claim Joan as a dependent on her return.

However, Joan is not a qualifying person for head of household filing status because she is not related to Mary Ann in one of the ways listed in the QC/R Tool (or on the chart in the NTTC 4012). She is Mary Ann's qualifying relative dependent only because she lived with Mary Ann all year as a member of her household.

Notice that the relatives who qualify a person for head of household may not be the same individuals who could qualify as a taxpayer's dependent. One such situation is when the custodial parent releases the child's exemption to the noncustodial parent. The child remains the custodial parent's qualifying person for head of household status.

The qualifying person for head of household filing status must be related to the taxpayer.

What are the advantages of filing as head of household?

The head of household filing status provides a higher standard deduction and, generally, a lower tax rate than single or married filing separately.

Who can be "considered unmarried" for head of household?

Married taxpayers may be "considered unmarried" and file as head of household if they:

- File a return for the tax year separate from their spouse.
- Paid more than half the cost of keeping up their home. See the Worksheet for Cost of Keeping Up a Home in Tab B of the NTTC 4012.
- Lived apart from their spouse during the entire last six months of the tax year. The spouse is considered to have lived in the home even if temporarily absent due to special circumstances, such as military service or education.
- Provided the main home for more than half the year of a *dependent* child, stepchild, or foster child placed by an authorized agency. This test is also met if the taxpayer cannot claim the exemption only because the noncustodial parent can claim the child as discussed in the Dependents lesson 6 of this publication.

Other relationships do not satisfy the dependent child requirement. For example, a grandchild does not satisfy the requirement.

Denise is married but has lived apart from her spouse for two years. Denise pays all the costs of keeping up her home for herself and her dependent 12-year-old son, who lives with her. Denise can choose to file as head of household for the tax year because she meets the definition of "considered unmarried."

A taxpayer who is married to a nonresident alien spouse may be able to file as head of household even if the taxpayer lived with the spouse for the year. Review the Unique Filing Situations lesson 7 for more information.

Who is a qualified surviving spouse?

Taxpayers who do not remarry in the year their spouse dies can file jointly with the deceased spouse for that year. For the two years following the year of death, the surviving spouse may be able to use the qualified surviving spouse filing status. To qualify, the taxpayer must:

- Be entitled to file a joint return for the year the spouse died, regardless of whether the taxpayer actually filed a joint return that year.
- Have had a spouse who died in either of the two prior years.
- The taxpayer must not remarry before the end of the current tax year.

- Have a child, stepchild, or adopted child who qualifies as the taxpayer's dependent for the year or would qualify as the taxpayer's dependent except that:
  - The child does not meet the gross income test,
  - The child does not meet the joint return test, or
  - The taxpayer may be claimed as a dependent of another taxpayer
- Live with this child in the taxpayer's home all year, except for temporary absences.
- Have paid more than half the cost of keeping up the home for the year.

A foster child does not qualify a taxpayer for the qualified surviving spouse filing status.

A grandchild does not qualify a taxpayer for the qualified surviving spouse filing status.

The standard deduction and tax tables are the same for qualified surviving spouse and married filing jointly filing statuses. These are more favorable than those for head of household filing status.

Laura's spouse, Jim, died in September of the tax year. She has not remarried, and provides all the support for their dependent children, ages 8 and 10. Laura can file as married filing jointly for this tax year. For the next two tax years, she can use the qualified surviving spouse status if she does not remarry.

How do I determine the correct filing status?

To determine the correct filing status, use your QC/R Tool (or follow the Filing Status Interview Tips in the NTTC 4012, Tab B, Starting a Return and Filing Status). Be sure to complete the shaded dependent portion on the Tax-Aide Intake Booklet.

Exercises (continued)

Review the lesson and use your QC/R Tool (or the Filing Status Interview Tips in the NTTC 4012) to determine the answer.

Question 2: Jane's husband moved out of their home in February of the tax year and has not returned. Jane provides all the cost of keeping up the home for herself and her two dependent children. Jane refuses to file a joint return with her husband. What filing status should she use?

a. Single
b. Married filing separately
c. Head of household
d. Qualifying surviving spouse

Question 3: Seth lives alone and has never married. He does not support either of his parents. What filing status(es) can he use?

a. Single
b. Married filing jointly
c. Married filing separately
d. Head of household
e. Qualifying surviving spouse

Question 4: Tanya's divorce became final in early September of the tax year. She has sole custody of her three children, who lived with her the entire year. The children are all under the age of 19. She provided more than half of the cost of keeping up the home. What filing status(es) can she use?

a. Single

b. Married filing jointly
c. Married filing separately
d. Head of household
e. Qualifying surviving spouse

Question 5: Sydney's spouse died two years ago in January and filed a joint return for that year as the surviving spouse. Since then, Sydney has not remarried, maintains a home for his young children who lived with him all year, and provides their sole support. What filing status Sydney should use?

a. Single
b. Married filing jointly
c. Married filing separately
d. Head of household
e. Qualifying surviving spouse

Summary

This lesson covered the five filing statuses:

- Single
- Married filing jointly
- Married filing separately
- Head of household
- Qualifying surviving spouse

If taxpayers qualify for more than one filing status, choose the one that results in a lower tax. For example, in most cases, married couples pay less tax if they file a joint return.

In general, the head of household filing status is for unmarried taxpayers who paid more than half the cost of maintaining a home for a qualifying person for the required period of time. However, some married taxpayers who lived apart from their spouse during the last six months of the year and provided for dependent children may be "considered unmarried" and qualify to file as head of household.

A widow or widower with one or more qualifying children may be able to use the qualified surviving spouse filing status, which is available for two years following the year of the spouse's death.

Where to find more information

Pub 501, Dependents, Standard Deduction, and Filing Information

Pub 17, Your Federal Income Tax

Pub 555, Community Property

Pub 504, Divorced or Separated Individuals

Pub 971, Innocent Spouse Relief

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- A spouse who may be relieved of joint liability as an innocent spouse
- Depending on the policy of your state/district/site, married taxpayers who wish to file a separate return from their spouse and are subject to community property tax laws

- Taxpayers who are not certain they are in a common law marriage (rules are complex and differ from state to state)

Exercise answers

Answer 1: b, no. Sebastian lived with Alexandra for five months, which is less than half the year.

Answer 2: c, head of household. Even though Jane is still married to her husband, she meets the requirements to be “considered unmarried” for filing status purposes and qualifies to file as head of household. Although she could file as married filing separately, it would not be to her advantage to do so.

Answer 3: a, single. He is not married, has no dependents living in his household, and does not claim his parents as dependents. Seth can only file as single.

Answer 4: d, head of household. Because she is legally divorced, Tanya could file as single. However, because she has children and meets the requirements, she should use head of household as her filing status because it will result in a lower tax.

Answer 5: e, qualified surviving spouse. Although Sydney meets the requirements to file as single, head of household, or qualified surviving spouse, he should use the qualified surviving spouse filing status because it will result in the lowest tax.

Personal Exemptions

Introduction

The deduction for personal and dependency exemptions is suspended (reduced to $0) for tax years 2018 through 2025 by the Tax Cuts and Jobs Act. Although the exemption amount is zero, the ability to claim an exemption may make taxpayers eligible for other tax benefits.

What do I need

- Tax-Aide Intake Booklet
- NTTC 4012

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Distinguish between personal and dependency exemptions
- Determine if a taxpayer can be claimed as a dependent on another taxpayer's return

What are exemptions?

An **exemption** is a dollar amount that can be deducted from an individual's total income, thereby reducing the taxable income. Taxpayers may be able to claim two kinds of exemptions:

- Personal exemptions generally allow taxpayers to claim themselves (and possibly their spouse)
- Dependency exemptions allow taxpayers to claim qualifying dependents

When can a taxpayer claim personal exemptions?

To claim a personal exemption, you must be able to answer "no" to question "Can anyone else claim the taxpayer or spouse on their tax return?" on the Tax-Aide Intake Booklet.

This applies even if another taxpayer does not actually claim the taxpayer as a dependent. In this case, the taxpayer or spouse, if filing jointly, must check the box on Form 1040 that indicates that they can be claimed as a dependent. This means they may have to use a smaller standard deduction amount. See the Deductions lesson 19 for more information on this topic.

An individual is not a dependent of a person if that person is not required to file an income tax return and either does not file an income tax return or files an income tax return solely to claim a refund of estimated or withheld taxes. If this is the situation, you should answer "no" to "can anyone claim the taxpayer/spouse as a dependent?" If that other individual chooses to file a return as described, they should **not** list the taxpayer as a dependent.

When can a taxpayer claim dependency exemptions?

The taxpayer must satisfy all the requirements to claim a dependent as discussed in the next lesson, Dependents.

Taxpayer interview and tax law application

Ray is a college student who worked during the tax year. Here's how the conversation might go:

Sample interview

Volunteer Says…	Ray Responds…
The questions I'm about to ask you will help us figure out if you can be claimed as a dependent by your parents. First of all, you aren't married and you are a U.S. citizen, correct?	Yes, that's correct.
And you were under age 24 at the end of the tax year and a full-time student?	That's right.

Volunteer Says…	Ray Responds…
Did you live with your parents for more than half the year?	I lived with them during the summer and other school breaks, but when school was in session, I lived in the dorm on campus.
Okay, that's considered a temporary absence so for tax purposes, you lived with your parents all year. Did you pay more than half of your own support?	I worked part-time, but I didn't make that much. I used my money to buy a few books and some food, but my parents paid my tuition, food and housing, and most of my other expenses like clothing and medical bills.
Based on what you've told me, you are considered a qualifying child of your parents and they can claim you as a dependent. We will indicate this on your return so it doesn't cause problems for your parents when they file their return.	Okay, thanks.

Summary

There are two types of exemptions:

- Personal
- Dependency

The deductions for personal and dependent exemptions are suspended (reduced to $0) for tax years 2018 through 2025.

If a taxpayer can be claimed as a dependent on another taxpayer's return, they must check the box on Form 1040 that indicates that they can be claimed as a dependent. An individual is not a dependent of a person if that person is not required to file an income tax return and either does not file an income tax return or files an income tax return solely to claim a refund of estimated or withheld taxes. If this is the situation, you should answer "no" to "can anyone else claim the taxpayer on their tax return?" on the Tax-Aide Intake Booklet. The other individual should not list the taxpayer as their dependent if they file a return.

Where to find more information

Pub 501, Dependents, Standard Deduction, and Filing Information

Pub 17, Your Federal Income Tax

Dependents

Introduction

Identifying and determining the correct number of dependents is a critical component of completing the taxpayer's return. The deductions for personal and dependency exemptions are suspended for tax years 2018 through 2025 by the Tax Cuts and Jobs Act. Although the exemption amount is zero, the ability to claim a dependent may make taxpayers eligible for other tax benefits. For example, the following tax benefits may all be associated with a dependent: child tax credit, additional child tax credit, credit for other dependents, earned income credit, child and dependent care credit, head of household filing status, and other tax benefits.

Use your Qualifying Child or Relative Resource Tool (QC/R Tool) (or the NTTC 4012, Tab C, Dependents) for helpful probing questions to use when interviewing the taxpayer.

When the interview is complete, the results are documented on the Tax-Aide Intake Booklet. This information will be the basis of your entries in the tax software.

What do I need?

- Tax-Aide Intake Booklet
- Qualifying Child or Relative Resource Tool
- NTTC 4012

Optional:

- Form 2120 (multiple support)
- Form 8332 (release child exemption)

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine if a taxpayer may claim a dependent on their tax return
- Determine if a taxpayer needs to list an individual on their tax return, even though they do not qualify as a dependent

Who are dependents?

Dependents are either a qualifying child or a qualifying relative of the taxpayer. The taxpayer's spouse cannot be claimed as a dependent. Some examples of dependents include a child, stepchild, brother, sister, or parent.

Individuals who qualify to be claimed as a dependent may be required to file a tax return if they meet the filing requirements.

Who are NOT dependents?

An individual is not a dependent of a person if that person is not required to file an income tax return and either does not file an income tax return or files an income tax return solely to claim a refund of estimated or withheld taxes.

Benny is 19 years old and a full-time student. His parents fully support Benny but are not required to file, and do not file, a return. Benny is not a dependent for any purpose.

How do I apply the dependency tests?

The marital status and household information sections of the Tax-Aide Intake Booklet address the issues concerning dependency, but you will still need to use your interview skills to clarify whether the individuals listed are eligible to be claimed as dependents.

Use caution when preparing this section of the taxpayer's return. Use the (QC/R Tool) or the NTTC 4012, Tab C, Dependents, to guide you in determining whether the taxpayer can claim a dependent or, if the individual does not qualify as a dependent, whether the taxpayer can claim the individual for a tax benefit. Be sure to verify the information on the Tax-Aide Intake Booklet. Avoid using information from the taxpayer's prior year documents to complete this section.

How do I use the QC/R Tool?

First, be sure to read the instructions on the first page. You will always start with Chart 1: Qualifying Child. If the individual is not a qualifying child, you may be directed to Chart 2: Qualifying Relative. When you get to a blue shaded box, it will tell you if the individual is a dependent and/or whether the individual qualifies the taxpayer for the listed tax benefit(s).

Be sure to read any footnotes that apply. Some tax benefits have additional requirements that are summarized on page 5 and 6 of the QC/R Tool. For ease of reference, the QC/R Tool also has a number of relevant definitions.

Once you get used to using the QC/R Tool, you will find it extremely helpful to make sure a return is accurate and all tax benefits to which a taxpayer is entitled are claimed. This is especially true in more difficult factual situations or when an individual can be claimed for certain tax benefits even though the individual is not a dependent.

How do I use the NTTC 4012?

Refer to Tab C, Dependents, in the NTTC 4012 for tools to assist you in determining if a taxpayer may claim a dependent. Whether you are a new or returning volunteer, Tables 1, 2, and 3 provide interview tips with guidelines and definitions to help you apply the dependency tests. They incorporate all of the exceptions, such as the special rules for children of divorced or separated parents as well as the special multiple support rules.

When determining if a taxpayer can claim a dependent, always begin with Table 1: All Dependents. If you determine that the person is not a qualifying child, then move to Table 2: Qualifying Relative Dependents. Depending on the taxpayer's answers, you may also be prompted to use Table 3: Children of Divorced or Separated Parents or Parents Who Live Apart or you may use the Qualifying Child of More Than One Person chart. As you become more experienced with the qualifying child and qualifying relative rules, you may find that you prefer the Overview of the Rules for Claiming a Dependent chart instead.

What tests must be met for all dependents?

A dependent may be either a qualifying child or a qualifying relative. Both types of dependents have unique rules, but some requirements are the same for both. These rules apply to **both** qualifying child and qualifying relative dependents:

- Dependent taxpayer test
- Joint return test
- Citizen or resident test

Dependent taxpayer test

A taxpayer (or taxpayer's spouse, if filing a joint return) who may be claimed as a dependent by another taxpayer may not claim anyone as a dependent on their own tax return. The Tax-Aide Intake Booklet asks you to answer this question: "Can anyone claim the taxpayer or spouse on their tax return." If the taxpayer or spouse can be claimed by another taxpayer, answer yes. In that case, the taxpayer cannot claim a dependent.

Use your interview skills because for some taxpayers, particularly students, the answer may not be obvious. Remember that an individual is not considered a dependent if:

- the person who could claim them is not required to file an income tax return, and
- the person either does not file an income tax return or files an income tax return solely to claim a refund of estimated or withheld taxes.

In this case, you should answer "no" to the question on his Tax-Aide Intake Booklet.

Joint return test

A married person who files a joint return cannot be claimed as a dependent unless that joint return is filed only to claim a refund of withheld income tax or estimated tax paid.

Ruth, who had no income, was married in November of the tax year and moved out of her parents' home. Ruth's husband had $30,000 income and had a filing requirement. Although Ruth's parents supported her and paid for the wedding, they cannot claim her as a dependent because she is filing a joint return with her husband. Even though Ruth is not her parents' dependent, they may be entitled to other benefits discussed in later lessons.

Citizen or resident test

To be claimed as a dependent, a person must be a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico.

- If a U.S. citizen or U.S. national legally adopts a child who is not a U.S. citizen, U.S. resident alien, or U.S. national, this test is met as long as the child lives with the taxpayer as a member of the household all year. If all other dependency tests are met, the child can be claimed as a dependent. This also applies if the child was lawfully placed with the taxpayer for legal adoption.
- Foreign exchange students generally are not U.S. residents and do not meet the citizen or resident test; they cannot be claimed as dependents. However, see charitable contributions in the Deductions lesson 19.

Joan, who is a U.S. citizen, adopted an infant boy from Cambodia who lived with her for the entire tax year. Even though Joan's child is not yet a U.S. citizen, he meets the citizen or resident test because he was a member of Joan's household for the entire year.

Taxpayers may be able to claim a qualifying person for a credit or other tax benefit even if the person cannot be claimed as a dependent.

What are the tests for a qualifying child?

The next step to determine if the taxpayer has a dependent is to apply the rules for a qualifying child. If these tests are not met, see if the tests for a qualifying relative are met. Remember, a person must meet the requirements of either a qualifying child or a qualifying relative to be claimed as a dependent. While reading about these tests, follow Chart 1 of the QC/R Tool (or, if you are using the NTTC 4012, steps 5-9 in Tab C, Dependents, Table 1).

Relationship

To meet this test, the child must be:

- The taxpayer's child, stepchild, foster child (placed by an authorized placement agency), or a descendant (for example, a grandchild) of any of them
- The taxpayer's sibling, half-sibling, step-sibling, or a descendant (for example, niece or nephew) of any of them

An adopted child is treated as the taxpayer's own child for the purposes of the relationships described above. For example, an adopted brother or sister is a brother or sister of the taxpayer. An adopted child includes a child who was lawfully placed with a person for legal adoption.

Age

To meet this test, the child must meet one of the following three criteria:

- Under age 19 at the end of the tax year and younger than the taxpayer (or the taxpayer's spouse, if filing jointly)
- A full-time student under the age of 24 at the end of the year and younger than the taxpayer (or spouse, if filing jointly)
    - To qualify as a student, the child must be enrolled in the number of hours or courses the school considers full-time during some part of at least five months of the year.
- Any age if permanently and totally disabled at any time during the year. An individual is considered permanently and totally disabled if both of the following conditions apply:

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

Sarah's son Julio is 32 years old and is permanently and totally disabled. Because he is disabled, Julio meets the age test to be a qualifying child of Sarah. If he meets all the other tests, Sarah can claim him as a dependent.

Attending an on-the-job training course, correspondence school, or a school offering courses only through the internet, does not qualify the child as a student.

Residency

To meet this test, the child must have lived with the taxpayer for more than half the year. The taxpayer's home is any location where they regularly live; it does not need to be a traditional home. For example, a child who lived with the taxpayer for more than half the year in one or more homeless shelters meets the residency test.

Exceptions to the residency test

The child is considered to have lived with the taxpayer during periods of time when either the child or the taxpayer is temporarily absent due to illness, education, business, vacation, military service, institutionalized care for a child who is permanently and totally disabled, or incarceration.

A child who was born (or died) during the year is treated as having lived with the taxpayer for more than half of the year if the taxpayer's home was the child's home for more than one-half of the portion of the taxable year during which the individual was alive.

Taxpayers may claim as a dependent a child who was born or died, or was kidnapped during the year, as long as the other dependency tests are met.

In the case of a child who was born and died during the year, an SSN is not required but the return cannot be e-filed. The tax return must be mailed.

A taxpayer may not claim a stillborn child as a dependent on their federal return. State tax laws may differ.

In most cases, because of the residency test, a child is the qualifying child of the custodial parent. However, special rules apply to divorced or separated parents or parents who live apart, which are covered later in this lesson.

Support

Support includes household costs such as housing, utilities, and food. Either the actual cost of housing or the fair rental value of housing can be used. Support also includes personal expenses such as clothing, education, medical, and recreation. Other items can be included in support based on the taxpayer's facts.

To meet this test, the child cannot have provided more than half of their own support during the tax year. This test is different from the support test for qualifying relative. A person's own funds are not support unless they are actually spent for support. If the taxpayer is unsure whether the child provided more than half of their own support, review the Worksheet for Determining Support in Tab C of the NTTC 4012 with the taxpayer.

Bob, 22, is a full-time student and lives with his parents when he is not at the dorm. He worked part-time but did not pay over half of his total support. Bob meets the relationship, age, residency, and support tests.

Doris, a U.S. citizen, is 8 years old and had a small role in a television series. She made $60,000 during the tax year, but her parents put all the money in a trust fund to pay for college. She lived with her parents all year. Doris meets the relationship, age, and residency tests. Doris also meets the support test since the $60,000 in earnings were not used for her own support. She meets the tests for a qualifying child.

These are some special rules for determining who provides the support:

- Government benefits provided to a person in need, such as welfare, food assistance (SNAP), or housing are generally considered support provided by the respective governmental agency.
    - Such governmental payments made to the taxpayer that the taxpayer uses, in part, to support others are treated as support provided by the taxpayer. For example, if a mother receives Temporary Assistance for Needy Families (TANF) and uses TANF payments to support her children, you can treat the mother as having provided that support.
    - On the other hand, any part of such governmental payments used for the taxpayer's own support would constitute support provided by a third party.
- If a child receives Social Security benefits that are used for the child's own support, the benefits are considered to be provided by the child.
- A scholarship received by a child who is a student isn't taken into account in determining whether the child provided more than half of their own support.

Qualifying child of more than one person

Although a child could meet the conditions to be the qualifying child of more than one person, only one taxpayer can claim the child as a qualifying child for the following tax benefits (exception: if the special rule for children of divorced or separated parents or parents who live apart applies):

- Dependent
- Child tax credit or credit for other dependents
- Head of household filing status
- Credit for child and dependent care expenses
- Exclusion from income for dependent care benefits
- Earned income credit
- Premium tax credit, generally

If two taxpayers have the same qualifying child, then only one taxpayer can generally claim all of the benefits for that particular qualifying child. The other taxpayer cannot claim any of the benefits, based on the same qualifying child. They cannot agree to split these benefits. There are special rules that apply to divorced or separated parents that allow the noncustodial parent to claim some of the benefits as explained later.

To determine which taxpayer can treat the child as a qualifying child and claim the benefits, apply these tie-breaker rules keeping in mind that an adopted child is treated as the taxpayer's own child:

- If only one of the taxpayers is the child's parent, the child is the qualifying child of the parent.
- If the parents file a joint return together and can claim the child as a qualifying child, the child is treated as the qualifying child of the parents.
- If the parents do not file a joint return together but both parents claim the child, IRS will treat the child as the qualifying child of the parent with whom the child lived for the longer period of time during the tax year. If the child lived with both parents the same amount of time, IRS will treat the child as the qualifying child of the parent who had the higher Adjusted Gross Income (AGI) for the tax year.
- If no parent can claim the child as a qualifying child, the child is treated as the qualifying child of the person who had the highest AGI for the tax year and who meets the requisite tests.
- If a parent can claim the child as a qualifying child but no parent does, the child is treated as the qualifying child of the person who had the highest AGI for the year, but only if that person's AGI is higher than the highest AGI of any of the child's parents who could claim the child.

Using these tie-breaker rules, taxpayers may be able to choose which one claims the child. If the qualifying child is claimed on more than one tax return in a given year, IRS will apply the tie-breaker rules to determine who will receive the benefits.

Mary and her 3-year-old daughter, Jane, lived with Mary's mother, Dorothy, all year. Mary is 25 years old, unmarried, and has an AGI of $19,000. Dorothy has an AGI of $25,000. Jane's father didn't live with Mary or Jane. Mary has not signed Form 8332 (or a similar statement).

Jane is a qualifying child of both Mary and Dorothy because she meets the relationship, age, residency, support, and joint return tests for both Mary and Dorothy. However, only one of them can claim Jane. Jane isn't a qualifying child of anyone else, including her father.

Mary agreed to let her mother claim Jane. This means Dorothy can claim Jane as a qualifying child for all of the tax benefits listed earlier, if the mother qualifies for each of those benefits. Mary cannot claim Jane as a qualifying child for any of those tax benefits.

However, if Mary and Dorothy can't agree, only Mary will be allowed to claim Jane as a qualifying child because Mary is Jane parent.

In the example above, if circumstances are the same except Mary's AGI is $28,000, only Mary can claim Jane as a qualifying child. Because Dorothy's AGI isn't higher than Mary's, Dorothy cannot claim Jane.

Lynne and her mother, Margaret, share a home and both contribute to the household expenses. Lynne's twelve-year-old-daughter, Karen, lives with them. Although Karen meets all the conditions to be a qualifying child for both Lynne and her mother, Karen is considered Lynne's dependent.

However, if Lynne chooses not to claim Karen, then Margaret may claim Karen as a qualifying child if Margaret's AGI is higher than Lynne's.

When both taxpayers are the child's parents and not filing a joint return, they may agree between themselves who will claim the child. This may occur when the parents are not married but the family lives together.

When a taxpayer's e-filed return is rejected because they claimed a dependent that was already claimed by another person, apply the tie-breaker rules. If the taxpayer is the person eligible to claim the dependent based on these rules, a paper return must be filed.

What are the tests for a qualifying relative?

The tests for qualifying relative are applied only when the tests for qualifying child are not met.

Dependents who do not meet the tests for qualifying child might meet the slightly different tests to be a qualifying relative. In addition to the dependent taxpayer, joint return, and citizen or resident tests, there are four additional tests that must be met for a person to be a qualifying relative. The tests are:

- Not a qualifying child test
- Member of household or relationship test
- Gross income test, and
- Support test

Unlike a qualifying child, a qualifying relative can be any age. Turn to Chart 2 of the QC/R Tool to follow along as the tests are described (or if you're using NTTC 4012, turn to Tab C, Dependents, Qualifying Relative Dependents table).

Not a qualifying child test

A child is not considered a taxpayer's qualifying relative if the child is the taxpayer's qualifying child or is the qualifying child of another taxpayer.

However, there is an exception to this statement. A child may qualify as the taxpayer's dependent under the tests for qualifying relative, even if that child is the qualifying child of another person. This is allowed only when the child's parent (or other person for whom the child is a qualifying child) is not required to file an income tax return and either:

- Does not file a return, or
- Only files to get a refund of income tax withheld or estimated tax paid

Sally has been supporting her friend Ann and Ann's young son, Bobby. Ann and Bobby lived with Sally the entire year and meet all the tests to be Sally's qualifying relatives. Ann worked part-time and made $3,100 in wages. Ann files a return only to have her withholding refunded. Sally can claim Ann and Bobby as dependents.

If Ann files a return to claim the earned income credit (with or without Bobby as her qualifying child), Sally cannot claim Bobby because he is Ann's qualifying child (regardless of whether she claims him on her return).

Todd has lived with his girlfriend, Eva, and her two children all year in his home. Eva is not required to file, and does not file, a tax return this year. Eva and her two children pass the "not a qualifying child test" to be Todd's qualifying relatives. If Todd meets all other tests, Eva and her two children are qualifying relatives. (Eva and Todd's relationship does not violate local laws.)

Exercises

Answers are at the end of the lesson.

Question 1: All the facts are the same as in the previous example, except that Eva's gross income is $25,000, and she is required to file a return. In this situation, are the children Todd's qualifying relatives?

a. Yes

b. No

Member of household or relationship test

To meet this test, the person must either:

- Live as a member of the taxpayer's household all year, or
- Be related to the taxpayer in one of the following ways:
  - Child, stepchild, foster child or a descendant of any of them
  - Sibling, half-sibling, step-sibling
  - Parent, grandparent or other direct ancestor, but not foster parent
  - Step-parent
  - Child of the taxpayer's sibling (nephew or niece)
  - Child of the taxpayer's half-sibling
  - Sibling of the taxpayer's parent (uncle or aunt)
  - Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law

An adopted child is treated as the taxpayer's own child for the purposes of the relationships described above. For example, an adopted brother or sister is a brother or sister of the taxpayer. An adopted child includes a child who was lawfully placed with a person for legal adoption.

Any of these relationships that were established by marriage are not ended by death or divorce. For example, a father-in-law remains a father-in-law after the taxpayer and spouse divorce or if either spouse dies.

An unrelated person who lived with the taxpayer for the entire year can also meet the member of household or relationship test. If the relationship violates local laws, this test is not met. For example, if the taxpayer's state prohibits cohabitation, then that person cannot be claimed, even if all other criteria are met.

Susan and Ted are married and file a joint return. They supported Ted's parents throughout the tax year. Even though Ted's parents do not live with Ted and Susan, Ted's parents meet the member of household or relationship test.

Note that:

- A person is still considered living with the taxpayer as a member of the household during periods when that person or the taxpayer is temporarily absent due to special circumstances such as illness, education, business, vacation, military service, and placement in a nursing home.
- Cousins are not one of the listed relationships and can meet the member of household test for qualifying relative only if they live with the taxpayer for the entire year.
- Qualifying relatives can be unrelated, as long as they lived with the taxpayer all year.
- A taxpayer may not claim a housekeeper or other household employee as a dependent.

Mary is a live-in nanny for Jack and Jane in exchange for living expenses for the entire year. Mary does not meet the test for qualifying relative.

Gross income test

To meet this test, the dependent's gross income for the tax year must be less than the threshold amount as shown in the Important Changes lesson. Gross income is all income in the form of money, property, and services that is not exempt from tax. Remember this test does not apply to qualifying children, only qualifying relatives.

For purposes of this test, the gross income of an individual who is permanently and totally disabled does not include income from a sheltered workshop.

Joe is 65 years old and lives with his son and daughter-in-law. Joe's taxable pension income for the year was $10,000. Joe is not a qualified relative because his income exceeds the threshold amount.

Support test

To meet this test, the taxpayer must have provided more than 50% of the person's total support for the tax year. Note that this support test is different from the one for a qualifying child, which tests whether the child provided more than one half of their own support.

When calculating the amount of total support, taxpayers should compare their contributions with the entire amount of support the person received from all sources (such as taxable income, tax-exempt income, savings, and loans). Refer to the Worksheet for Determining Support in the NTTC 4012, Tab C, Dependents.

Sherrie's father received $2,700 from Social Security, but he put $300 of it in a savings account and spent only $2,400 for his own support. Sherrie spent $2,600 of her income for his support, so she has provided over half of his support.

Steve provided $4,000 toward his mother's support during the year. His mother had nontaxable Social Security benefit payments of $4,800 and tax-exempt interest of $800. She used all of these for her support. Steve's mother provided more than half of her total support of $9,600. Therefore, Steve cannot claim his mother as a dependent.

Recall the special rules for who provides the support:

- Government benefits provided to a person in need, such as welfare, food assistance (SNAP), or housing are generally considered support provided by the respective governmental agency.
    - Such governmental payments made to the taxpayer that the taxpayer uses, in part, to support others are treated as support provided by the taxpayer. For example, if a mother receives Temporary

Assistance for Needy Families (TANF) and uses TANF payments to support her children, you can treat the mother as having provided that support.

  - On the other hand, any part of such governmental payments used for the taxpayer's own support would constitute support provided by a third party.

- If a child receives Social Security benefits that are used for the child's own support, the benefits are considered to be provided by the child.
- A scholarship received by a child who is a student isn't taken into account in determining whether the child provided more than half of their own support.

Multiple support agreements (Form 2120)

Sometimes no one provides more than half the support of a person. *Multiple support* refers to situations wherein two or more individuals meet all the tests to claim the person as a qualifying relative dependent and together those individuals provide more than half of the dependent's support. In this situation, the individuals who provide more than 10% of the person's total support, and who meet the other tests for a qualifying relative, can agree that one of them will claim the person as a dependent for any applicable tax benefits.

- The taxpayer claiming the dependent must file Form 2120, Multiple Support Declaration or similar statement, with the tax return.
- The other taxpayers providing over 10% of the person's support must provide a written and signed statement agreeing *not* to claim the dependent for that year. The person who claims the dependent must keep a copy of this written statement as a record. A list of the statement requirements can be found in Form 2120 Instructions.

Multiple Support Agreements apply only to a qualifying relative, not to a qualifying child.

If you can claim a person as a dependent only because of a multiple support agreement, that person isn't a qualifying person for head of household status.

Fred's father, Charlie, lives with him and receives 27% of his support from Social Security, 40% from Fred, 24% from Charlie's brother Ray, and 9% from one of Charlie's friends. Charlie may be a qualifying relative for either Fred or Ray because they each provided more than 10% of Charlie's support, and together contributed more than 50% toward his support. If they agree that Fred will claim Charlie as a dependent, Ray will sign Form 2120 and Fred will attach the form to his tax return.

Exercises (continued)

Question 2: Diane and her brother each provided 20% of their grandmother's support for the year. Two persons who are not related to Diane's grandmother, and who do not live with her, provided the remaining 60% of her support equally. Who is entitled to claim the grandmother as a dependent?

The taxpayers who provide multiple support for a dependent decide among themselves who will claim the dependent for the year. Volunteer tax preparers do not decide.

Special rule for children of divorced or separated parents or parents who live apart

The rules for divorced or separated parents (and Form 8332) apply until the child is emancipated under local law. Thereafter, the regular qualifying child or qualifying relative rules apply. For most states, emancipation occurs at age 18; but there are many exceptions that vary by state that include marriage, military service, or by court action.

In most cases, the child is the qualifying child of the custodial parent. However, a child will be treated as the qualifying child or qualifying relative of the noncustodial parent if all the following conditions apply:

1. The parents

- are divorced or legally separated under divorce or separate maintenance decrees or written separation agreements, or
- lived apart at all times during the last six months of the year whether or not they are or were married.

2. Over half of the child's support for the year was from the parents. (Multiple support agreement rules do not apply.)
3. The child was in the custody of one or both parents for more than half the year.
4. The custodial parent signs a written declaration (Form 8332 or a similar statement) that they will not claim the child as a dependent for the year and the noncustodial parent attaches this declaration to their return. If the decree or agreement went into effect after 1984 and before 2009, the noncustodial parent may be able to attach certain pages from the decree or agreement instead of Form 8332. For a pre-1985 decree or agreement, see Pub 17.

This special rule is the exception to:

- The residency test for qualifying child
- The support test for qualifying relative

This rule does not apply for head of household filing status, the credit for child and dependent care expenses, or the earned income credit. For these benefits, the child must meet the residency test. The custodial parent may still qualify for these provisions even though the noncustodial parent can claim the dependent for other tax benefits.

Custodial and noncustodial parent

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

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

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

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

Chloe has one child, Timmy, and is divorced. During the tax year, Timmy lived with Chloe 210 nights and with his father 155 nights. Chloe is the custodial parent because Timmy lived with her more nights during the year.

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

Exercises (continued)

Question 3: Ted is divorced and has a daughter who lived with him and his ex-spouse for an equal number of nights. Ted's adjusted gross income is $45,000 and his ex-spouse's adjusted gross income is $30,000. Who is considered the custodial parent?

If a child is emancipated under state law, the child is treated as not living with either parent for purposes of determining which parent is the custodial parent. See more examples and additional information in Pub 17.

When Troy turned age 18 in May, he became emancipated under the law of the state in which he lives. As a result, he is not considered in the custody of his parents for more than half of the year. The special rule for children of divorced or separated parents does not apply.

Revocation of release of claim to an exemption

Custodial parents can revoke a release of claim to exemption they previously provided to the noncustodial parent on Form 8332 or a similar statement. The custodial parent must provide, or make a reasonable effort to provide, the noncustodial parent with written notice of the revocation in the calendar year prior to the tax year in which the revocation is to take effect. Part III of Form 8332 can be used for this purpose. Attach a copy of the revocation to the return for each tax year the child is claimed as a dependent as a result of the revocation.

Be sure to document the family and dependent information on the taxpayer's Tax-Aide Intake Booklet before entering the data into the tax software.

This table summarizes the benefits that remain with the custodial parent, even after they have released the claim to the dependent to the noncustodial parent.

Who May Claim	Custodial Parent	Noncustodial Parent with Form 8332
Dependent		✓
Head of household	✓	
Earned income credit (EIC)	✓	
Child tax credit or credit for other dependents		✓
Dependent care credit	✓	
Education credits		✓
Premium tax credit		✓

Be sure to add the child to the custodial parent's return, even though you will indicate that they are not a dependent. The software will then have the information needed for an accurate return.

Tax law application

Elaine Smith has one Form W-2 from her clerk job of 36 years, showing wages of $37,000. She has been divorced from her husband for over 20 years. She pays all the costs of keeping up her home and is the main provider for her seven-year-old granddaughter, Lisa and her 30-year-old son, Todd. Lisa is Todd's niece. Both her son and granddaughter lived with Elaine all year. Her son worked part time and earned $9,000. He is not disabled. She would like to file a tax return and claim her son and granddaughter as dependents.

How do I apply the dependency tests to Elaine's son?

Use the QC/R Tool to apply the tests to Elaine's son (or if using the NTTC 4012, use the tables in Tab C, Dependents).

How do I apply the dependency tests to Elaine's granddaughter?

Use the QC/R Tool to apply the test to Elaine's granddaughter (or if using the NTTC 4012, use the tables in Tab C, Dependents). You will find that Lisa is a qualifying child of both Elaine and Todd. However, under the tie-breaker rules, Elaine is entitled to claim Lisa as a dependent because she has the higher AGI.

Dependent/Nondependent Determinations

Elaine can claim her granddaughter as a dependent, but cannot claim her adult son because he does not meet the gross income test to be Elaine's qualifying relative.

Summary

For a taxpayer to claim a dependent, the following conditions must be met:

- The taxpayer may not claim a dependent if the taxpayer may be claimed as a dependent on another taxpayer's return. But see "who is not a dependent" at the beginning of this lesson.

- The taxpayer may not claim a dependent who files a joint return unless the joint return is filed only to claim a refund and no tax liability would exist for either spouse on separate returns.
- A person cannot be claimed as a dependent unless that person is a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico, for some part of the year. (There is an exception for certain adopted children.)
- A dependent must be either a *qualifying child* or *qualifying relative*.

Where to find more information

Pub 501, Dependents, Standard Deduction, and Filing Information

Pub 17, Your Federal Income Tax

Exercise answers

Answer 1: No, since Eva has a filing requirement and her children meet the tests to be Eva's qualifying children, Todd cannot claim the children as qualifying relatives.

Answer 2: No one is entitled to claim the grandmother as a dependent. The individuals who provided more than half of the grandmother's support are not eligible to claim her because they are not related to her and did not live in the same household all year.

Answer 3: Ted is his daughter's custodial parent because he had a higher adjusted gross income.

Unique Filing Situations

Introduction

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1040-NR

This lesson will assist you in addressing some filing status issues you may encounter when helping taxpayers who are not U.S. citizens.

This lesson also covers dependent issues related to taxpayers who may have nonresident alien stepchildren (children of a nonresident spouse who is married to U.S. citizen or resident alien).

This lesson does not cover the preparation of returns for taxpayers who are in the U.S. on an F, J, M, or Q visa. Tax returns for taxpayers with one of these visas is out of scope unless the volunteer preparer and reviewer are certified to prepare tax returns for foreign students or scholars. The Foreign Student and Scholar course and certification test are part of Link & Learn Taxes, which is available on https://apps.irs.gov/app/vita/.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine whether an individual is a resident or nonresident alien
- Apply the support test and citizen or resident test to determine whether an individual can be claimed as a dependent
- Apply special rules for head of household status when the spouse is a nonresident alien

How do I apply tax law to nonresident aliens?

Nonresident aliens can include students, teachers, trainees, or undocumented immigrants. Your role is to determine if the nonresident alien can be treated as a resident alien for tax purposes; most tax rules that apply to a U.S. citizen will also apply to the resident alien, including filing status and dependent issues. Resident aliens and U.S. citizens must report worldwide income on their Form 1040. A person who appears to be resident may be treated as nonresident alien under certain circumstances as discussed later.

Nonresident aliens may have a filing requirement in the U.S. in certain situations. On the other hand, a person who appears to be resident is treated as nonresident under certain circumstances or under a treaty. These situations are described in Pub 519 and are out of scope.

Keep in mind that a person is considered married no matter where in the world they were married. It does not matter if one spouse is living in another country. The person who is the resident alien or citizen still must follow the tax rules for married persons.

Filing a tax return as a resident alien does not affect the person's immigration status in any way.

Who is a resident alien or nonresident alien?

Let's begin by looking at the Tax-Aide Intake Booklet. Locate the part of the form where taxpayers and their spouses indicate whether they are U.S. citizens. In another part of the form, taxpayers indicate citizenship or residency of family members and dependents.

If the taxpayer has checked "No" for U.S. citizen on the Tax-Aide Intake Booklet, you must determine if the person can be treated as a resident alien for tax purposes before continuing. An individual must meet **one** of the following tests to be considered a resident alien for tax purposes:

- Green card test
- Substantial presence test

What is the green card test?

Individuals who were lawful permanent residents of the U.S. at any time during the tax year are resident aliens. They were given the privilege, according to immigration laws, of residing permanently in the U.S. They receive alien registration cards, commonly known as a "green cards," attesting to this status. Green cards are approximately the size of driver licenses. They are no longer green in color but still hold the name. Most green card holders have valid Social Security numbers and must follow the same tax laws as U.S. citizens, including the requirement to report worldwide income on their tax returns.

What is the substantial presence test?

This test is based on a formula of days and years a person is physically present in the United States. Individuals who do not have green cards may still be considered resident aliens if they meet the requirements of the substantial presence test for the calendar year.

Use the Resident or Nonresident Alien Decision Chart in the NTTC 4012, Tab L, Resident/NR Aliens, or on the next page, to determine an individual's residency status for tax purposes. Information can also be found in Pub 519, U.S. Tax Guide for Aliens.

On their Tax-Aide Intake Booklet, Gloria indicated that her husband, Dante, is not a U.S. citizen. During the interview, you learn that Dante does not have a tax home in another country. He was physically present in the U.S. for 150 days during the current tax year and both of the two prior years. Using the Nonresident Alien or Resident Alien? – Decision Chart on the following page, determine if Dante is a resident alien under the substantial presence test for the tax year.

The decision chart indicates that Dante does meet the substantial presence test and is considered a resident alien for tax purposes. You can assist Gloria and Dante in filing their joint return.

Current tax year: 150 days Prior year: 1/3 of 150 = 50 days Two years prior: 1/6 of 150 days = 25 days Total = 225 days

Resident or nonresident alien decision chart

Use the following chart to determine residency status for federal income tax purposes ("you" refers to the individual whose status needs to be determined). The footnotes are on the next page.

Step	Probe	Action
1	Were you a lawful permanent resident of the United States (had a "green card") at any time during the current tax year?	YES – RESIDENT Alien for U.S. tax purposes[1, 2, 7] NO – Go to Step 2
2	Were you physically present in the United States on at least 31 days during the current tax year?[3]	YES – Go to Step 3 NO – NONRESIDENT Alien for U.S. tax purposes[5, 6, 8]
3	Were you physically present in the United States on at least 183 days during the 3-year period consisting of the current tax year and the preceding 2 years, counting: • all days of presence in the current tax year, • 1/3 of the days of presence in the first preceding year, and • 1/6 of the days of presence in the second preceding year?[3]	YES – Go to Step 4 NO – NONRESIDENT Alien for U.S. tax purposes[4, 5, 6, 8]
4	Were you physically present in the United States on at least 183 days during the current tax year?[3]	YES – RESIDENT Alien for U.S. tax purposes[1, 2, 7] NO – Go to Step 5
5	Can you show that for the current tax year you have a tax home in a foreign country and have a closer connection to that country than to the United States? (Out of scope, Form 8840, Closer C Connection Exception Statement for Aliens required).	YES– NONRESIDENT Alien for U.S. tax purposes[5, 6, 8] NO – RESIDENT Alien for U.S. tax purposes[1, 2, 7]

Footnotes

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, U.S. Tax Guide for Aliens. (Out of scope)
2. In some circumstances you may still be considered a nonresident alien and eligible for benefits under an income tax treaty between the U.S. and your country. See Effect of Tax Treaties in Pub 519 and check the provision of the treaty carefully. (Out of scope)
3. See Days of Presence in the United States in Pub 519 for days that do not count as days of presence in the U.S. (Exempt individuals such as students, scholars, and others temporarily in the U.S. under an F, J, M, or Q visa's immigration status do not count their days of presence in the U.S. for specified periods of time. Foreign Student and Scholar certification is required to prepare a return for these individuals.)
4. If you meet the substantial presence test for the following year, you may be able to choose treatment as a U.S. resident alien for part of the current tax year. See Substantial Presence Test under Resident Aliens and First Year Choice under Dual Status Aliens in Pub. 519. (Out of scope)
5. Nonresident students from Barbados, Hungary, and Jamaica, as well as trainees from Jamaica, may qualify for an election to be treated as a U.S. resident for tax purposes under their tax treaty provisions with the U.S. A formal, signed, election statement must be attached to the Form 1040 (preparation of the statement is Out of Scope). The election continues until formally revoked.
6. If after using the Substantial Presence Test – Decision Tree/Chart and the Resident or Nonresident Alien Decision Tree/Chart on the prior page, you have determined a taxpayer is a nonresident alien for U.S. tax purposes:
   - You will only complete a tax return for a nonresident alien if you have certified on the Foreign Student and Scholar tax law, and at least 1 other person at your site is also certified on the Foreign Student and Scholar tax law, can quality review the return.
   - You confirm that Form 1040-NR is in scope.
   - Be sure to have the taxpayer complete Form 13614-NR, Nonresident Alien Intake and Interview Sheet, and use Pub 4011, VITA/TCE Foreign Student and Scholar Volunteer Resource Guide, to conduct the quality review.
   - As the initial return screen opens or under the basic information section in TaxSlayer Pro, select Nonresident Alien. After selecting the nonresident alien filing status, you will be given three (3) choices; single nonresident alien, married nonresident alien, or qualifying surviving spouse with dependent child.
7. If after using the Substantial Presence Test – Decision Tree/Chart and the Resident or Nonresident Alien Decision Tree/Chart on the prior page you have determined a taxpayer is a resident alien for U.S. tax purposes, and does not meet any of the exceptions that would be out of scope, select one of the filing statuses listed in the Filing Status lesson 4. A resident alien is treated like a U.S. citizen when determining filing status.
8. At the end of the tax year, if you are married and one spouse is a U.S. citizen or a resident alien and the other spouse is a nonresident alien, the taxpayers can choose to treat the nonresident spouse as a U.S. resident. In this case, both spouses must report and pay tax on their worldwide income.

   Starting in TY2024, a checkbox is provided on Form 1040 to make this election (the checkbox is in scope, but choosing to make the election is the responsibility of the taxpayer and spouse). Advising on making this election is out of scope (refer taxpayer to a professional tax preparer for advice). This election is effective for the current tax year and also applies to future years unless suspended or ended. A joint return must be filed for the first year in which this election is made, however a joint or separate returns may be filed in subsequent years.

The above chart and footnotes are available in your NTTC 4012, Tab L.

Tax returns are out of scope for taxpayers if they:

- *Are dual-status aliens, or*
- *Wish to claim a special treaty provision or tax topic not specifically addressed as within the scope of the Foreign Student and Scholar training, or*
- *Wish to claim resident status for a prior year based on days present in the U.S. after that year (first year choice), or*
- *Wish* to claim a closer connection exception on Form 8840

What counts as days of presence?

Count any day a person is physically present in the United States at any time during the day as a day of presence. There are exceptions to this rule. For example, do not count days a person regularly commutes to work in the United States from their home in Canada or Mexico or days the person is an exempt individual. The full list of exceptions and an explanation of each can be found in Pub 519, U.S. Tax Guide for Aliens.

Who is an exempt individual?

Generally, an exempt individual is a:

- Foreign government-related individual
- Teacher or trainee who is temporarily present under a J or Q visa
- Student who is temporarily present under an F, J, M, or Q visa
- Professional athlete who is temporarily in the United States to compete in a charitable sports event

Do not count the days present in the U.S. for purposes of the substantial presence test for an exempt individual. In general, they will be considered nonresident aliens for tax purposes and should file a Form 1040-NR if required. Exempt individuals must file Form 8843, Statement for Exempt Individuals and Individuals with a Medical Condition, to exclude days present in the U.S. from the substantial presence test. Foreign student or scholar certification is required for these tax returns.

Pub 519 has detailed information on determining who is a resident or nonresident alien.

If a person's visa has expired or the person is not complying with the requirements of the visa, then that person is not an exempt individual and cannot exclude those days they are physically present in the U.S.

What if a nonresident alien meets the substantial presence test?

Nonresident aliens who meet the substantial presence test are treated as resident aliens for tax purposes.

No paperwork or documentation is needed to indicate that a person is a nonresident alien filing as a resident alien under the substantial presence test.

Even if an individual meets the substantial presence test, they can be treated as a nonresident alien if they:

- Are present in the United States for less than 183 days during the year,
- Maintain a tax home in a foreign country during the year, and
- Have a closer connection during the year to one foreign country in which they have a tax home than to the United States (unless they have a closer connection to two).

Treaty provisions may also take precedence. See Pub 519 for more information. These situations are out of scope.

All persons listed on the return must have either a Social Security number or an individual tax identification number (ITIN). ITINs are discussed in the Filing Basics lesson 3. A return with an ITIN can be e-filed. A return without an SSN or ITIN cannot be e-filed.

What if a nonresident alien does not meet the green card or substantial presence test?

If an unmarried nonresident alien does not meet the green card or substantial presence test, there tax return is out of scope unless the taxpayer is a foreign student or scholar and the volunteer preparer and reviewer have been so certified.

If a U.S. citizen or resident alien is married to a spouse who is not a resident alien using the green card or substantial presence test, you may be able to provide assistance. Their options are discussed next.

Paul, a U.S. citizen, is married to Gabriella, who does not have a green card or a valid visa. They have no children and are not supporting anyone else.

Gabriella lived in the U.S. for 120 days during the current tax year. She was also in the U.S. for 120 days in each of the prior two years. Gabriella does not have a tax home in another country. Does Gabriella meet the substantial presence test?

Following the decision tree, you find that Gabriella does not meet the substantial presence test. For tax purposes, she is considered a nonresident alien.

Current tax year: 120 days Prior year: 1/3 of 120 days = 40 days Two years prior: 1/6 of 120 days = 20 days Total = 180 days

Individuals can be both a nonresident alien and a resident alien during the same tax year. This usually occurs in the year of arrival in or departure from the United States. This is referred to as a dual-status tax year. Individuals with a dual-status for the tax year are out of scope. This does not apply to an individual who is married and chooses to be treated as a U.S. resident for the entire year.

What are the filing status options?

A U.S. citizen or resident alien who is married to a nonresident alien spouse who does not meet either the green card or substantial presence test generally has three filing status options:

- The taxpayer may choose to file as married filing separately
- The couple may choose to file as married filing jointly
- The taxpayer may qualify for head of household under the regular rules for a married person who is "considered unmarried" even while living with the nonresident alien spouse

What happens when a U.S. citizen and nonresident alien spouse file separate returns?

The U.S. citizen can file a married filing separately return. The nonresident alien spouse, if required to file a return, would file Form 1040 NR. In this situation, the volunteer can assist in the preparation of Form 1040 for the U.S. citizen but the tax return for the spouse is out of scope.

When can nonresident aliens file a joint return?

A married couple may elect to treat a nonresident alien spouse as a resident alien for tax purposes and file a joint return. If taxpayers make this choice, both spouses are treated for income tax purposes as residents for the entire tax year. Neither spouse can claim under any tax treaty not to be a U.S. resident. Both spouses are taxed on worldwide income. See footnote 8 to the Resident or Nonresident Alien Decision Chart above.

In the previous example, you determined that Gabriella, Paul's nonresident alien wife, does not meet either the green card or the substantial presence tests to be considered a resident alien. However, Paul and Gabriella choose to treat Gabriella as a resident alien. They must check the box that indicates this choice. You can assist Paul and Gabriella in preparing their joint return. They must report their worldwide income for the year and for all later years unless the choice is ended or suspended. Although Paul and Gabriella must file a joint return for the year they make the choice, they may file either joint or separate returns for later years.

When can a citizen or resident alien, who lives with a nonresident alien spouse, file as head of household?

There is an exception that allows U.S. citizens and resident aliens who have a nonresident alien spouse to file as head of household. All of the following requirements must be met:

- The taxpayer is a U.S. citizen, or resident alien for the entire year.
- The nonresident alien spouse chooses **not** to file a joint return.
- The taxpayer meets the other requirements for this filing status.
- The spouse is **not a qualifying person** for head of household purposes. The taxpayer must have a qualifying person in order to be eligible for this filing status.

Exercises

Answers are at the end of the lesson.

Question 1: Gloria's husband, Dante, meets the substantial presence test for the entire tax year. Gloria is a U.S. citizen. They do not have any children and do not support anyone else. Dante is applying for an ITIN. Gloria has an SSN. They live together.

What filing status options do Gloria and Dante have?

Question 2: Raul is a U.S. citizen and serving in the U.S. Army in Japan. His wife and his 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 for tax purposes. She does not want to file a joint return with him.

Raul meets all of the other qualifications for head of household. Even though he is married and living with his spouse, can he claim head of household status?

a. Yes
b. No

In the NTTC 4012, Tab B, Starting a Return and Filing Status, note that if a spouse is a nonresident alien, the living apart rule does not apply to the taxpayer. This information is found in Pub 519.

Can a taxpayer with a nonresident alien spouse claim the earned income credit?

A taxpayer who was a nonresident alien for any part of the year can't claim the EIC unless their filing status is married filing jointly. They can use that filing status only if their spouse is a U.S. citizen or resident alien and the nonresident spouse chooses to be treated as a U.S. resident. If they make this choice, both spouses are taxed on their worldwide income. If a married taxpayer was a nonresident alien for any part of the year and their filing status isn't married filing jointly, they are not eligible for the EIC.

A married taxpayer who meets the special rules for separated spouses (discussed in the Earned Income Credit lesson 29) may claim EIC even though they are married to a nonresident alien and are filing a separate return.

Family members qualifying as dependents

Can a taxpayer claim a nonresident alien spouse as a dependent?

A taxpayer's spouse does not meet the relationship test for either qualifying child or qualifying relative. Thus, taxpayers cannot claim a spouse as their dependent.

Can a child born overseas be claimed as a dependent?

A child born overseas to U.S. citizen parents is considered a U.S. citizen for tax purposes. A child can be claimed as a dependent as long as all the other rules for qualifying child or qualifying relative are met.

The birth of a child abroad should be reported as soon as possible to establish an official record of the child's claim to U.S. citizenship. Form FS-240, Consular Report of Birth Abroad, establishes official evidence that the child is a U.S. citizen.

Patricia, a U.S. citizen, is married to Gilberto, a nonresident alien from Spain. Their daughter, Eva, was born while they were living in Spain.

Eva is entitled to U.S. citizenship. Eva will need a SSN to be claimed as a dependent on her mother's tax return.

While applying for the Consular Report of Birth Abroad, parents should also apply for a Social Security number and passport for their child. 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 credit or the child tax credit, even if all of the other prerequisites are met.

Can a foreign-born stepchild be claimed as a dependent?

Before determining if a foreign-born stepchild is a dependent, it is necessary to determine the child's U.S. residency status for tax purposes by answering the questions in the Nonresident Alien or Resident Alien Decision Chart. If the foreign-born child is a nonresident alien for tax purposes, the child must be a resident of Canada or Mexico to be claimed as a dependent.

Terry, a U.S. citizen, is married to a German citizen whose three children are German citizens and do not have green cards. Terry has not adopted the children. They all live in Germany. The children were not physically present in the U.S. during the tax year. Since the children are not U.S. citizens and are not residents of the U.S., Canada, or Mexico, Terry cannot claim the children as dependents.

Exercises (continued)

Question 3: Terry moved his family to the U.S. in January of the tax year. His stepchildren are not U.S. citizens and they do not have green cards. They meet the other dependency tests. If he can claim them, he will apply for ITINs for them. Can he claim the stepchildren as dependents on his tax return?

a. Yes
b. No

Question 4: John, a U.S. citizen, lives in Germany. His wife is a German citizen who has never lived in the U.S. Their two-year-old son was born in Germany. John's 12-year-old stepdaughter, a German citizen whom John has not adopted, also lives with them. John and his wife provide all the support for the two children. How many dependents can John claim?

a. One
b. Two
c. Three
d. Zero

Can a taxpayer claim an adopted foreign-born child as a dependent?

A U.S. citizen or national can claim a legally adopted child who is not a U.S. citizen, U.S. resident alien, or U.S. national provided the child is a member of the taxpayer's household all year. All the other rules for a qualifying child or qualifying relative must be met, and the child must have an SSN, ITIN, or ATIN to be claimed as a dependent.

An ATIN can be obtained when a domestic adoption is pending and other rules are met. An ATIN can be obtained in a foreign adoption when the child already possesses a green card or a certificate of citizenship, which identifies a child born overseas as a U.S. citizen.

See Pub 519 for more information about the citizen or resident test, including who is considered a U.S. national.

An adopted nonresident alien child must live with the taxpayer all year to pass the citizen or resident test.

Summary

Resident aliens follow the same tax laws as U.S. citizens.

To determine the residency status of a noncitizen, use the Nonresident Alien or Resident Alien Decision Chart (also in Tab L of the NTTC 4012).

If a citizen or resident alien is married to a person who does not meet the green card or substantial presence test, the couple can elect to treat the nonresident spouse as a resident alien for tax purposes and file a joint return.

A U.S. citizen's child is usually a U.S. citizen by birth, even if the child is born in another country.

A nonresident alien stepchild generally will not pass the citizenship or resident test and therefore cannot be claimed as a dependent, unless the child is a resident of Canada or Mexico.

An adopted nonresident alien child can usually be claimed as a dependent if the child lives with the taxpayer the entire year.

Where to find more information

Pub 519, U.S. Tax Guide for Aliens

Pub 17, Your Federal Income Tax

Pub 3, Armed Forces' Tax Guide

Pub 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Taxpayers with F, J, M, or Q visas, unless there is a volunteer and quality reviewer at your site with Foreign Student or Scholar certification
- Nonresident aliens who do not meet the green card or substantial presence test and are not married to a U.S. citizen or resident alien
- Individuals having a dual status for the tax year
- Giving advice to nonresidents who are married to U.S. citizens or resident aliens regarding the election to treat the nonresident spouse as a resident in order to file a joint return

Exercise answers

Answer 1: Since Dante meets the substantial presence test, he is considered a U.S. resident alien for tax purposes and must follow U.S. tax laws. Dante and Gloria can use either the married filing jointly or married filing separately filing status.

Answer 2: a, yes. Raul can claim head of household status because his children are his qualifying persons. If Raul did not have a qualifying person, he would have to use the married filing separately filing status since his wife chose not to file a joint return.

Answer 3: a, yes. The children meet the substantial presence test because they were in the United States more than 183 days. Terry's stepchildren are considered resident aliens for tax purposes. As long as the other

requirements for qualifying child or qualifying relative are met, Terry can claim the stepchildren as dependents on his tax return. They have to obtain SSNs or ITINs.

Answer 4: a. John can claim his son as a dependent. The son qualifies as a U.S. citizen because his father is a U.S. citizen. The stepdaughter does not meet the U.S. citizen or resident test. A spouse is never considered a dependent.

Income – Wages, Interest, Etc.

Introduction

This is the first of nine lessons covering the Income section of the taxpayer's return. A critical component of completing the taxpayer's return is distinguishing between taxable and nontaxable income and knowing where to report the different types of income on Form 1040.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012
- Tax-Aide Scope Manual

Optional:

- Form 1040 Instructions
- Form 1099-PATR (distribution from a cooperative)
- Form 1040, Sch B & Instructions (interest and dividends)

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Distinguish between taxable and nontaxable income
- Distinguish between earned and unearned income
- Report income included in this lesson correctly:
  - Part I: wages income from Form W-2
  - Part II: taxable and nontaxable interest income
  - Part III: dividend income
  - Part IV: taxable and nontaxable alimony income

How do I determine taxable and nontaxable income?

Gross income is all income received in the form of money, goods, property, and services that is not exempt from tax. It includes income from sources outside the U.S. or from the sale of a primary residence, even if part or all of that income can be excluded. Gross income may include part of Social Security benefits received and certain scholarship and fellowship grants.

- Income that is taxable must be reported on a taxpayer's return and is subject to tax.
- Income that is nontaxable may have to be shown on a taxpayer's return but is exempt from tax.

The Income Quick Reference Guide in the NTTC 4012, Tab D, Income, includes examples of taxable and nontaxable income. Further information can be found in P525, Taxable and Nontaxable Income.

Who gets taxed on a decedent's income?

A decedent's income received by the beneficiary after the decedent's death is generally taxable to the beneficiary. It is not unusual for a surviving spouse or a beneficiary to not change the decedent's SSN with the payer on a timely basis. Even if the income is reported using the decedent's SSN, the beneficiary who receives the income and is entitled to it needs to report it on their tax return.

If there is an estate that will file an estate income tax return (Form 1041), income received and kept by the estate is taxed to the estate. The estate or trust may distribute the income it receives to the beneficiaries, in which case the taxpayer will receive Form 1041, Sch K-1 (discussed in a later lesson).

What are types of taxable income?

Form 1040 and its associated schedules are used to report earned and unearned taxable income.

- Earned income – any income received for work, such as wages or business/self-employment income
- Unearned income – any income not earned from work, such as unemployment income or income produced by investments, such as interest on savings, dividends on stocks, or rental income

What are examples of nontaxable or exempt income?

Some nontaxable income such as gifts and inheritances are excludible and not shown on the return.

Exempt income includes such things as interest income produced from certain types of investments. There are some instances when exempt income is shown on the return but not included in the income tax computation, for example, tax-exempt municipal bond interest income.

Under the Victims of Terrorism Tax Relief Act of 2001, certain payments to survivors of terrorist attacks and death benefits paid to victims are not included in income. The Act also provides that the federal income tax liability of those who died as a result of certain attacks is forgiven for certain tax years. For additional details, see Pub 3920, Tax Relief for Victims of Terrorist Attacks.

How do I get started?

To determine a taxpayer's income, discuss and review the income items of the Tax-Aide Intake Booklet with the taxpayer.

Income is reported on a variety of forms depending on its source. Ask taxpayers to show you all Forms W-2, Forms 1099, and other statements reporting income. Also ask taxpayers if they received income that was not reported on a tax form, such as odd jobs or tips from customers.

Do not confuse Form 1099 with Form 1098. Generally, Form 1098 reports expenses the taxpayers have paid, not income they have received.

Tax returns for taxpayers who can check No to the digital asset question on Form 1040 are in scope. Taxpayers are instructed to check No if:

- *They held digital assets (such as virtual currency or a non-fungible token) in a digital wallet*
- *Their only transactions involving digital assets during the year were a cash purchase, inheritance, bona fide gift, or a transfer between two wallets the taxpayer owns.*

A Yes answer makes the return out of scope. Receipt of digital assets as payment for property or services, as an award, from mining or staking, from a hard fork require a Yes answer. Any disposition of a digital asset also requires a Yes answer, except if given as a gift for no consideration. Identify these situations as early in the interview as possible.

Part I: Wages, salaries, tips, etc.

What is Form W-2?

Employers must report wages and other employee compensation on Form W-2. Employers are not required to mail Forms W-2, but they must make them available to employees by January 31. Employees may need to pick up Form W-2 from their employers or obtain it electronically. Most employers issue a standardized version of Form W-2, Wage and Tax Statement.

Additional Medicare tax applies to an individual's wages, Railroad Retirement Tax Act compensation, and self-employment income that exceeds a threshold amount based on the individual's filing status. This topic is out of scope. Refer to the ***When high income can cause a return to be out of scope*** *chart in the Tax-Aide Scope Manual for this and other income limits to scope.*

What if the taxpayer does not receive Form W-2 by January 31?

Taxpayers who do not receive Form W-2 by January 31 should first contact the employer and find out if, or when, the form was mailed, or if it can be picked up or accessed online. Also, taxpayers may order transcripts from IRS.gov and receive the information by mail.

If Form W-2 is still not received after allowing a reasonable amount of time for the employer to issue or reissue it, then the taxpayer should contact the IRS for assistance after February 15.

If taxpayers do not receive Form W-2 before the filing deadline, they should file their tax return with Form 4852, Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. Taxpayers will need to provide the information required to complete Form 4852, such as the last paycheck stub. The employer's EIN is required to e-file the return.

The Tax-Aide Colorado Resource Toolbox has the EIN Search Tool that may be helpful in finding or confirming a payer's EIN.

Taxpayers should keep a copy of Form 4852 for their records. If the taxpayer eventually receives the employer's Form W-2, and the numbers differ from those on Form 4852, the taxpayer will need to amend the return to report the correct amounts.

It's likely that the earnings reported on Form 4852 will not be reflected on the taxpayer's Social Security Statement. Advise the taxpayer to contact the Social Security Administration at the number shown on the statement to resolve the matter.

EXAMPLE

During the tax year, Tina earned income from both a full-time and a part-time job. She received two Forms W-2, each listing different employers. Her return will list her wages as the total of the amounts in Box 1, but each Form W-2 must be entered into the tax software separately.

What if the taxpayer has an ITIN, but a Form W-2 is showing a different SSN?

Use the taxpayer's ITIN when starting the return. Enter the SSN as shown on the Form W-2 when prompted by the tax software.

Form W-2

Most of the boxes on Form W-2 are self-explanatory and you can simply transfer the information into the tax software. The following additional information is provided for some of the other boxes.

What is Box 10, Dependent care benefits?

Box 10 is used by employers to report dependent care benefits paid to the taxpayer or incurred on behalf of the taxpayer. Complete Form 2441, Child and Dependent Care Expenses, to determine if any part of this benefit is taxable to the taxpayer and to calculate the allowable amount of dependent care credit. Some employer plans provide a carryover or forfeiture of benefits that are not used by year end. This may require part III of Form 2441 to be completed.

What is Box 11, Nonqualified plans?

This amount is (a) reported in box 1 if it is a distribution made from a nonqualified deferred compensation or nongovernmental section 457(b) plan, or (b) included in box 3 and/or box 5 if it is a prior year deferral under a nonqualified or section 457(b) plan that became taxable for Social Security and Medicare taxes this year because there is no longer a substantial risk of forfeiture. This box shouldn't be used if the deferral and distribution occur in the same calendar year.

What do Box 12 codes mean?

There are numerous code letters that the employer can use to designate certain items, such as employee contributions to the company retirement plan. Refer to the list of codes in the NTTC 4012, Tab D, Income.

The tax software will automatically transfer qualified voluntary retirement contributions (codes D through H) to Form 8880, Credit for Qualified Retirement Savings Contributions, and calculate the retirement savings credit, if any. See the Miscellaneous Credits lesson 25.

Code FF in Box 12 of a Form W-2 indicates a Qualified Small Employer Health Reimbursement Arrangement (QSEHRA) and is out of scope. Codes R, T, and Z are also out of scope.

A Form W-2 with code Q in Box 12, indicates combat pay and requires Military certification to prepare the return.

What do Box 13 checkmarks mean?

There are three checkboxes in Box 13:

- Statutory employees receive Form W-2 for their pay and have taxes withheld; however, statutory employees may report their income and deduct their expenses on Sch C. See the Business Income lesson 9 for more information.
- Retirement plan indicates that the employee participated in the employer's retirement plan. If the taxpayer or spouse (if MFJ) makes IRA contributions, their deduction may be limited. See the Adjustments to Income lesson 17 for more information on IRA deductions.
- Third-party sick pay is reported on Form W-2 by the insurance company when it is taxable. If there is no amount in box 1, then none of the sick pay is taxable; and if no income tax was withheld, the W-2 does not need to be entered into the tax software.

What do Box 14 codes mean?

This box may be used for other information, such as state disability insurance taxes withheld, union dues, uniform payments, health insurance premiums deducted, nontaxable income, educational assistance payments, or a minister's parsonage allowance and utilities. In addition, the following contributions to a retirement plan may be entered in Box 14: (a) nonelective employer contributions made on behalf of an employee, (b) voluntary after-tax contributions (but not designated Roth contributions) that are deducted from an employee's pay, (c) required employee contributions, and (d) employer matching contributions.

Generally, none of the box 14 items are taxable for federal purposes. Some may be treated as a state income tax and deductible if the taxpayer itemizes. Many are informational only and do not impact the tax return.

Exercises

Answers are at the end of the lesson.

Question 1: Bruce is certified at the Advanced level. In order to assist a military taxpayer with combat pay shown on Form W-2, both Bruce and his reviewer must be also certified in Military.

a. True
b. False

Question 2: Devon worked for a small employer who is out of business and has not received a W-2. He brings his last pay stub that has all the needed information, including the employer's FEIN. Since he does not have a W-2, Tax-Aide cannot prepare his return.

a. True
b. False

Question 3: Janine spent more on child care so she could work than the amount of employer Dependent Care benefit shown on her W-2 (box 10). Must she complete Form 2441?

a. Yes
b. No

Are tips taxable income?

If taxpayers have jobs for which they get a W-2 and in which tips are normally received (e.g., restaurant server, bellhop, or motel/hotel housekeeper), be sure to ask about any tips they may have received and whether they reported all their tip income to their employer. All tip income is taxable, whether or not it is reported to the employer.

If a taxpayer receives more than $20 per month in tips at one job and reports their tip income to their employer, the tips will be included in Boxes 1 and 7 on Form W-2.

Self-employed taxpayers who receive tips, such as hair stylists and manicurists, should include their tips in gross receipts on Sch C.

What are allocated tips?

To ensure that everyone reports their fair share of income from tips, some employers have tip allocation programs, which are approved by the IRS. If an employee reports tips to the employer that were less than the designated share based on the employer's formula, the employer reports the difference as "allocated tips" and includes it on the employee's Form W-2.

Allocated tips are shown separately in Form W-2, Box 8. Social Security and Medicare taxes are not withheld on allocated tips. Allocated tips are not included in the amount in Form W-2, Box 1. Explain to the taxpayer that unless they kept a written and reliable record of tips actually received at that job, the allocated tips must be included in Form 1040 as wages.

When allocated tips are reported on Form W-2, the software automatically adds them to Form 1040 and also completes Form 4137, Social Security and Medicare Tax on Unreported Tip Income. Refer to the NTTC 4012 for instructions to enter the taxpayer's actual amount of tips according to their tip log.

What about unreported tips?

Be sure to ask taxpayers whether they received any tip income that was not reported to their employer.

- Noncash tips (e.g., tickets or passes) do not have to be reported to the employer, but must be included as taxable income at their fair market value.
- Tips of less than $20 per month or noncash tips are not required to be reported by an employee to their employer and not subject to Social Security and Medicare taxes; but those tips are still subject to federal income tax and must be added to wage income on the return.
- If tips of more than $20 a month were not reported to the employer, the taxpayer must also pay Social Security and Medicare taxes. Complete Form 4137 if the taxpayer received tips that were not reported to the employer. This form calculates the appropriate income, Social Security, and Medicare taxes.

Other wage income

Can a disability pension be treated as wages?

An individual who has not reached their employer's minimum retirement age and is receiving a disability pension reports the disability pension as wages, which may allow the taxpayer to qualify for certain benefits, such as the earned income credit. This is discussed in the Income – Retirement lesson 11.

What about income received by household employees?

The term "household employee" refers to an individual who works in someone's home performing household duties such as caring for children, cleaning, or cooking. Generally, an employer is not required to provide Form W-2 to a household employee who earns less than the threshold amount for that year and less than $1,000 in a calendar quarter. In this situation, neither the employer nor the employee will owe Social Security or Medicare tax on those wages.

The threshold amount is in the Important Changes lesson.

However, employers who withhold federal income taxes from their employee's wages must issue Form W-2. Regardless of whether Form W-2 is issued, the income must be included on Form 1040.

What about qualified Medicaid waiver payments?

Qualified Medicaid waiver payments, as defined in IRS Notice 2014-7, may be excluded from gross income only when the care provider and the care recipient reside in the same home. When the care provider and the care recipient do not live together in the same home, the Medicaid waiver payments may not be excluded from gross income.

A taxpayer may choose to include qualified Medicaid waiver payments in the calculation of earned income for the Earned Income Credit (EIC) and Additional Child Tax Credit (ACTC), even if the taxpayer chooses to exclude those payments from gross income:

- A taxpayer may not choose to include or exclude only a portion of qualified Medicaid waiver payments. Either include all or none of the qualified Medicaid waiver payments for the taxable year in earned income.
- If the taxpayer chooses to include qualified Medicaid waiver payments in earned income, that amount will be included in the calculation for both the EIC and the ACTC.
- A taxpayer and spouse can each make separate elections to include or not include their respective Medicaid waiver payments in earned income.

For the rare instance where both spouses have Medicaid waiver payment income, each spouse can make a separate and different election. Tax-Aide volunteers can use the Medicaid Waiver Payments Guide for a complete discussion and software entries in this rare situation.

Taxpayers who excluded qualified Medicaid waiver payments from gross income in prior tax years may wish to amend a prior year return to include Medicaid waiver payments in earned income for the EIC and ACTC if not so treated originally.

Form W-2 box 12 has a new code "II" for Medicaid waiver payments that excluded from income under Notice 2014-7. You should confirm the facts with the taxpayer to confirm that Medicaid waiver payments are properly reported.

See the Income – Other lesson 15 if your state reports Medicaid waiver payments on a Form 1099.

Exercises (continued)

Question 4: Medicaid waiver payment income that is excluded from taxable income must also be excluded for all other purposes of the law.

a. True
b. False

What is penal income (or prisoner income)?

An individual may be compensated while in a penal institution, a work-release program, or in a halfway house. The compensation will be reported on Form W-2 but it is not treated as earned income for the earned income credit or the additional child tax credit. The amount is reported as wages on Form 1040, Sch 1. Refer to the NTTC 4012, Tab D, Income, for instructions on how to identify and enter penal income, also known as prisoner income.

Under the PATH Act, a wrongfully incarcerated individual does not include in income any civil damages, restitution, or other monetary award received that relates to their incarceration.

What about scholarship and fellowship income (Form W-2 and Form 1098-T)?

Scholarships and fellowships may be fully or partially taxable, or nontaxable. Taxable amounts include:

- Payment for services
- Money used for personal living expenses

If the taxpayer received Form W-2 for the scholarship or fellowship, it is considered earned income. Include the amount on Form 1040 as wages just as you would any other Form W-2.

Form 1098-T reports scholarships and grants received as well as qualified tuition and related expenses paid to the school. Verify that these amounts are correct by reviewing the student's detailed financial account transcript which lists scholarship and grant money the student received. If scholarships or grants exceed the qualified educational costs, some of the grant or scholarship may be taxable to the student (not the taxpayer claiming the student as a dependent).

In certain situations, the student may choose to include all or part of certain scholarships or grants as taxable income in order to increase an education credit. This is explained in the Education Credits lesson 22, and examples can be found in the Form 8863 Instructions and Pub 970, Tax Benefits for Education. Taxable scholarship income is treated as earned income for:

- determining whether the student has a filing requirement and
- computing their standard deduction amount.

Taxable scholarship income is treated as unearned income for other purposes, such as the kiddie tax, earned income credit, or additional child tax credit. The software handles this.

What about loan repayment assistance programs (LRAPs) for health care professionals?

Education loan repayments are not taxable if they are made to taxpayers by:

- The National Health Service Corps Loan Repayment Program
- A state education loan repayment program eligible for funds under the Public Health Service Act, or
- Any other state loan repayment or loan forgiveness program that promotes increased availability of health professionals/services in underserved areas

The taxpayer should not receive a tax form because the amount is not taxable. If there is any question, the taxpayer should contact the repayment agency.

The discharge of certain student loan debt in tax years 2021 through 2025 is excluded from gross income. If excludible, the lender will not issue Form 1099-C.

An employer may pay down an employee's student loan debt on a nontaxable basis up to a maximum of $5,250 per year for all qualified education benefits. The amount paid down will not be included in the employee's W-2 box 1 taxable wages because it is not taxable.

What about ministers, other members of the clergy, and non-clergy church workers?

The ministry profession presents unique issues that are discussed in detail in Publication 157, Social Security and Other Information for Members of the Clergy and Religious Workers. Some clergy may be able to exclude their parsonage/housing allowance, their earnings may or may not be covered under FICA or SECA (self-employment tax), and there are specific rules for being exempt. This information is provided for awareness only and a tax return for a member of the clergy is out of scope.

The religious organization may not have to withhold FICA taxes from non-clergy church employees. If FICA was not withheld and the earnings are more than $108.28, the worker must pay self-employment tax. This is in scope and discussed in the Other Taxes lesson 27.

What about employer contributions to a Roth?

Employer matching and nonelective contributions to a Roth SEP, Roth Simple IRA, or designated IRA will be reported on Form 1099-R with code G. See the Income – Retirement lesson 11.

Part II: Interest income

Common sources of taxable interest income are checking and savings accounts, certificates of deposit (CDs), savings certificates, U.S. government bonds, municipal bonds, interest on insurance proceeds, and loans that the taxpayer makes to others. Some savings and loans, credit unions, and banks call their distributions "dividends" but are really interest and reported correctly as interest on Form 1099-INT.

The financial institution might not issue Form 1099-INT if the total interest for the year was less than $10. The interest amount for the year will typically be shown on the December statement. Even if the taxpayer did not receive Form 1099-INT, they must still report all of their taxable interest income, including any interest paid by the IRS.

Tax returns for taxpayers who have additional Foreign Bank and Financial Accounts (FBAR) filing requirements are out of scope. Ask if the taxpayer:

- *Had financial accounts or signature authority over a financial account in a foreign country (generally with a value of $10,000 or more at any time during the year).*
- *Received a distribution from, or was the grantor of, or transferor to, a foreign trust.*

Specified persons who had an interest in specified foreign financial assets during the year in excess of the applicable threshold may have to file Form 8938. If the FATCA (Foreign Account Tax Compliance Act) filing requirement box is checked on Forms 1099-INT, 1099-DIV, or any other income reporting document, the taxpayer may have a FATCA filing requirement (Form 8938). Form 8938 is out of scope.

Where do I get interest income information?

There are many sources of information about interest income. Ask the taxpayer to supply all Form(s) 1099-INT and year-end summary statements from institutions that pay interest.

Original Issue Discount (OID) is a form of interest income. A debt instrument generally has OID when issued for an amount that is less than its stated redemption price at maturity. The issuer of the debt instrument will report the amount of OID that is currently taxable on Form 1099-OID, Original Issue Discount, or a similar statement.

Generally, you will transfer the information from Forms 1099-INT to the software. However, these situations are out of scope:

- If the amount reported in Box 11, bond premium, exceeds the amount reported in Box 1, interest income
- If the amount reported in Box 12, premium on U.S. obligations, exceeds the amount reported in Box 3, interest on U.S. obligations
- If the amount reported in Box 13, exempt bond premium, exceeds the amount reported in Box 8, exempt interest income
- If the taxpayers cashed in Series EE or Series I bonds, they should have received a Form 1099-INT. Most taxpayers report the total interest when they cash in the bonds. Few taxpayers elect to report savings bond interest as it accrues each year. The accrual method is out of scope.
- Interest on qualified U.S. Series EE and Series I savings bonds that are used to pay for higher education expenses may be eligible for exclusion from income using Form 8815, Exclusion of Interest From Series EE and Series I U.S. Savings Bonds Issued After 1989. Form 8815 is out of scope.
- A net investment income tax applies to individuals that have certain investment income above certain threshold amounts (refer to the Tax-Aide Scope Manual for the income thresholds). This topic is out of scope.

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 the interest from the redemption of a bond, see Pub 17, Interest Income.

Ask the taxpayer if they made any loans to someone else or holds a seller-financed mortgage. The taxpayer will likely not receive a tax form for interest received from a private borrower. The name, Social Security number, and address of the payer (the buyer) of interest on a seller-financed mortgage is required to e-file a return.

The return is out of scope if the taxpayer (the seller) is reporting their gain on the sale under the installment method (Form 6252).

Bob holds a promissory note for a cash loan that he made to his brother-in-law, Stan. Stan pays Bob principal and interest each month. Even though Bob does not receive a Form 1099-INT, he reports that interest on Sch B of his tax return.

Hazel has four savings accounts in four different banks. The total amount of interest earned from the accounts is $3,000. Hazel will receive four Forms 1099-INT. She will list each payer and amount on Sch B and file it with her tax return.

The manner of reporting interest income on Series E, Series EE, or Series I U.S. savings bonds, after the death of the owner (decedent), depends on the accounting and income-reporting methods previously used by the decedent. See Pub 550, Investment Income and Expenses, for additional information.

What interest income is tax-exempt?

Certain types of interest are exempt from federal income tax. However, they may be taxable on the state tax return, and sometimes the reverse is true; the interest may be taxable on the federal return and exempt from state income tax.

Interest from bonds issued by the following is exempt from federal income tax:

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

Read the taxpayer's Form(s) 1099-INT carefully; both taxable and tax-exempt interest may be listed. Specific software entries are needed based on the source of the municipal interest income. Consult with your Coordinator if you have any questions.

Municipal mutual funds report the exempt interest as dividends on Form 1099-DIV. This income is interest income and while you may enter the amounts as "exempt interest dividends" in the software, they will appear on the interest income line of Form 1040.

Interest from U.S. government obligations is not taxable by any state. Also, each state may or may not tax interest from municipal obligations. Refer to the NTTC 4012, Tab D, Income, for the entries needed to identify the interest that is not taxable for state purposes.

Interest from private activity bonds (PAB) may be shown on the interest statement. It is a subset of tax-exempt interest and may affect the alternative minimum tax. Tax returns for taxpayers who are subject to the

alternative minimum tax are out of scope. Although tax-exempt interest is not taxable, it must be reported on Form 1040. Tax-exempt interest is used in calculating the tax impact on some items, such as the portion of Social Security benefits that is taxable.

What if a bond is sold between interest payment dates?

If a bond is sold between interest payment dates, part of the sales price represents interest accrued to the date of the sale. This amount is taxable to the seller and must be reported as interest income for that tax year, even if the seller does not receive a Form 1099-INT. The buyers of the bond may receive a 1099-INT reflecting the accrued interest and will treat this amount as a return of capital investment, reducing their basis in the bond. Payers and brokers will report the correct amount of interest on the Form 1099-INT/OID for all covered securities. Tax returns for taxpayers who sell noncovered bonds between interest payment dates are out of scope.

Covered securities are stocks, mutual funds, ADRs, and bonds that are subject to additional reporting by the payer on the applicable 1099 form. Securities acquired prior to the effective date of the additional reporting requirements are called noncovered securities. Taxpayers will need to provide needed information if the payer has not provided it, such as supplemental information on U.S. obligation interest or tax-exempt interest. The supplemental information may be available for download on the payer's website.

What about the interest on an IRA?

Generally, interest or other earnings on a Roth IRA is not taxable. However, if the criteria for a qualified distribution are not followed, the interest or other earnings may be taxable.

Interest earned in a traditional IRA is tax-deferred. Do not include that interest in taxable income until the taxpayer receives distributions from the IRA, which will be reported on Form 1099-R.

Refer to the Income – Retirement lesson 11.

Mike makes contributions to a traditional IRA each year. Throughout the year, he gets statements listing the interest earned. Because it is tax-deferred, he does not report any of the interest income from his traditional IRA on his tax return.

How do I report interest income?

Interest income is entered on Form 1040 and Sch B, if required. Amounts labeled Interest income and Interest on U.S. Savings Bonds and Treasury obligations on Form 1099-INT are reported as taxable interest. Be sure to enter any tax-exempt interest as directed in the software.

If the taxpayer receives Form 1099-OID, ensure that all the amounts included on 1099-OID are entered in the correct places in the software and on Form 1040. For example, amounts shown in the early withdrawal penalty box will appear in the Adjustments section and any federal income tax withheld is shown in the Payments section. These will be discussed in later lessons. Entries shown in the foreign tax paid and foreign country boxes will be discussed in the Foreign Tax Credit lesson 23.

If taxpayers indicate they are a nominee, if there are adjustments needed for any of the amounts listed on Form 1099-OID, or if they have income from original issue discount but did not receive a Form 1099-OID, their tax return is out of scope.

Taxpayer interview and tax law application

Barbara Smith is a clerk with the United States Postal Service. She has one Form W-2.

Sample interview

Volunteer Says…	Barbara Responds…
Now we will complete the income section of your return. I believe you told me that you work at the post office?	Yes. Here is my W-2.
Are you employed by anyone else?	No way, they keep me busy enough at the post office!
Did you have any disability income?	No, I'm not disabled.
Now, let's go on to interest income. Did you earn any interest on checking accounts, savings accounts, or a certificate of deposit?	Yes, I have a savings account that earns interest. Here is the 1099INT.
What about U.S. savings bonds? I know that a lot of postal employees buy them at work	Yes, I do, every pay period.
Are they for educational purposes, or just an investment?	No, they aren't educational. I don't have any information about my bonds with me. Why would I need that?
Some people report the interest as it accrues every year. You have to make this decision in the first year after you buy the bonds. Have you ever declared accrued interest from your savings bonds on your federal tax return?	Oh, no, never.
Well, did you redeem any bonds, or did any of them mature during this tax year?	No to both questions. I've been buying them for 15 years and they don't become fully mature for 30 years.
Okay, then it sounds like your only interest income is from the savings account.	

Part III: Dividend income

Corporate distributions are reported on Form 1099-DIV and these items are in scope:

- Ordinary dividends
- Section 199A dividends
- Qualified dividends
- Capital gain distributions
- Unrecaptured Sec. 1250 gain
- Nondividend distributions

Refer to the Tax-Aide Scope Manual for items reported on Form 1099-DIV that are out of scope.

What are ordinary dividends?

Ordinary dividends are corporate distributions paid out of the earnings and profits of a corporation. Any dividend received on common or preferred stock is an ordinary dividend unless the paying corporation states otherwise. Ordinary dividends are reported on Form 1099-DIV.

Olivia held both common stock and preferred stock in several U.S. corporations. Several of them paid dividends during the tax year. The following January she received Forms 1099-DIV listing these as ordinary dividends and qualified dividends, if appropriate.

What are qualified dividends?

Qualified dividends are ordinary dividends that qualify for lower, long-term capital gains tax rates. See Pub 550, Investment Income, for a detailed definition of qualified dividends.

Taxpayers who have questions about why a dividend is qualified or not qualified should contact the company that paid the dividend.

What are Section 199A dividends?

Section 199A dividends are REIT dividends and represent a subset of ordinary dividends that are eligible for the qualified business income deduction (QBID). See the Deductions lesson 19 for the QBID.

Real estate investment trusts (REITs) are companies that own, operate, or finance income-producing real estate across a wide range of property sectors. A REIT's income or gains are taxable to the investor in the REIT, similar to a mutual fund.

What are capital gain distributions?

Capital gain distributions, also called capital gain dividends, come from certain flow-through investments, such as mutual funds or REITs. Capital gain distributions are taxed at the lower long-term capital gains rate, regardless of how long the taxpayer holds the shares. Capital gain distributions are reported to the taxpayer on Form 1099-DIV. While you may enter these distributions in the dividend section of the software, these distributions will appear as long-term capital gains on Form 1040 and on Sch D if required.

Capital gain distributions are not the same as capital gains. A capital gain distribution is the owner's portion of the capital gains that were realized when the mutual fund or REIT sold assets.

A capital gain occurs when the owner of a mutual fund or other capital asset sells the asset for more than its cost.

During the tax year, Olivia owned shares in a mutual fund and in a real estate investment trust. Both made capital gain distributions that year. The following January she received Forms 1099-DIV listing these capital gain distributions.

What are unrecaptured Sec. 1250 distributions?

Unrecaptured Sec. 1250 distributions are a subset of capital gain distributions that are not eligible for capital gain treatment. Enter the amount as shown and the tax software will make the proper tax calculation.

What are nondividend distributions?

Form 1099-DIV also shows nondividend distributions, which are nontaxable and represent a return of the taxpayer's cost or other basis in a security. Brokers keep track of these and other basis adjustments for covered securities. Otherwise, taxpayers should keep this information with their tax records in order to calculate the adjusted basis of the stock when it is sold.

Where do I get dividend information?

Taxpayers that hold their securities in a brokerage account will receive Form 1099-DIV from their broker. For stocks held directly, corporations use Form 1099-DIV to report dividend distributions to each shareholder. Ask the taxpayer for any Form(s) 1099-DIV. If the taxpayers did not receive a Form 1099-DIV for a dividend, they should contact the payer or their broker to get the needed forms.

What about patronage dividends on Form 1099-PATR?

Taxpayers may receive a Form 1099-PATR that reports dividends paid on co-op purchases. The dividends may have been in cash, written notices of allocation (at stated dollar value), or other property (not including nonqualified allocations).

Ask the taxpayer if the patronage dividends are only for goods purchased for personal use. Any dividends paid on purchases for personal use are not taxable and do not need be entered into the software. Dividends on purchases for non-personal use, e.g. for a self-employed business, are out of scope.

How do I report dividend information?

Generally, all dividend income is reported on Form 1040. Sch B may be needed if the taxpayer's ordinary dividends exceed a specified amount or if the taxpayer was the nominee for dividends that actually belong to someone else. If the taxpayer received income as a nominee or if Form 1099-DIV includes amounts in boxes labeled Section 1202 gain, Collectibles (28%) gain, Cash liquidation distributions, or Noncash liquidation distributions, the return is out of scope.

Section 897 ordinary dividends and Section 897 capital gain is information for some nonresident alien taxpayers. If filing Form 1040-NR, these items are out of scope.

Any federal income tax withheld shown on a Form 1099-DIV is reported on the federal income tax withheld line of the return. Foreign tax paid will be covered in the Foreign Tax Credit lesson 23.

Taxpayer interview and tax law Application

Leonard and Gloria are filing a joint return. Leonard and the volunteer are discussing dividend income.

Sample Interview

Volunteer Says…	Leonard Responds…
Do you and your wife own shares of stock, mutual funds, or bond funds?	Yes, I have an IRA and I own shares in several mutual funds and a bond fund. My wife has an IRA. Here are the statements.
The earnings on the IRAs are tax deferred until you take a distribution. These 1099-DIVs are what we want right now. Are these the only Forms 1099-DIV that you received?	Yes
We will enter the information from each of these in the tax software. It will add everything up and display it properly on your tax return	

Part IV: Alimony income

Alimony is a payment to or for a spouse or former spouse under a separation or divorce instrument. It may include payments on behalf of the spouse or former spouse, such as medical bills, housing costs, and other expenses. It does not include child support or voluntary payments outside the instrument.

The taxability of alimony income depends on the date of the divorce or subsequent modification event.

Post-2018 divorces

The Tax Cuts and Jobs Act provides that alimony and separate maintenance payments are not deductible by the payor spouse and repeals the code provisions that specify that alimony and separate maintenance payments are included in income by the recipient of the payments.

This treatment is effective for any divorce or separation instrument executed after December 31, 2018, or for any divorce or separation instrument executed on or before December 31, 2018, and modified after that date, if the modification expressly provides that the amendments made by the Tax Cuts and Jobs Act, Section 11051, apply to such modification.

If the taxpayer might itemize their deductions, include the nontaxable alimony income in the sales tax deduction worksheet of the software. The sales tax deduction amount can be increased by having more income for purposes of the sales tax tables.

Post-1984 and pre-2019 divorces

The person receiving alimony must include it as income. The person paying alimony can subtract it as an adjustment to income. Both items are reported on Form 1040, Sch 1. The date of divorce or separation agreement must also be provided.

If the taxpayer is unsure whether a payment is alimony or child support, ask if the payments will stop once the child is grown.

Alimony income received under a pre-2019 divorce or separation instrument is unearned income. However, it is considered compensation, which may allow the taxpayer receiving alimony income to make a deductible traditional IRA or nondeductible Roth IRA contribution.

Pre-1985 divorces

If the agreement was executed before 1985, the former spouses could have chosen the tax treatment of alimony payments as part of their divorce or separation documents and their returns are out of scope.

Where do I get alimony information?

Ask if the taxpayer received alimony under a divorce or separation instrument. If so, explain that you need the exact amount, since it may also be reported as a deduction by the payor, and the two amounts must agree.

State laws may differ.

Summary

This lesson covered some of the income items reported on Form 1040, including how to differentiate taxable and nontaxable income, and earned or unearned income.

- Earned income is any income received for work, such as wages or business/self-employment income.
- Unearned income is any income produced by investments, such as interest on savings, dividends on stocks, or rental income.
- Wages are generally reported on Form W-2 and are included on Form 1040.
- Common sources of taxable interest income are checking and savings accounts, certificates of deposit (CDs), savings certificates, or U.S. government bonds. This interest is reported by the payer on Form 1099-INT and included in the taxpayer's income on Form 1040.
- Interest on certain bonds, such as from state political subdivisions, District of Columbia, or port authorities, are exempt from federal income tax but must be reported on Form 1040.
- Dividends are reported to the taxpayer on Form 1099-DIV. Ordinary dividends are corporate distributions paid out of the earnings and profits of a corporation. Qualified dividends are ordinary dividends that qualify for lower, long-term capital gains tax rates. Capital gain distributions are reported on Form 1040 and Sch D, if required.
- Alimony is income received from a spouse or former spouse under a separation or divorce instrument. If the alimony was paid pursuant to a divorce or separation instrument executed on or before December 31, 2018, it is taxable income and included on Form 1040, Sch 1.
- Child support is never reported on the tax return.

Where to find more information

Pub 17, Your Federal Income Tax

Pub 525, Taxable and Nontaxable Income

Pub 3920, Tax Relief for Victims of Terrorist Attacks

Pub 531, Reporting Tip Income

Pub 926, Household Employer's Tax Guide

Pub 970, Tax Benefits for Education

Pub 517, Social Security and Other Information for Members of the Clergy and Religious Workers

Pub 550, Investment Income and Expenses

Pub 504, Divorced or Separated Individuals

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Taxpayers who must check "yes" to the digital asset question on Form 1040.
- Form W-2 with codes FF, R, T, or Z in box 12
- Taxpayers subject to the additional Medicare tax, the net investment income tax, or the alternative minimum tax
- Taxpayers who use the accrual method for reporting income
- Taxpayers who buy or sell noncovered bonds between interest payment dates
- Form 1099-INT premium amount is greater than the respective amount of interest reported.

- Form 1099-DIV amounts reported in the boxes labeled Section 1202 gain, Cash liquidation distributions, and Noncash liquidation distributions
- Adjustments needed for any of the amounts reported on Form 1099-OID or if the taxpayer should have received Form 1099-OID but did not receive one
- Alimony related to divorce agreements executed before 1985
- Tax returns for ministers and members of the clergy because of unique tax issues
- The FATCA filing requirement box is checked on any 1099 form.
- The taxpayer is required to file form FINCEN 114 or received a distribution from, or was the grantor of, or transferor to, a foreign trust.

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: True.

Answer 2: False. You can use Form 4852 as a substitute Form W-2.

Answer 3: Yes. Until Form 2441 is completed, the dependent care benefits will be added to her taxable income. Also, since Janine spent more than her employer's assistance, she may get a child and dependent care credit (covered in a later lesson).

Answer 4: False. Excluded MWP income can be included as earned income for purposes of the earned income and additional child tax credits. The taxpayer (or spouse if MFJ) may each make different elections but such election applies to all the MWP income earned by the taxpayer or spouse, respectively.

Income – Business

Introduction

This lesson will help you prepare an accurate return for taxpayers who have business income, also called self-employment income. Form 1040, Sch C, Profit or Loss From Business, is used to report income from a business or profession operated as a sole proprietor or independent contractor. Preparation of tax returns with Sch C are in scope with certain limitations as detailed below.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012
- Form 1040 Sch C & Instructions

The following provisions, which may affect taxpayers who have a business, are discussed in later lessons:

- Deductible part of self-employment tax
- Self-employed health insurance deduction
- Qualified business income deduction
- Self-employment tax

Remember that any transaction involving digital assets (virtual currency), such as a disposition, sale, exchange, or transfer, is out of scope. Be sure to ask about digital assets during the interview.

Objectives

You will learn how business income is determined and how it affects eligibility for certain tax credits. At the end of this lesson, using your resource materials, you will be able to:

- Determine what is or is not a business
- Identify “red flags” when preparing a Sch C return with earned income credit (EIC)
- Determine the sources of business income and how to report it
- Determine which business expenses are within the scope and how to report them

This lesson also discusses general recordkeeping requirements for taxpayers with business income and expenses.

What is a business?

Based on your interview and the completion of the taxpayer’s Tax-Aide Intake Booklet, you may discover that the taxpayer or spouse had business income from being self-employed or working as an independent contractor. Taxpayers are self-employed if they carry on an unincorporated trade or business as a sole proprietor or independent contractor. Carefully review the Tax-Aide Intake Booklet and ask follow-up questions to determine if the taxpayer or spouse had business income. Taxpayers may not think of themselves as “self-employed” if they have a small home business or work part-time as an independent contractor.

An activity qualifies as a business if the primary purpose for engaging in the activity is for income or profit and the taxpayer is involved in the activity with continuity and regularity. For example, a sporadic activity or a hobby does not qualify as a business. A hobby is an activity typically undertaken for pleasure and not for profit.

Special rules apply to certain activities and are, therefore, out of scope. Out-of-scope activities include professional gamblers, day traders, illegal activities, name/image/likeness (NIL) income of student athletes, or activities that are a hobby or otherwise not for profit.

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

What is in scope?

Volunteers can assist taxpayers who have returns that require Sch C with certain limits:

- Have no more than $50,000 in business expenses
  - Business expenses are amounts that are ordinary and necessary to carry on the business
- Use the cash method of accounting
  - The cash method reports income when received and expenses when paid
  - The accrual method reports income when earned and expenses when incurred, and is out of scope
- Have no inventory at the beginning of the year.
  - Inventory is the items the taxpayer buys or makes for resale to others
  - The cost of an item of inventory is generally expensed when it is sold
  - Small business cash-basis taxpayers can expense purchases and not maintain inventories, discussed below
- Do not have a net loss from the business
- Have no employees during the year and did not pay contract labor for services (possible classification as an employee or may require a 1099 to be issued)
- Do not barter property or services
  - Bartering is an exchange of property or services
- Are not required to file Form 4562, Depreciation and Amortization, for this business to report depreciation or the election to expense business assets (also called a Sec. 179 expense)
  - Depreciable assets are those expected to last more than a year
  - Depreciation is the annual deductible part of the asset's cost (spread over a period of years rather than deducted in the year of purchase)
  - The de minimis expense election is different than a Sec. 179 expense election and allows an immediate deduction as discussed below
- Do not answer Yes to the digital asset (virtual currency) question on Form 1040
- Do not deduct expenses for business use of a home

During the interview, if you discover taxpayers have issues that are out of scope, you should first double check with your Coordinator and, if confirmed, you must decline the return.

More than one Sch C should be prepared if the taxpayer and/or spouse have more than one business or to report each spouse's share of the business if it is jointly operated and filing a joint return.

An individual may have set up a limited liability company (LLC) or other type of legal entity to limit their business risk. Such entities have filing requirements that are out of scope as are tax returns for taxpayers with these entities.

Taxpayer interview and tax law application

As you review the Tax-Aide Intake Booklet with taxpayers, ask questions to determine if they have any self-employment income, their accounting method, and their business expenses, as shown in this sample interview:

Sample interview

Volunteer Says…	Jason Responds…
What kind of business do you have and were you the sole owner?	I install air conditioners and, yes, I own the business myself. No partners or employees.
Do you have a record of your business income and expenses for last year?	Yeah, I've got a separate checking account for my business. I had a pretty decent first year actually.
Do you use the cash method of accounting?	Yes. I have a printout of my year-end summary here.
And what were your expenses?	Well, I do the installations myself. I spend a lot of money on parts, tools that last less than a year, and equipment repairs. My expenses for the year total $2,212.
Do you keep any parts in inventory?	No, I purchase the parts when an order is placed with me.
And you say you had a good year? In other words, did you make a profit?	That's correct.
Do you plan on deducting expenses for the business use of your home?	No, I don't.
Okay, and how much business income did you have?	My gross totaled $30,762.
On page 2 of the Tax-Aide Intake Booklet, indicate Jason's responses to these questions.	

Exercise

Answers are at the end of the lesson.

Question 1: Based on the information in the sample interview, is Jason's return in scope?

- **a.** Yes
- **b.** No

Statutory employees

Statutory employees receive Form W-2 for their pay and have taxes withheld; however, statutory employees can report their income on Sch C, which allows them to deduct their business expenses. Statutory employees include full-time life insurance agents, certain agent or commission drivers, traveling salespersons, and certain home workers.

Social Security and Medicare taxes should have been withheld from the earnings; therefore, the taxpayer does not owe self- employment tax on these earnings. Be sure to indicate that this is a statutory employee on the input screen so that the self-employment tax is not computed by the software.

Statutory employee income and self-employment income cannot be reported on the same Sch C. The taxpayer must file two separate Schedules C if they also have a business.

Overview of business income and expenses

All IRS-certified volunteers must exercise due diligence when preparing tax returns. This means, as a volunteer, you must do your part when preparing or reviewing a tax return to ensure the information on the return is correct and complete. Generally, you can rely in good faith on information from a taxpayer without requiring documentation as verification.

However, when preparing a tax return with a Sch C and the earned income credit (EIC), take additional steps to determine that the net self-employment income used to calculate the amount of, or eligibility for, EIC is correct and complete. Additional clarification or inquiries should be made if the information furnished by the

taxpayer appears to be incorrect, incomplete, or inconsistent. Taxpayers sometimes want to over report or under report their income to qualify for or maximize the amount of EIC.

Ask sufficient questions of taxpayers claiming self-employment income to be satisfied that:

- The taxpayer actually conducts a business
- The taxpayer has records to support income and expenses, or can reasonably reconstruct income and expense records
- All income and related expenses have been included on the taxpayer's Sch C

Emphasize to taxpayers that in the event of an IRS audit, they would need to provide receipts to support their reported income and expenses.

What Schedule C situations raise a "red flag"?

As a volunteer preparing a tax return with Sch C, watch for examples of incorrect, incomplete, or inconsistent information, such as:

- Income reported in round numbers
- Cash as the only source of income on a return claiming EIC
- Sch C income that qualifies the taxpayer for the maximum EIC
- Sch C without a Form 1099
- Little or no expenses when expenses would be expected
- Taxpayers with little or no records for income and expenses
- Taxpayers who present information that is not consistent with a legitimate business activity

If you believe the taxpayer is presenting questionable information and they are not resolving your concerns, check with your Coordinator for guidance. Together, you may decide to decline preparing that return.

Taxpayer interview and tax law application

Dana comes to have her tax return prepared. She tells you she runs her own babysitting business and wants to claim the EIC. To assist her in completing an accurate return, you need to ask more questions to determine if Dana incurred allowable business expenses and that the income she reported is correct.

Sample interview

Volunteer Says…	Dana Responds…
Tell me about your business, and were you the sole owner?	I have a babysitting service that I handle all by myself.
Do you have a record of your business income and expenses for last year?	Well, I'm not very good at keeping records, but I can tell you that I made $14,000 over the course of the year. I didn't have any expenses.
How did you determine that you made a net profit of $14,000?	I based my income on deposits to my checking account.
I see. We may be able to reconstruct your business income based on your deposits. Did you bring any bank statements or your checkbook record with you today?	No, I'm sorry.
How many children did you care for, and was this a fulltime or part- time job for you?	Babysitting is just part-time. I watch several of my neighbors' children along with my own kids who are 8 and 10 years old.
What is your fee for babysitting?	It averages about $10 an hour.

Volunteer Says…	Dana Responds…
Do you have a calendar or schedule of the children present each day?	No, but I may be able to come up with one.
Do you have a business license or permit, and do you watch the children in your own home or in a daycare facility or in the client's home?	My home and sometimes at my neighbors' homes. I don't need a permit.
Do you buy any supplies such as food, diapers, toys, or other items necessary for the business?	Sometimes I need to buy supplies. But I didn't bring receipts with me.
Did you intend to deduct expenses for the business use of your home?	No, I don't think so.
Be aware that the IRS requires that you report all income and allowable expenses on your tax return. In the event of an IRS audit, you will be responsible for providing support for the income and expenses claimed on your return. Before we can proceed, you'll need to gather some additional facts and records. I'll write down a list of items that could help us more accurately calculate your net profit from your business.	OK – thanks. I'll see what I can pull together.

The information provided by the taxpayer appears to be both inconsistent and incomplete, because it is unlikely that someone who operates this type of business:

- Has no business expenses. Most businesses have expenses, even if it is just a few dollars here and there.
- Has annual gross receipts from the business that are an exact round dollar amount, and that amount maximizes EIC.

The volunteer cannot complete a return based on information provided, but gives Dana the chance to gather materials to document her business.

Where do I get business income information?

Business income (gross receipts) information may come from the following:

- Forms 1099-NEC, Nonemployee Compensation
- Forms 1099-MISC, Miscellaneous Income
- Forms 1099-K, Payment Card and Third Party Network Transactions
- Forms W-2, Wage and Tax Statement, with Statutory Employee checked in Box 13
- Taxpayer's books and records

Income received from all sources in a self-employed taxpayer's business must be reported, unless excluded by law.

Tax-Aide volunteers can provide the Self-Employed Sch C Worksheet to taxpayers that have a business to summarize their business income and expenses.

Income not reported on a tax form

Some taxpayers may indicate that they received cash income for self-employment activity. This includes checks, electronic funds transfers, etc., and must be reported, unless excluded by law. Be sure to ask about any other income the taxpayer may have received such as tips or gratuities.

If taxpayers do not have adequate records of the cash income they received, you may be able to assist them with simple record reconstruction. See the section on reconstructing records later in this lesson.

Form 1099-NEC, Nonemployee compensation

Taxpayers who are independent contractors should receive Form 1099-NEC showing the income they earned from payers who are required to file Forms 1099. Individuals (including for-hire drivers) who receive less than $600 may not receive Form 1099-NEC, but must still report all their income. Ask for documentation of any business income that was not reported on Form 1099-NEC, Form 1099-MISC, or Form W-2 (e.g., payments received from individual clients who do not need to file Form 1099).

Tim works as an independent contractor for ABC Construction Company. The company sent Tim a Form 1099-NEC that shows he received $15,000 for the work he did for them. He also received cash payments of $4,150 from several different individuals for the work he completed. He did not receive Forms 1099-NEC for the $4,150. Tim must include the $4,150 cash payments as self-employment income along with the $15,000 from Form 1099-NEC.

Form 1099-MISC, Miscellaneous income

Taxpayers may receive other business income reported on Form 1099-MISC, Boxes 2 and 3. Box 2 royalties from the taxpayer's own personal services are generally reported on Sch C. Examples include authors and composers. If the royalty is from another person's services, they are generally reported as other income in Box 3. An example is inherited royalties, which are reported as other income on Sch 1 (not on Sch C).

Form 1099-K, Payment card and third party network transactions

Form 1099-K is used by third-party networks (such as Visa, MasterCard, Venmo, or others) to report transactions processed for taxpayers, including for hire or ride share services such as Uber, Lyft, Sidecar, etc., also known as the gig economy. Taxpayers may not receive the Form 1099-K, but the amount received must still be reported.

The third-party processor will not know whether the activity is a business unless the taxpayer has set up their payment account properly or identified nonbusiness transactions as such. Receipt of Form 1099-K or 1099-NEC may or may not represent a business activity. Individuals who receive Form 1099-K for personal transactions should contact the reporting entity or adequately identify personal transactions so they are not reported on Form 1099-K in the future.

Amounts reported on Form 1099-K that do not relate to a business should not be reported on Sch C. Proceeds from the sale of personal assets at a loss can be reported on Sch 1. Sale of personal assets at a gain but not as a business makes the return out of scope. For more guidance on Form 1099-K, see the NTTC Form 1099-K Payments tax law paper.

The 1099-K reporting threshold for 2024 is $5,000. Third-party processors may issue forms even if not required. Due diligence is needed to ascertain the correct reporting of these proceeds, if any.

Gig economy drivers (Uber, Doordash, etc.) may receive both Form 1099-K for their fare income and Form 1099-NEC for other income such as commissions. Both are part of the same business and both are reported on the same Sch C as gross receipts.

Qualified Medicaid waiver payments

Certain caregiving income may be qualified Medicaid waiver payments (MWP) and may be excluded from gross income. To be qualified Medicaid waiver payments, the care provider and the care recipient must reside in the same home. When the care provider and the care recipient do not live together in the same home, the Medicaid waiver payments are fully taxable.

Medicaid waiver payments are most often reported on Form W-2 (discussed in an earlier lesson); but, some payers report on a Form 1099. To find out how Medicaid waiver income is reported in your state, check with your Instructor or Coordinator. Taxable caregiving income reported on Form 1099 is reported on Sch C if it constitutes a business. If the caregiving activity is not a business, the income is reported as other income (not subject to self-employment tax). If the payments are excluded as MWP, expenses related to that income are not deductible.

IRS has provided guidance on when family caregivers have or don't have a business subject to self-employment tax [https://www.irs.gov/businesses/small-businesses-self-employed/family-caregivers-and-self-employment-tax].

A taxpayer may choose to include qualified MWP in the calculation of earned income for the earned income credit (EIC) and additional child tax credit (ACTC). The taxpayer may include qualified MWP in earned income even if the taxpayer chooses to exclude those payments from gross income.

- A taxpayer may choose to include all or none of the qualified MWP for the taxable year in earned income. They may not include or exclude only a portion of qualified MWP
- If the taxpayer and spouse, filing jointly, both have MWP income, each can elect to include all or none of their respective payments in earned income.
- If the taxpayer chooses to include qualified MWP in earned income, that amount will be included in the calculation for both the EIC and the ACTC.

Business expenses

Taxpayers deduct the costs of running their business. These costs are known as business expenses. To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in the taxpayer's industry. A necessary expense is one that is helpful and appropriate for the taxpayer's trade or business. All ordinary and necessary expenses incurred in a self- employed taxpayer's business must be reported. See the Instructions for Sch C for more detailed information on deductible business expenses. Examples of these expenses include the following:

Every self-employed taxpayer must claim all allowable deductions in computing net earnings from self-employment so that a tax benefit, such as the EIC, is not overstated.

Advertising

Advertising expenses are the costs associated with promoting the business through various means including internet ads, newspapers, magazines, billboards, racing sponsors, and television spots.

Car and truck expenses

A taxpayer who uses a car or truck in a business may be able to deduct the costs of operating and maintaining the vehicle. Vehicle expenses can be calculated using actual expenses or the standard mileage rate.

Actual expenses include depreciation. The calculation of depreciation is outside our scope. If the taxpayer has used actual expenses in the past, or wishes to use actual expenses in the current year, their tax return is out of scope.

For the standard mileage deduction, the number of business miles is multiplied by the applicable standard mileage rate. The standard mileage rate includes depreciation, lease payments, maintenance, repairs, gasoline (including gasoline taxes), oil, insurance, and vehicle registration fees — no additional deduction is allowed for these items when claiming the standard mileage deduction.

A few items can be added when the standard mileage rate is used. Self-employed taxpayers can also deduct the business part of interest on a car loan, state and local personal property tax on the car, parking fees, and tolls. For-hire drivers may have other deductible car expenses such as a dash camera and ride-sharing insurance in addition to using the standard mileage rate.

Commuting miles, parking tickets, traffic fines or penalties are not deductible.

The IRS defines commuting as transportation between the taxpayer's home and their main or regular place of work or primary workstation. A home office could be the regular place of work but is out of scope. In scope for-hire drivers cannot therefore claim the mileage between their home and their first stop or from their last stop to their home because they do not claim an office-in-the-home deduction.

Wendy is a self-employed masseuse and does not maintain an office in her home. She does neck massages for office workers and travels to three office buildings each work day. It is 10 miles from home to the first office and 5 miles from the last office back home. These 15 miles are commuting miles and, therefore, not deductible. The 13 miles Wendy drives from the first office to the second office and 5 miles from the second office to the third office are deductible. Of the 33 miles driven each work day, 18 miles are deductible.

Darryl used his car only for personal purposes during the first 6 months of the year. During the last 6 months of the year, he drove the car a total of 18,000 miles. Of those miles, 15,000 miles were driven providing transportation through a ride-sharing service. He received a Form 1099-K showing the income he received from the ride-sharing business. Darryl can deduct the 15,000 miles using the standard mileage rate as well as any other ordinary and necessary business expenses, such as supplies, a cell phone, food and drinks for passengers, parking fees, tolls, roadside assistance plans, business insurance, and taxes.

For-hire drivers who have mileage in between customer pick-ups can claim the mileage as a business expense.

Commissions and fees

Commissions or fees are paid to both individuals and businesses. If payments to a single individual are $600 or more, the taxpayer must report the payments on Form 1099-MISC or Form 1099-NEC. In this case, the taxpayer's return is out of scope.

Insurance

Insurance policies and coverage are deductible for the business operation. This includes property and business liability insurance.

If the standard mileage rate is used, no deduction is allowed for regular automobile insurance premiums.

A for-hire driver's cost of extra liability coverage can be added to the standard mileage rate if separate from the main policy.

Health insurance for the sole proprietor and their family is not deductible as a business expense on Sch C. However, these medical premiums may be deducted on Form 1040 as an adjustment to gross income, subject to qualifications, and is discussed in the Adjustments to Income lesson 17.

Other interest

This category can include interest paid on business operating loans, but not mortgage interest. Business interest includes the business portion of interest on a car loan – it can be added to the standard mileage rate.

Legal and professional services

Expenses included on this line are fees paid to professionals, such as attorneys, accountants, appraisers, and engineers.

Legal fees paid to acquire business assets are not deductible. These costs are added to the basis of the property. Some accountant fees and attorney fees may be for personal services (e.g., wills or estate planning) and are not deductible as business expenses.

Payments over $600 may require a Form 1099-MISC or 1099-NEC to be filed, which would make the return out of scope.

Office expense

Office expense generally includes supplies such as pens, paper, and postage.

Rent or lease – vehicle, machinery, and equipment

This category includes rental fees for cars, trucks, vans, machinery, equipment, and other personal property. Vehicle leases of more than 30 days are out of scope. If the taxpayer uses the standard mileage rate method for business miles of a leased vehicle, the return remains in scope.

Repairs and maintenance

Repairs on equipment, office space, and buildings are some possible expenditures reflected in this category. Expenses that should not be reflected are:

- Capital equipment that should be capitalized and depreciated.
- Repairs that substantially improve a facility or equipment that should be capitalized and depreciated.

However, see the de minimis expense election below under Other Expenses.

Supplies

Supplies expense includes costs for general operating supplies not associated with the cost of goods sold.

Business meal expenses

When not traveling, a business owner can deduct a percentage, generally 50%, of the actual cost of a meal if the following conditions are met:

- The meal expense was an ordinary and necessary expense in carrying on the taxpayer's trade or business;
- The expense was not lavish or extravagant under the circumstances;
- The taxpayer was present at the meal;
- The meal was provided to a current or potential business customer, client, consultant, or similar business contact; and
- In the case of food or beverages provided during or at an entertainment event, the food and beverages were purchased separately from the entertainment, or the cost of the food and beverages was stated separately from the cost of the entertainment on one or more bills, invoices, or receipts.

Taxes and licenses

Taxpayers can deduct taxes and license fees paid in the operation of their business. Examples include:

- State and local sales taxes imposed on the taxpayer as the seller of goods or services
- Real estate and personal property taxes on business assets
- Certain licenses and regulatory fees

State or local income taxes cannot be deducted on Sch C.

Travel expenses

Travel expenses are the ordinary and necessary expenses of traveling away from home for business. Examples of deductible travel expenses are in the NTTC 4012, Income tab.

Utilities

Utilities typically consist of normal electric, gas, water, and telephone expenses incurred for the business. There should be no deduction for personal expenses or expenses for a home office in this category.

Kiana runs a small business from her home. She has only one phone landline and frequently makes long- distance calls for business. The cost of the basic phone line cannot be deducted, but Kiana can deduct the long-distance or additional charges for her business calls.

Other expenses

Taxpayers may also be able to deduct other ordinary and necessary business expenses not deducted elsewhere on Sch C. Here are a few examples.

Education or training: Taxpayers can deduct the cost of their education expenses (including certain related travel) related to the trade or business. Taxpayers must be able to show the education maintains or improves skills required in their trade or business, or that it is required by law or regulations, for keeping a license to practice, status, or job..

De minimis safe harbor: Taxpayers may elect to apply a de minimis safe harbor to amounts paid to repair, acquire or produce tangible property used in the taxpayer's trade or business. They may use this safe harbor to deduct amounts paid for tangible property up to $2,500 per invoice or item (substantiated by invoice) if they have accounting procedures in place whereby they deduct amounts paid for business property if the costs of such property are under a certain de minimis amount.

The de minimis safe harbor election does not include amounts paid for inventory or land. The election applies for the taxable year and, if made, applies to each expenditure meeting the criteria for the election.

Make the election by attaching a statement titled "Section 1.263(a)-1(f) de minimis safe harbor election" to a timely filed original federal tax return including extensions for the taxable year in which the de minimis amounts are paid. The statement should include the taxpayer's name, address, and Taxpayer Identification Number, as well as a statement that the taxpayer is making the de minimis safe harbor election. This can also be accomplished by clearly labeling the expense as "Section 1.263(a)-1(f) de minimis safe harbor election" in Other Expenses.

Barry makes his living as a handyman and earned $17,438 during the tax year. In the same year, Barry bought a new ladder for $450 and uses it exclusively in his business. In keeping his books and records, Barry uses an accounting procedure whereby he expenses amounts he pays for business equipment if the cost of the equipment is $1,000 or less. Under the de minimis safe harbor, Barry can deduct the full cost of the ladder as a business expense, as well as any other equipment purchases of $1,000 or less.

Inventory exception for small business taxpayers: A small business taxpayer can choose not to keep an inventory when the cash basis is the method used in their books and records. Business purchases can be expensed as other expenses instead of using the Cost of Goods section of Sch C. Tax returns for taxpayers who wish to maintain inventories or had inventories at the beginning of the year (a change in method of accounting form must be filed) are out of scope.

How do I complete Schedule C?

Refer to the NTTC 4012, Tab D, Business Income for software entries and guidance on completing Sch C. The following is provided as an overview.

General information section

Accounting method — only cash method is in scope; if taxpayers use another method, their return is out of scope.

Materially participate in the operation of the business — in general, the taxpayer materially participates if based on all the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis during the year. See the Sch C Instructions for specific tests to determine if the taxpayer meets the requirements for material participation. If the taxpayer does not materially participate or is uncertainty about materially participating in the business, their return is out of scope.

Did the business make any payments in the tax year that would require filing of Form(s) 1099? — only a "No" answer is in scope as discussed above

Part I: Income

Enter each tax form (1099-NEC, 1099-K, etc.) that the taxpayer received for their business. Also enter income that was not reported on a form.

Determine if the taxpayer received business income that was not reported on a tax form. For example, tips received by self-employed hair stylists or manicurists are to be included in Line 1 gross receipts on Sch C. ***Do not enter on line 6, Other Income****.*

Part II: Expenses

On Sch C there is a separate line for the most common expenses that are incurred in a business. The taxpayer will decide whether a particular expense is ordinary and necessary for their business. Your role is to inform the taxpayer of the rules and ask probing interview questions to resolve incomplete or inconsistent data.

Part III: Cost of Goods Sold

This part relates to inventory and is out of scope.

Part IV: Information on Your Vehicle

This includes information for claiming the standard mileage rate for vehicle expenses.

Part V: Other Expenses

This includes all ordinary and necessary expenses not deducted elsewhere on Sch C. Report the cost of purchases as other expenses and not as cost of goods sold for a small business using the cash method of accounting.

Exercises (continued)

Question 2: Daniel has his own business. He received Form 1099-NEC for $13,000 for work he completed as an independent contractor. He also received cash payments that total $2,500 for other jobs he completed for different individuals. Must Daniel report the cash payments of $2,500 on his return?

a. Yes
b. No

Question 3: Ellen has a small business. The gross income from her business is $40,000, her business expenses total $11,500, and she must file a Sch C. Is Ellen's tax return in scope?

a. Yes
b. No

Taxpayers who report a profit on Sch C may be able to deduct up to 20% of their qualified business income on Form 1040 as a qualified business income deduction. For more information, see the Deductions lesson 19.

Recordkeeping

Taxpayers are responsible for maintaining records needed to determine their correct tax liability. That includes records of income and expenses for their business. Refer to Pub 334, Tax Guide for Small Business and Pub 583, Starting a Business and Keeping Records, for more information.

Why keep records?

Everyone in business must keep records. Good records will help the taxpayer do the following:

- Monitor the progress of their business
- Prepare their financial statements
- Identify source of receipts

- Keep track of deductible expenses
- Prepare tax returns
- Support items reported on tax returns

Kinds of records to keep

Except in a few cases, the law does not require any specific kind of records. Taxpayers can choose any recordkeeping system suited to their business that clearly shows their income and expenses.

The recordkeeping system should include a summary of business transactions. This summary is usually made in the taxpayers' books and records (for example, accounting journals, and ledgers). The books and records must show the gross income, as well as the deductions and credits. For most small businesses, the business checkbook is the main source for entries in the business books and records. In addition, supporting documents must be kept.

Supporting documents

Supporting documents include sales slips, paid bills, invoices, receipts, deposit slips, bank or credit card statements, and canceled checks. These documents contain information that must be recorded in the business books and records.

When a business involves the use of a vehicle, a mileage log would be a supporting document.

It is important to keep these documents organized and in a safe place because they support the entries in the business books and records, and on the tax return. For instance, organize them by year and type of income or expense.

Records include electronic records. Taxpayers should retain paper and electronic records that support their tax return data.

Reconstructing records

Make adequate inquiries to be satisfied that the taxpayer is carrying on a business and that the income and expenses reported on the tax return are substantially correct and complete.

You may help a taxpayer with simple record reconstruction. Assisting the taxpayer in reconstruction will help teach the taxpayer about recordkeeping. Extensive record reconstruction is the responsibility of the taxpayer. If you are not satisfied with the accuracy of the reconstructed records, you have the right to decline to prepare the return. See your Coordinator for guidance in these situations.

The goal of record reconstruction is to use available documentation to develop a sound and reasonable estimate of the taxpayer's business income and expenses to support the Sch C prepared. When reconstructing records, you can use such tools as:

- Appointment books or calendars
- Online map tools or apps that track business miles
- IRS standard allowances
- Checkbooks and canceled checks
- Cash apps and accounting software
- Bank or credit card statements
- Lists of regular clients
- Partial receipts or sales tax records
- Cell phone records, call history, or computer logs
- Prior year returns

How long to keep records

Generally, taxpayers must keep records that support income or deductions on a return until the statute of limitations for that return runs out.

The statute of limitations is the time period in which a taxpayer can amend a return to claim a credit or refund, or the IRS can assess additional tax. For more information on recordkeeping see Pub 583, Starting a Business and Keeping Records.

Taxpayer interview and tax law application

Remember our taxpayer, Dana, with a babysitting business? She said she made $14,000 in net profit from her business, and wants to claim the EIC. After careful interviewing, the volunteer has determined the return cannot be completed without record reconstruction. The volunteer asked Dana to go home and return with some documentation to support her claims.

Based on the taxpayer's materials and additional questions, you may now have a good indication if Dana should be claiming expenses for business use of her home. A home office, generally requires regular and exclusive use of a portion of the home. If she has claimed a home office in the past or appears to qualify for a home office, you should confirm with your Coordinator that her tax return is out of scope.

Sample interview

Volunteer Says…	Dana Responds…
Nice to see you again, and I see you have some additional materials. What kind of documentation were you able to put together?	As you suggested, I completed a calendar that shows the number of children that I cared for on each date.
That sounds great. First, let's multiply the number of children that you cared for by the corresponding charged rate to confirm your income figure. Did you also bring documents to support your business expenses?	Yes, I have some grocery store receipts, canceled checks, bank statements, and credit card statements. I have highlighted the regular purchases I made for my business.
OK, then we'll calculate a reasonable estimate of expenses incurred.	Good. I'm sure my first estimate of $14,000 business income is not accurate after all. I appreciate learning what I need to do to keep track of my income and expenses.

Self-employment tax

Self-employment tax is due on the net profit from self-employment. The software will automatically calculate the required tax and the adjustment to income for the portion of the tax that is deductible. See the Other Taxes lesson 27 and Adjustments to Income lesson 17 for additional information.

Summary

This lesson explained:

- What is or is not a business
- Certain situations involving Sch C and EIC should raise "red flags"
- Where to get business income and expense information
- Cash income must be reported
- Subcontractors or individuals who receive less than $600 may not receive Form 1099-NEC, Form 1099-MISC, or Form 1099-K, but still must report all taxable income
- What business expenses are within scope

- Additional inquiries about the taxpayer's income and expenses may be necessary to ensure an accurate return
- How to complete Sch C
- The records that should be maintained
- How to complete a simple record reconstruction

Where to find more information

NTTC's Schedule C Guidelines

Pub 17, Your Federal Income Tax

Pub 334, Tax Guide for Small Business

IRS.gov on crowdfunding

Pub 463, Travel, Gift, and Car Expenses

Pub 583, Starting a Business and Keeping Records

IRS.gov with information for gig workers

IRS.gov with information on family caregivers who may have a business

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Sch C with:
  - Gambling, day trading, student athletes with NIL income, hobby income, or not-for-profit activity
  - Bartering income
  - Returns and allowances
  - Cost of goods sold (inventory), if not able to expense purchases when paid under the exemption for small businesses
  - Expenses over $50,000
  - Expenses for employees
  - Business use of home deduction
  - Contract labor expense
  - Casualty losses
  - Vehicle expenses reported as actual expenses
  - Depreciation or the election to expense business assets (other than the de minimis expense safe harbor election)
  - Rental or lease expenses – vehicle leases of more than 30 days (other than leased vehicles for which the standard mileage method is used)
  - Accounting methods other than the cash method
  - Net losses
  - A "No" response that indicates the taxpayer does not meet any of the tests for material participation, or is uncertain about materially participating in a business

- Taxpayers who wish to report less than the full amount of taxable income, whether received through credit cards or otherwise
- A “Yes” response indicating there is a requirement to file Form(s) 1099
- Income from the manufacture, distribution, or trafficking of controlled substances (such as marijuana) or any other illegal activity

- Taxpayers with farm income
- Taxpayers who must answer Yes to the digital asset question on Form 1040

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the practice lab on L&LT.

Exercise answers

Answer 1: a, Yes. Jason meets all requirements to be considered in scope.

Answer 2: a, Yes. The cash payments must be included in Daniel’s gross receipts the same as the $13,000 reported on Form 1099-NEC. Cash payments are compensation for his services and must be reported on his Sch C.

Answer 3: a, Yes. Ellen’s total business expenses are within the scope limit.

Income – Capital Gain or Loss

Introduction

Gains that are derived from the sale of investments are called capital gains and may be subject to tax rates that are lower than those on ordinary income — often, a zero tax rate.

This lesson includes topics on the sale of stock, mutual funds, certain bonds, and the sale of a personal residence. If the taxpayer sold any other taxable investment or personal asset, the return is out of scope.

Transactions involving a digital asset (virtual currency, etc.) are out of scope. However, the tax return is in scope if the taxpayer can check the "No" box on Form 1040. Refer to the Tax-Aide Scope Manual and Form 1040 Instructions for details on digital assets.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1040 Instructions
- Form 1040, Sch D & Instructions (capital gains & losses)
- Form 1099-B (broker proceeds)
- Form 1099-DIV (dividends)
- Form 1099-S (real estate proceeds)
- Form 8949 (disposition of capital assets)

Objectives

This lesson will help you assist taxpayers who must use Form 8949, Sales and Other Dispositions of Capital Assets, in conjunction with Form 1040, Sch D, Capital Gains and Losses, to report capital gains and/or losses on the sale of assets. At the end of this lesson, using your resource materials, you will be able to:

- Determine the adjusted basis of investment securities
- Determine if the asset's holding period is long-term or short-term
- Calculate the taxable gain or deductible loss from the sale of capital assets
- Determine the amount of a capital loss allowed and the amount carried over to the next year
- Determine whether a home is the taxpayer's main home
- Determine if a taxpayer can exclude gain on the sale of a main home by:
  - Meeting the ownership and use tests, including eligibility for suspension of the 5-year period
  - Meeting the prior sale test
  - Satisfying the requirements for married couples or surviving spouses

The Tax-Aide Intake Booklet asks about income from the sale of property such as stock, bonds, digital assets, or real estate. Ask taxpayers if they sold any stock, securities, other investment property, or a home during the tax year.

Reporting a capital gain or loss

First, identify the asset(s) disposed to make sure that the return is in scope. Most of the time, the tax form or broker's statement will provide all the information you need to input into the software. This includes:

- Proceeds from the sale:
  - Form 1099-B reflects gross or net proceeds for a security
  - Form 1099-S usually reflects gross proceeds of real estate transactions
- Basis and/or adjusted basis:
  - Basis is the original cost of the asset

- Adjusted basis of an asset includes the original cost, including commissions and fees on the purchase, plus any increases or minus any decreases to that cost

- Holding period (when acquired and when disposed):
  - Short-term property is held one year or less
  - Long-term property is held more than one year

We will refer to the payers who are required to report on Form 1099-B as "brokers." Payers include brokerages, mutual funds, transfer agents, etc.

All brokers must report the securities sold, the sales price (net of commissions), and the sale date. If the securities sold were covered securities, the broker must also report cost or other basis, the date acquired, and whether the gain or loss is short-term or long-term on Form 1099-B.

Covered securities are stocks, mutual funds, ADRs, and bonds that are subject to additional reporting by the taxpayer's broker on the applicable 1099 form. Securities acquired prior to the effective date of the additional reporting requirements are called noncovered securities.

Taxpayers will have to provide the basis, holding period, or other missing information when it is not available on the tax form or the brokerage statement, including supplemental pages the broker provides.

Taxpayers may receive a consolidated tax statement from their broker that can be many pages in length. Be sure to review the entire statement during your interview with the taxpayer to identify out-of-scope issues as early as possible.

What is the basis of stock?

Investors buy securities at various times, in various quantities, and at various prices. For a **covered** security, you can use the basis reported on Form 1099-B or the broker's statement. The following is for general information and in case the securities are noncovered.

Many investors reinvest dividends using a DRIP (dividend reinvestment plan). With a DRIP, cash dividends are automatically used to buy additional shares. The dividend is reported as discussed earlier in the Income – Wages, Interest, Etc. lesson 8. Upon reinvestment, the newly acquired shares have a new basis and a new purchase date.

Taxpayers may use the average cost method of keeping track of their basis for mutual fund shares:

- The original basis of mutual fund shares bought is usually their purchase price. The purchase price includes any commissions or load charges paid for the purchase.
- Reinvested dividends work the same as a DRIP above.
- Basis is recomputed each time there is an additional purchase to compute an average cost for all the shares held of that particular mutual fund.

Most mutual funds and brokers use this average cost method for mutual fund shares unless the taxpayer has elected a different method, such as first-in-first-out or specific identification.

Mike paid $1,000 for 100 shares of XYZ mutual fund. The original basis was $10 per share ($1,000 ÷ 100). Later, he purchased another 10 shares for $72.50. His total basis of $1,072.50 is spread over 110 shares or $9.75 per share using the average cost method.

For **noncovered** securities, the broker will provide the basis information if they have it. If the securities sold were noncovered securities, brokers often report cost or other basis of securities in supplemental pages to the year-end tax statement furnished to the taxpayer.

The 1099-B or broker's statement identifies noncovered security sales. You may see that information is missing, particularly basis. The taxpayer must provide their basis, adjusted as necessary, in the securities sold.

- If taxpayers need help determining their basis and do not have the original purchase documents, refer them to Pub 551 and their broker.
- If taxpayers cannot provide their basis in the property, the IRS will deem it to be zero.

It is important for the taxpayer to keep track of the basis per share of all their securities.

In some cases, basis is not determined by a purchase price. These special rules are covered in this lesson in the topic, “Basis other than cost.” As a volunteer, you are not expected to determine the basis in these situations. The return is out of scope if the taxpayer cannot provide the missing information and/or does not want to use zero for the missing basis amount.

Adjusted basis

Events that occur after the purchase of the stock can require adjustments (increases or decreases) to the “per share” basis of stock. Again, the broker will keep track of all these for covered securities. The original basis per share can be changed by events such as the following.

- Stock dividends are issued in lieu of cash dividends. These additional shares increase the taxpayer’s number of shares held, but do not increase the total cost. The adjusted basis of the original stock shares is split among the new total of shares, including the new shares issued as a dividend. This lowers the taxpayer’s basis per share.

Alice paid $1,100 for 100 shares of ABC, Inc. stock. The original basis per share was $11 ($1,100 ÷ 100). She received 10 additional shares as a tax-free stock dividend. Her $1,100 basis must be allocated to the 110 shares (100 original shares plus the 10-share stock dividend). This results in an adjusted basis of $10 per share ($1,100 ÷ 110).

- A stock split is a method used by corporations to lower the market price of stock. A two for one stock split doubles the number of shares held and therefore decreases the basis per share by half. For example, the original basis of $200 for 100 shares ($2 each) becomes $200 for 200 shares ($1 each). A reverse split is similar but the number of shares are reduced, not increased.
- A wash sale is the sale of securities at a loss and the acquisition of the same (substantially identical) securities within 30 days of the sale date (before or after).
    - Taxpayers cannot deduct losses from the disposition of securities in a wash sale (unless the loss was incurred in the ordinary course of business as a dealer in stock or securities, which is out of scope).
    - The disallowed loss is added to the cost of the new securities. The result is an increase to the basis in the new securities. This adjustment postpones the loss deduction until the disposition of the new securities.
    - The holding period for the new securities is increased by the holding period of the stock or securities disposed.

The taxpayer buys 100 shares of X stock for $1,000. The taxpayer sells these shares for $750 and within 30 days from the sale buys 100 shares of the same stock for $800. Because the taxpayer bought substantially identical stock, the taxpayer cannot deduct the loss of $250 on the sale. However, the taxpayer adds the disallowed loss of $250 to the cost of the new stock, $800, to obtain the basis in the new stock, which is $1,050. The broker will track all this.

The reporting of wash sales is in scope only if reported by the broker on Form 1099-B (Box 1g) with code W.

Brokers will make the appropriate adjustments to the basis of stocks, bonds, and mutual fund shares for covered securities. Still, taxpayers should keep track of their basis.

Basis other than cost

There are times when cost cannot be used as basis. This discussion is for informational purposes. The taxpayer is responsible for providing basis information when it is not provided by the broker. If the taxpayer

cannot provide the basis information, the return is out of scope (assuming using a basis of zero is not acceptable).

- Property received as a gift: To determine 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. Taxpayers also need to know the FMV at the time of the gift and the amount of any gift tax paid on the donation. Lastly, the basis used (adjusted cost or FMV) will depend on whether the disposition is at a gain or a loss.
- Inherited property
  - For inherited property, the extent to which the property is stepped to FMV may depend on how the property was owned and state law. These are complex legal questions.
  - Before 2010 and after 2010: the basis of property inherited during this time is generally the FMV of the property on 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 or other acceptable method.
  - During 2010 (after December 31, 2009, and before January 1, 2011): the basis of property inherited from a decedent who died in 2010 could be the FMV as in the preceding bullet or it could be a different amount as shown on the decedent's estate tax return (Form 706).
- The basis of securities acquired through an employee stock option is generally the amount of money they used to exercise the option plus the amount of compensation that the employee included in income when the option was granted or at the time of exercise.

F3922 reports the acquisition of shares from the exercise of a stock option. The form is information for the taxpayer, who remains responsible for providing the cost basis of shares upon disposition. If the taxpayer is unable to do so and using zero for basis is not acceptable, the return is out of scope.

If the taxpayer knows the basis of property that was acquired in one of the situations listed above, you can provide assistance. If they do not know the basis of the property, the return is out of scope.

How do I determine the holding period?

Determining the correct holding period is important because short-term gains are taxed at regular income tax rates and long-term gains are taxed at a lower rate than other income reported on the return.

The purchase and sell dates will determine the holding period. Capital gains and losses are either long-term or short-term, depending on how long the taxpayer owned the security.

- One year or less has a short-term holding period
- More than one year has a long-term holding period

When you enter the sale date and the purchase date into the software, it will compute whether it is short-term or long-term.

Investors buy securities at various times, in various quantities, and at various prices. For a **covered** security, you can use the acquisition date reported on Form 1099-B or the broker's statement. A broker's summary of Form 1099-B reporting can also be used, especially for covered securities. The summary can be used if the basis information is complete.

Ana's broker statement shows a summary of covered short-term gains and losses and covered long-term gains and losses. After you confirm that the underlying securities are in scope, you can enter the summary information and do not need to list each disposition.

Assume Ana's broker statement showed a noncovered security long-term gain or loss. You confirm that the security is in scope and that the broker included the basis in the summary. You can enter the summary information and do not need to list each disposition.

The following is a recap of the basic rules:

- Each purchase has its own acquisition date. Multiple purchases of the same security will mean that some may be long-term and some may be short-term when sold. This is also true for mutual fund shares for which the average cost method may be used.
- Stock acquired in a DRIP has its own purchase date.
- Stock acquired as a nontaxable stock dividend or stock split has the same holding period as the original stock owned. They are considered to have been acquired on the same day as the original stock.
- The holding period for stock received as a taxable stock dividend begins on the date of distribution.
- For property that was inherited, a special rule applies and the capital gain or loss is treated as long-term regardless of how long it was actually held by the beneficiary.
- The acquisition date of property acquired as gift depends on how the basis to the donee was determined. The taxpayer must provide the holding period information or you will not be able to assist with their tax return.

If taxpayers cannot provide the date of acquisition and disposition, refer them to their broker or financial advisor.

Lenny bought 500 shares of XYZ Corporation stock for $1,500, including his broker's commission. Five years later, XYZ distributed a 2% nontaxable stock dividend (10 shares). Three days after the stock dividend was distributed, Lenny sold all his XYZ stock for $2,030.

Although Lenny owned the 10 shares for only three days, all the stock has a long-term holding period. Stock acquired as a nontaxable stock dividend has the same holding period as the original stock owned. Because he bought the stock for $1,500 and then sold it for $2,030 more than a year later, Lenny has a long-term capital gain of $530 on the sale of his 510 shares.

Although brokers and mutual fund companies are not required to report basis and purchase date information for noncovered securities, most brokers provide supplemental information that can be used if the taxpayer concurs with the information. If the broker says it's long-term, you can use that.

Bonds

Bonds that mature or are sold with no gain or loss, or are reported on a brokerage statement with capital gain or loss only (no ordinary income/loss), are in scope for Tax-Aide.

Worthless securities

The disposition of totally worthless securities is in scope for Tax-Aide. However, securities worth anything, even $1, are not totally worthless. If held in a brokerage account, the disposition will appear on the consolidated brokerage statement.

1099-B or broker information

The tax return is out of scope if any of the following 1099-B boxes has an entry:

- Accrued market discount
- Profit or (loss) realized on closed contracts
- Unrealized profit (loss) on open contracts – prior year
- Unrealized profit (loss) on open contracts – current year
- Aggregate profit (loss) on contracts
- Proceeds are from collectibles
- Bartering
- The FATCA box is checked

Most brokers report using a substitute Form 1099-B, not the IRS form. All the same information is included, but the order of the information may vary. Be sure you have all the pages of the broker's tax statement, not just the summary pages. Carefully review the entire broker statement during the interview to confirm that all transactions are in scope.

Somewhere in a multi-page broker's tax statement, you may find:

- Investment expenses that would be possible itemized deductions (subject to the 2% threshold) that are suspended through 2025. State tax treatment may differ.
- Interest expense or margin interest. Such interest is investment interest and if the taxpayer is itemizing deductions, the return is out of scope.
- Miscellaneous income may be from an investment that is out of scope, such as a virtual currency investment.
- Detail listing of all the sales that comprise the summary 1099-B. You should briefly review for out-of-scope investments such as stock options, futures, virtual currencies, etc.

Check with your Coordinator or a more experienced Counselor if you are unsure whether an item is in scope or not.

For state purposes, you may need to determine if interest income or money market dividends from a federal fund is taxable. The broker or mutual fund will have a supplemental sheet on its website with the relevant information. Ask the taxpayer to download that information for your use if they wish to possibly exclude some of the income for state purposes.

Exercises

Refer to the Tax-Aide Scope Manual and NTTC 4012 to answer this exercise. Answers are at the end of the lesson.

Question 1: Which of the following found on a broker's consolidated tax statement are in scope?

a. 1099-DIV has an amount for collectibles (28%) gain
b. 1099-INT has an amount for market discount
c. 1099-B indicates the transaction is short-term
d. 1099-B indicates it's a noncovered security and basis has not been reported to IRS

Reporting capital gains and losses

The Volunteer Reference Guide, Tab D, Income, shows how to enter the data into the software and includes a list of adjustment codes that can be used when completing Forms 8949. The software now supports the simpler Sch D direct input of sale transaction when all sales were of covered securities and there are no adjustments.

In the rare event that the net proceeds on Form 1099-B are not correct, do not change the sales price amount. Instead, use the adjustment column on Form 8949 with the proper code.

What about capital losses?

Taxpayers can deduct capital losses up to the amount of their capital gains plus $3,000 ($1,500 if married filing separately). Net capital losses (i.e. losses less gains) that exceed the limit or exceed taxable income before the capital loss deduction become capital loss carryovers. The unused net capital loss carries over to subsequent years until used; it does not expire.

Be sure to review the Tax-Aide Intake Booklet, any taxpayer notes in the software, and notes on the prior year's documents envelope for a capital loss carryover. Check the prior year's return for a capital loss deduction on Form 1040. If the capital loss deduction was capped at $3,000/$1,500, then any excess loss will

carry over. A more commonly missed capital loss carryover situation is when the taxpayer had a capital loss deduction and they did not have enough taxable income to absorb the full deduction, i.e. taxable income would end up negative so the taxpayer did not get full benefit for their capital loss deduction.

Capital loss carryover worksheet

If there appears to be a capital loss carryover, look for the capital loss worksheet in the prior year's return. Note that the software may have already brought the carryover amount into the current year's return.

If needed, use the Capital Loss Carryover Worksheet from the Form 1040, Sch D instructions to compute the amount of capital loss carryover from the previous year. To complete the worksheet, you will need information from the prior year's return.

If the taxpayer's current year capital loss exceeds the deduction limit and the remainder must be carried forward to the next tax year, remind the taxpayer to bring their copy of the current year's return to assist in preparing next year's return. Make a note on the outside of the taxpayer's tax return record envelope to alert next year's preparer.

Exercises (continued)

Question 2: Kevin paid his broker a $75 fee on the sale of his stock. His Form 1099-B shows $925, and the box next to net proceeds is checked. What is the amount Kevin reports as his sales price?

- **a.** $925
- **b.** $1,000
- **c.** $850
- **d.** $75

Taxpayer interview and tax law application

Taxpayers Jeremy and Janice Smith indicated that they had sales of stock on the Tax-Aide Intake Booklet. The volunteer asks for details.

Sample interview

Volunteer Says…	Jeremy Responds…
Previously we discussed your dividends from the Pembroke Fund, reported on Form 1099-DIV. Did you have any other income from the sale of stock, securities, or other investments?	Yes, I sold some stock this year.
Do you have a Form 1099 for that?	Yes, I have this broker's statement.
We already discussed the capital gain distribution from the mutual fund when we entered the dividends. We'll examine the stock sale information now. I see the broker's statement has the sale details I need, but not the acquisition information. Do you know when you purchased the Purdue stock?	I bought the Purdue stock back on July 13, 2000.
I see the sale date was March 10, 2024. That means the holding period for the stock was more than one year. They call that long-term, and it determines both where the information is reported and the tax rate for any gain. Now, do you know the basis for the stock?	What is that?
That's what it cost you, including any broker fees or commissions.	Yes, it cost $10,053, plus I had to pay $35 in fees.

Volunteer Says…	Jeremy Responds…
Have you had any other costs, stock dividends, or stock splits related to the stock since then, such as additional fees?	No, that's it. Wait, when I sold it, I had to pay $35 more.
That means that the basis for the stock is $10,088. The Form 1099-B shows that you received net proceeds of $8,859 when you sold the stock so the $35 you paid on the sale is already taken into account. After I enter these other transactions from the broker's statement, we'll get a final net gain or loss on Sch D. This will determine the amount that will be reported on Form 1040. [*Indicate Jeremy's responses to these questions on the Tax-Aide Intake Booklet*.]	

Sale of home

The Tax-Aide Intake Booklet asks about the sale of real estate. Ask taxpayers if they sold any real estate, such as their principal residence or "main home" during the tax year. The taxpayer may be eligible to exclude all or part of the gain from their taxable income. Only the sale of a personal residence used by the taxpayer or spouse, if filing jointly, is in scope. The sale of real estate other than a home used as a residence by the taxpayer or their spouse is out of scope.

Bertha inherited her mother's house in February 2024 and sold it in November. She did some minor fix-ups to the house but did not use it as her home. You will not be able to help Bertha with her tax return because it is out of scope since she did not use the home as a residence herself.

If the home was ever used in a business or if the home (or part of a home) was ever rented out, the return is out of scope.

Who must report the sale of a home on their tax return?

Taxpayers must report the sale of a home if ANY of the following is true:

- If it's the taxpayer's home and the taxpayer:
  - Does not meet the ownership and use tests for the exclusion
  - Does not meet the look-back test
  - The taxpayer has a gain and chooses not to exclude it or the gain exceeds the maximum exclusion
  - Has a gain and qualifies for a reduced exclusion only
- The taxpayer received Form 1099-S

Generally, if the taxpayer can exclude all of the gain and did not receive Form 1099-S, it is not necessary to report the sale. If the taxpayer has gain that cannot be excluded, it is taxable and reported on the return whether or not Form 1099-S was received. A loss on the sale cannot be deducted, however, the taxpayer may be required to report it.

Refer to Pub 523, Selling Your Home for additional guidance, transfers to a spouse or former spouse, or in cases of divorce or separation.

What is the sale of main home exclusion?

Taxpayers who sold their main home may be able to exclude gain up to a maximum of $250,000 ($500,000 for married taxpayers who file a joint return or for certain surviving spouses).

What is considered a "main" home?

Only gain from the sale of a taxpayer's main home may be excluded from the taxpayer's income; gain from the sale of a home that is not the taxpayer's main home will generally have to be reported as taxable.

A taxpayer's "main" home is where they live most of the time. It does not have to be a traditional house; for example, it may be a houseboat, mobile home, cooperative apartment, or condominium, but it must have

cooking, sleeping, and bathroom facilities. The taxpayer's main home may also be a rented house or apartment. Taxpayers with more than one home cannot choose which home to designate as their main home.

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. Even though she does not own it, Lucille's main home is her rental apartment in Denver, because she lives there most of the time.

What are the ownership and use tests?

To claim the exclusion on the gain from the sale of a home, the taxpayer must meet the ownership and use tests. This means that during the five-year period ending on the date of the sale, taxpayers must have:

- Owned the home for at least two years (the ownership test), and
- Lived in the home as their main home for at least two years (the use test)

There are special rules for members of the Armed Forces, intelligence personnel, and Peace Corps volunteers in the application of the five-year period. See "Five-year Test Period Suspension" later in this lesson.

The required two years of ownership/use do not have to be continuous. Taxpayers meet the tests if they can show that they owned and lived in the property as their main home for either a total of 24 full months or 730 days (365 x 2) during the five-year period ending on the date of sale. Short, temporary absences are counted as periods of use even if the property is rented during those absences.

Also, if the taxpayer becomes physically or mentally unable to care for themselves, and used the residence as their principal residence for 12 months in the 5 years preceding the sale or exchange, any time spent living in a care facility (such as a nursing home) counts toward the 2-year residence requirement, so long as the facility has a license from a state or other political entity to care for people with the taxpayer's condition.

The 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.

Helen lived in a rented apartment in 2016. The apartment building was later changed to a condominium, and she bought her unit on December 1, 2020. In 2022, Helen became ill and on April 14 of that year she moved into her daughter's home. On July 10, 2024, while still living in her daughter's home, she sold her unit.

For the 2024 tax year, Helen can exclude all the gain on the sale of her condominium because she met the ownership and use tests. Her five-year period is from July 11, 2019, to July 10, 2024, the date she sold the condominium. She owned her unit from December 1, 2020, to July 10, 2024 (over two years). She lived in the unit from July 11, 2019 (the beginning of the five-year period) to April 14, 2022 (over two years).

Exercises (continued)

Question 3: Emily, who is single, bought a home in 2010. She lived in the home until January 1, 2019, when she accepted a temporary job assignment in Venezuela and left the house vacant. Emily returned to her home on December 31, 2020 and lived there until she sold the house on January 10, 2024. Does Emily meet the ownership and use test?

a. Yes
b. No

What is the look-back test?

To be able to claim any exclusion, the taxpayer must not have claimed an exclusion on a gain from the sale of another home during the two-year period ending on the date of the sale. A taxpayer may choose to amend their prior return and elect out of the exclusion, in which case they could then use the exclusion for the current year's sale if it qualifies.

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 of these conditions:

- They file a joint return
- Either spouse meets the ownership test
- Both individuals meet the use test
- Neither one excluded gain in the two years before the sale of the current home

If either spouse does not satisfy all these requirements, they cannot claim the maximum exclusion ($500,000). The most they can claim is the total of the maximum exclusions each 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 out of scope.

Sale of main home by surviving spouse

If a surviving spouse doesn't meet the 2-year ownership and residence requirements on their own, and hasn't remarried at the time of the sale, then they may include any time when the late spouse owned and lived in the home, even if without the taxpayer, to meet the ownership and use tests.

An unmarried surviving spouse can claim the maximum exclusion for a married couple ($500,000) if the sale occurs no later than two years after the date of the spouse's death, and all other requirements are met.

Upon the death of the first spouse, some or all of the property may have a new basis based on the fair market value on the date of death. Generally, the basis of the home steps up or down to the value on the date of death for the decedent's half of the home in a separate property state. The entire home's basis steps to the value on the date of death in a community property state when the home was community property. However, the extent to which property is stepped to FMV is a complex legal matter that can vary by state. A step-up in basis may substantially reduce the amount of gain.

If the taxpayer knows the basis of property that was inherited, you can provide assistance. If they do not know the basis of the property, the return is out of scope.

Reduced exclusion

Taxpayers who owned and used a home for less than two years (do not meet the ownership and use test) may be able to claim a reduced exclusion under certain conditions. These include selling the home due to a change in place of employment (beyond a certain distance), health, or unforeseen circumstances as more fully described in Pub 523. If any apply, the return is out of scope.

What if there was nonqualified use?

Gain from the sale or exchange of a main home is not excludible from income if allocable to periods of nonqualified use. Generally, nonqualified use means any period in 2009 or later where neither the taxpayer nor spouse (or former spouse) used the property as a main home (with certain exceptions). A list of exceptions to a period of nonqualified use can be found in Pub 523. If the taxpayer had nonqualified use, the return is out of scope.

How do I compute the gain (or loss) from the sale of a home?

After determining that a taxpayer is eligible for the exclusion, figure the gain (or loss) on the sale based on the selling price, basis, and adjusted basis (including selling expenses). If the selling price of the taxpayer's home is less than the allowable exclusion of up to $250,000 ($500,000 if married filing jointly or eligible surviving spouse), it is not necessary to calculate the gain; none of it will be taxable. Loss on the sale of a residence is not deductible.

If the taxpayer ever used the home for business purposes or as rental property, or if the taxpayer did not use it as their residence, the return is out of scope.

Selling price

The selling price is the gross amount the taxpayers (the seller) received for their 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 Form 1099-S, Proceeds from Real Estate Transactions, use it to report the selling price. Box 1 shows the date of sale (closing) and Box 2 shows the gross proceeds received from the sale of the home. For taxpayers who did not receive a Form 1099-S, use sale documents and other records.

Use the gross selling price on Form 8949. Selling expenses are discussed below.

If the taxpayer can exclude the entire gain from the sale of a main home, the person responsible for closing the sale (i.e., a real estate broker or settlement agent) generally will not issue Form 1099-S. If Form 1099-S is issued and you determine that the gain is excludible, the sale should be reported on Form 8949 and Sch D to notify the IRS of the exclusion.

Basis

The basis in a home is determined by how the taxpayer obtained the home. If a taxpayer bought or built a home, the basis is what it cost the taxpayer to buy or build that home. If the taxpayer inherited the home, the basis is generally its fair market value on the date of the decedent's death, or on the later alternate valuation date chosen by the representative for the estate.

Valuation issues and determining the adjusted basis of property inherited or received as a gift can be very complex. If the taxpayer cannot provide the basis of their home, the return is out of scope.

Adjusted basis

The adjusted basis is the taxpayer's basis in a home increased or decreased by certain amounts.

Adjusted basis = Basis + Increases – Decreases

Increases include additions or improvements to the home such as building a recreation room or adding a bathroom. In order to be considered an increase, the 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 may include:

- Deductible casualty losses.
- Deferred gains a taxpayer postponed from the sale of a previous home before May 7, 1997.
- Depreciation during the time the home was used for business purposes or as rental property.
- Certain income tax credits such as the first-time homebuyer credit or a residential energy credit.

If any of these decreases apply, the tax return is out of scope.

Decreases will also include the cost of items removed from the property. An example would be a new furnace that is later replaced with a second new furnace. The cost of the first furnace is removed and only the cost of the second furnace will increase basis.

To determine basis adjustments, taxpayers can use Worksheet 2, How to Figure Your Gain or Loss, in Pub 523. While volunteers may provide assistance, the taxpayer has ultimate responsibility for all items on their return.

Selling expenses

Selling expenses reduce the gain or increase the loss. Selling expense may include commissions, advertising fees, legal fees, mortgage points, or other loan charges paid by the seller that would normally have been the buyer's responsibility, such as transfer taxes, courier fees, and many other expenses. Selling expenses would not include items such as proration of homeowner fees, property taxes, interest on the loan to the date of sale,

among others. Some items may be claimed as itemized deductions (property taxes and qualified home mortgage interest). Others are never deductible because they are personal expenses.

Report the total selling expenses as an adjustment (code E). Do not reduce the gross proceeds. Use the gain after the selling expense adjustment to determine the amount of exclusion available, if any.

How much of the gain from a home sale can a taxpayer exclude?

Once you've determined the gain or loss on the sale of a taxpayer's main home and the allowable exclusion, you can determine whether any of the gain is taxable.

If all the requirements are met, an individual taxpayer may exclude up to $250,000 of the gain from taxable income; taxpayers who use the married filing jointly filing status and some surviving spouses may exclude up to $500,000.

Pub 523 contains Worksheet 3, Determine If You Have Taxable Gain, which may be used to figure the gain or loss, the exclusion, and the taxable gain from a sale.

Where do I report any taxable gain from the sale of a home?

The disposition of a home is reported on the tax return if any part of the gain is taxable or if Form 1099-S was received. When completing Form 8949 and Sch D, use adjustment code H to claim the allowable exclusion. Enter both code E (for selling expenses) and code H (for the excluded gain) and the aggregate amount of both as an adjustment.

If the home was used for business purposes or as rental property, the gain would be reported on Form 4797, Sales of Business Property, and the tax return is out of scope.

If the taxpayer sold a home with a taxable gain and is receiving payments in a later year, they may be eligible to report the gain using the installment method. If so, Form 6252 is required. Form 6252 is out of scope.

How do I report a nondeductible loss if taxpayer received Form 1099-S on the sale of a main home?

If the taxpayer has a loss on the sale of a main home for which Form 1099-S was received, the transaction must be reported on Form 8949 and Sch D even though the loss is not deductible. Adjustment code L is used for a nondeductible personal loss. Enter both code E (for selling expenses) and code L (for the nondeductible loss) and the net amount of both as an adjustment to zero out the loss. Reporting the transaction should prevent the taxpayer from receiving a notice from the IRS.

Taxpayer interview and tax law application

Jeremy and Janice Smith checked the "Yes" box for selling some real estate on the Tax-Aide Intake Booklet. The volunteer asks for details.

Sample interview

Volunteer Says…	Jeremy Responds…
Did you sell a home during this tax year?	Yes, I was going to mention that to you because I should get a tax break on that.
Well, you may be able to exclude all or part of your gain from that sale, but to find out, I have to ask you a few questions. First, how long did you own the home?	Three and a half years.
And was it the main place you lived for at least two years of that time?	Yes, we lived there the whole time.
Great, you meet the ownership and use tests. During the two years before you sold the house did you claim an exclusion on a gain from another house?	No, this is my only house.

Volunteer Says…	Jeremy Responds…
Did you receive Form 1099-S?	No, but I do have my paperwork from the sale. My real estate broker said I wouldn't need that form because I was within the limits.
Your paperwork shows a selling price of $360,000. Do you have anything that lists the basis in the home, that is, the cost of the home at the time you bought it?	Yes, I bought it for $280,000 and put in $20,000 of improvements – mostly new bathrooms.
With a basis of $300,000, your gain from the sale is $60,000. As a married couple who meets the ownership and use tests, you can exclude up to $500,000 from the sale, so you don't have to report the sale on your return.	Sounds good.
[Indicate Jeremy's responses to these questions on the Tax-Aide Intake Booklet.]	

What is the five-year test period suspension?

Taxpayers can choose to have the five-year test period for ownership and use suspended during any period the homeowner (either spouse if married) served on "qualified official extended duty," which includes

- serving at a duty station at least 50 miles from their main home or live in government quarters under government order
- being called to active duty for more than 90 days or an indefinite period
- being a member of the armed services or certain foreign service
- being an employee of the intelligence community
- being an employee or volunteer of the Peace Corps.

This means that the taxpayer may be able to meet the two-year use test even if the taxpayer and/or spouse did not actually live in the home during the normal five-year period required of other taxpayers.

Period of suspension

The period of suspension cannot last more than ten years. Together, the ten-year suspension period and the five-year test period can be as long as fifteen years. The suspension can be used on only one property at a time.

This extension of time can apply to taxpayers who have recently left the military.

Peter bought a home in 2014 and lived in it for 2½ years. Beginning in 2017, he was on qualified official extended duty in the U.S. Army. He sold his home in 2024 and had a $12,000 gain. Peter would normally not meet the use test in the five-year period before the sale (2019-2024). Because of the suspension, Peter's test period is the five years before he went on qualified official extended duty.

For more information about the suspension of the five-year test period, see Service, Intelligence, and Peace Corps personnel, in Pub 523.

Exercises (continued)

Question 4: In this exercise, John purchased a home in 2009. Through your interview process, you discover that he sold his main home in 2024. John had not lived in the home for six years. Which of the following conditions would allow John to exclude his gain?

a. John went on sabbatical for four years and backpacked through Europe.

b. John lived with a co-worker for four years and let his brother occupy his home.

c. John was deployed to Europe on official extended military duty for five years.

d. John married and his bride had her own home. The couple chose to live in the wife's home and rent out John's home, until it was sold.

Summary

This lesson covered how to report the sale of capital assets and the sale of a main home. In most cases, a taxpayer must use Form 8949 and Sch D to report capital gains and losses on the sale of assets. You learned how to identify the asset's holding period, adjusted basis, net short-term and long-term capital gains or losses, the taxable gain or deductible loss, and the amount of capital loss carryover.

Qualified taxpayers may be able to exclude a portion of the gain on the sale of their main home if they meet the ownership and use tests. Taxpayers can choose to have the five-year test period for ownership and use suspended during any period the homeowner (either spouse if married) served on qualified official extended duty.

A loss on the sale of a principal residence is not deductible but must be reported if the taxpayer received Form 1099-S.

Where to find more information

Pub 544, Sales and Other Dispositions of Assets

Pub 551, Basis of Assets

Pub 550, Investment Income and Expenses

Pub 523, Selling Your Home.

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- The disposition of any asset other than stock, mutual fund shares, certain bonds, or the taxpayer's personal residence. Assets that are out of scope include:
  - Property held as a nominee
  - Qualified small business stock or small business loss
  - DC zone assets
  - A residence with a rollover of a gain prior to May 5, 1997
  - Inherited or gifted home not used as personal residence
  - Collectibles, such as artworks, jewelry, coin or stamp collections, etc.
- Tax returns for taxpayers who trade in options, futures, or other commodities, whether or not they disposed of any during the year
- A "Yes" to the digital asset (virtual currency) question on Form 1040
- Determination of basis issues:
  - Basis of any asset acquired other than by purchase, such as an employee stock option, unless the taxpayer provides the basis and holding period
  - Basis of gifted or inherited property unless the taxpayer provides the basis and holding period
- Like-kind exchanges (available only for business or rental property)
- Worthless securities, unless reported on Form 1099-B
- Form 1099-B, boxes with entries for any of the following:
  - Bartering

- Profit or (loss) realized on closed contracts
- Unrealized profit (loss) on open contracts – prior year
- Unrealized profit or (loss) on open contracts – current year
- Aggregate profit (loss) on contracts
- Proceeds from collectibles
- FATCA filing requirement

- Relating to the sale of a home:
  - Reduced exclusion computations/determinations for the sale of a home
  - Married homeowners who do not meet all requirements to claim the maximum exclusion on the sale of a home
  - Decreases to basis
  - Taxpayers with nonqualified use issues
  - Sale of a home that was ever used for business purposes or as rental property
  - Sale of a home eligible for the installment method of accounting

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: b, c, and d are in scope. A sale of a collectible (28%) is out of scope.

Answer 2: a. Never change the sales price.

Answer 3: a, Yes. Emily meets the ownership and use test because she owned and lived in the home for at least two years of the five-year period ending on the date of the sale.

Answer 4: c. The only circumstance that will allow John to exclude the gain is if he can extend the five-year period due to qualified official extended duty.

Income – Retirement

Introduction

This lesson will help you identify and report the taxable portion of retirement income received by the taxpayer. To do this, you must understand the types of retirement income and the forms used to report them. You should also be able to recognize when taxpayers should adjust their withholding.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1099-R (retirement)
- Form 8606 (basis in IRA)

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify how retirement income is reported to the taxpayer using Form 1099-R series
- Calculate the taxable portion of different types of retirement income
- Determine how to report retirement income on the tax return
- Identify distributions that are eligible for favorable tax treatment
- Determine when an adjustment to withholding should be made

What is retirement income?

Retirement income can include Social Security benefits as well as distributions from individual retirement accounts (IRAs), pension plans, profit sharing plans, insurance contracts, annuities, etc. Retirement income may be fully or partially taxable. Social Security benefits and tier 1 Railroad Retirement benefits are discussed in the Income – Social Security Benefits lesson 14.

Retirement income interview

To determine if the taxpayer must report retirement income, review the taxpayer's completed Tax-Aide Intake Booklet. If the taxpayer had retirement income, you may need to ask additional questions to clarify the type of plan, whether the taxpayer's contributions to the plan were before-tax or after-tax dollars, etc. This is explained later in this lesson.

Be considerate when probing for the information you need to complete the return. When taxpayers cannot provide the required information (and have not retained the packet of "retirement papers" they received when they retired), suggest that they contact their former employer or plan administrator. You may even give the taxpayer a written list of questions that need to be resolved.

Forms reporting retirement income

Retirement income can be reported on one of the forms in the Form 1099-R Series:

- Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,
  - If Form 1099-R is for a traditional IRA distribution, it will be indicated in Box 7.
  - The IRA/SEP/SIMPLE box is not checked for Roth IRAs. Instead, Roth IRAs are identified on Form 1099-R (Box 7) with a distribution code Q, J, H, or T.
- Form CSA 1099-R, Statement of Annuity Paid (civil service retirement payments),
- Form CSF 1099-R, Statement of Survivor Annuity Paid (civil service retirement payments to survivors), and
- Form RRB 1099-R, Annuities or Pensions by the Railroad Retirement Board (tier 2 Railroad Retirement benefits)

These forms differ in appearance but generally contain the same information, such as the amount received, the taxable portion, the taxpayer's cost (investment) in the plan, and any tax withheld.

There are many codes for Form 1099-R box 7 that are listed on the back of Form 1099-R. The more commonly seen codes are discussed in this lesson.

Missing Form 1099-R

Similar to a missing Form W-2, if the taxpayer failed to secure the 1099-R from the payer, Form 4852 substitute form can be used. The taxpayer will need to supply all the information that appears on Form 1099-R. Some payer information may be the same as in the prior year. You can e-file the return only if the EIN is available — otherwise a paper return is required.

The Tax-Aide Colorado Resource Toolbox has the EIN Search Tool that may be helpful in finding or confirming a payer's EIN.

The taxpayer should retain a copy of Form 4852 and should be advised that an amended return may be necessary if Form 1099-R is received later and the information differs.

Taxable portion already calculated

In many instances, the payer will compute the taxable portion of the distribution and report the taxable amount on Form 1099-R. You can simply enter the calculated taxable portion on the 1099-R input screen if no adjustment is needed, such as a rollover, public safety officer exclusion, or qualified charitable distribution as discussed below.

Taxable portion not calculated

If the payer did not provide the taxable amount on Form 1099-R, CSA- or CSF-1099-R, if taxpayers have Form RRB 1099-R, or if taxpayers have basis in their traditional IRA, you will need to compute the taxable portion of the distribution. This lesson will help you determine the additional information needed to calculate the taxable portion of distributions from IRAs, pensions, or annuities. Further adjustment may be needed if some portion of the distribution is eligible for favorable tax treatment.

Retirement income distributions

Retirement plans are funded by either before-tax or after-tax contributions. "Before-tax" simply means that the employee did not pay taxes on the money at the time it was contributed. This happens when the employee's contribution to their company's retirement plan reduces their taxable wages (a salary-reduction plan) or when the taxpayer takes a full deduction for their traditional IRA contribution. "After-tax" means the employee paid income tax on the money when it was contributed, i.e., not a salary-reduction plan or the taxpayer did not get a full deduction for their traditional IRA contribution.

If the taxpayer made all contributions to a plan with before-tax dollars, the entire distribution will be fully taxable. The funds are taxed at the time of the distribution because neither the contributions nor the earnings/investment gains were previously taxed. This is common in 401(k), Thrift Savings Plans, and most traditional IRAs.

If the taxpayer did not contribute to the retirement plan (it was fully employer-funded), all the distributions are fully taxable.

If the taxpayer made contributions to a plan with after-tax dollars, then distributions from that plan will be partially taxable and partially nontaxable. The portion of the distribution that is considered a return of the after-tax dollars will not be taxed again. It is considered a return of the taxpayer's cost basis (an amount for which taxes have already been paid). The portion of the distribution that represents the earnings/investment gains is taxable since it has not been previously taxed. This is common in employer retirement plans.

Qualified distributions from an employer plan designated Roth account are wholly nontaxable, similar to a Roth IRA.

Mark retired after working 30 years for a construction company. Each week, he contributed to the Carpenter's Pension Plan. Every year, Mark paid tax on the gross amount of his salary, including his pension contribution. This means his pension contributions were made with dollars that had already been taxed. Now that he is receiving payments from the pension, he will not be taxed on the portion that represents his contribution; he will be taxed on the portion that represents earnings.

Taxpayers may not always understand why they must pay taxes on their retirement income. When this is the case, take the time to clearly explain what retirement funds are taxed and why. It is usually a good idea to question taxpayers about the nature of their contributions to ensure that they will not be taxed twice on the same funds.

During the interview, you may find that the taxpayer (or spouse) has made a contribution to an employer retirement plan or an IRA. As you enter the information from a 1099-R into the software, be sure to consider whether a retirement distribution should or should not carry to Form 8880 for the retirement savings credit (discussed in the Miscellaneous Credits lesson 25).

Individual Retirement Accounts

Are IRA distributions taxable?

Earnings and investment gains in a taxpayer's IRA generally accumulate tax free or tax deferred until they are withdrawn as fully or partially taxable distributions. There are four kinds of IRAs:

- Traditional IRA
- Roth IRA
- Savings Incentive Match Plans for Employees (SIMPLE) IRA
- Simplified Employee Pension (SEP) IRA

Only the Roth IRA is funded with after-tax money.

Traditional IRA

Distributions from traditional IRAs are fully taxable unless nondeductible contributions have been made. Form 8606, Nondeductible IRAs, is used to keep track of nondeductible contributions.

When you learn about IRA accounts in the Adjustments to Income lesson, be sure to note the difference between "contributions" and "deductions." Simply put, contributions are the amounts deposited into an IRA account and deductions are the portion of the contribution that is deducted on the tax return. The deductible portion may be less than the amount allowed as a contribution.

The taxable amount can be reduced for a rollover or qualified charitable distribution as discussed below.

Roth IRA

Qualified distributions from a Roth IRA are tax free and may be excluded from income. You can identify Roth IRAs from the distribution code used on Form 1099-R, box 7. Distribution codes Q, J, H, and T are specific to Roth IRAs.

Savings incentive match plans for employees (SIMPLE) IRA

Some employers offer their employees (including self-employed individuals) the chance to contribute part of their pay to an IRA as part of a SIMPLE plan. The employer is also generally required to make contributions on behalf of eligible employees. Generally, SIMPLE IRA contributions are not included in an employee's income when paid into an IRA, and the distributions are fully taxable when the employee receives them in later years.

Simplified employee pension (SEP) IRA

Some employers (including self-employed individuals) offer their employees the chance to contribute part of their pay to an IRA as part of a SEP plan. Generally, SEP IRA contributions are not included in an employee's income when paid into the IRA. Because of this, distributions are generally fully taxable when the employee receives them in later years.

Exercises

Answers are at the end of the lesson.

Question 1: Distributions from all IRAs discussed in this topic are fully taxable with the exception of the Roth IRA.

a. True
b. False

How are IRA distributions reported?

Traditional IRA

If IRA/SEP/SIMPLE is checked on Form 1099-R and to determine whether there is any basis in the IRA, ask the taxpayer "Were the contributions to your traditional IRAs fully deducted from income in the year they were made?" If so, the entire distribution is taxable. If not, the distribution is partially taxable and Form 8606 is required.

Richard contributed $500 a year to a traditional IRA. Each year, he deducted these contributions from his income. This year he received his first distribution from the traditional IRA. It is fully taxable: Richard will pay income tax on the distributions he receives, which represent the contributions he made and deducted, as well as the earnings on these contributions over the years.

Form 8606 Parts I and II are in scope for Tax-Aide. Use Part I to track an individual's aggregate spanning all their traditional IRAs, except inherited IRAs. Use Part II when part or all of a traditional IRA is converted to a Roth IRA. The amount converted is taxed as a distribution but there is no penalty for early distribution. A conversion of a traditional IRA to a Roth IRA or a rollover from any other eligible retirement plan to a Roth IRA cannot be recharacterized as having been made to a traditional IRA, that is, it cannot be undone.

When an individual has inherited a traditional IRA and the decedent had basis in that IRA, the basis in that inherited IRA is tracked separately from any other IRA accounts (additional Forms 8606 may be needed). A surviving spouse can elect to take the deceased spouse's IRA as their own. If they do so, it is no longer treated as an inherited IRA.

Even in a year that there is no distribution, Form 8606 should be included with the return so that the basis is not lost.

Also see qualified charitable distributions below, which may reduce the taxable amount.

Be sure to review the prior year's tax return during the interview process – you may find Form 8606 and the basis that should be tracked.

An early distribution (Form 1099-R, Box 7 code 1) from a traditional IRA may be subject to an additional tax. Refer to the Other Taxes lesson 27 for more information.

Roth IRA

The IRA trustee will indicate the distribution is qualified by using Code Q (Qualified distribution from a Roth IRA) in Box 7 if the following requirements are met:

- The distribution is made after the 5-year period beginning with the first day of the first taxable year for which a contribution was made to a Roth IRA set up for the taxpayer's benefit, *and*
- The distribution is:
  - Made on or after age 59½, or
  - Made because the taxpayer was disabled, or
  - Made to a beneficiary or to an estate, or
  - To pay certain qualified first-time homebuyer amounts (up to a $10,000 lifetime limit)

The 5-year rule applies to each Roth conversion and rollover for purposes of the addition to tax on early distributions.

Jerry makes a conversion contribution on February 25, 2023, and makes a regular contribution for 2022 on the same date, the 5-year period for the conversion begins January 1, 2023, while the 5-year period for the regular contribution begins on January 1, 2022.

The trustee may have used code J (early distribution from a Roth IRA, no known exception (in most cases, under age 59½)) or T (Roth distribution, exception applies) due to insufficient information. If the taxpayer has

met the requirements to make the Roth distribution qualified and therefore not taxable, it is in scope for Tax-Aide. Code H is for a rollover and not taxable.

Remember, you don't have to memorize all these codes — they are all in your NTTC 4012.

Nonqualified Roth distributions

Even though a Roth distribution is not qualified, it may still be nontaxable. There is an ordering rule in Pub 590-B whereby the taxpayer's basis in the Roth comes out first. The only part that could be taxable is the earnings on contributions and that is the last to come out.

If the above Roth requirements are not met, the distribution is nonqualified and additional taxes may apply to the taxable portion of the distribution. Tax returns for taxpayers who received nonqualified Roth IRA distributions are out of scope.

Exercises

Question 2: Mary opened a Roth IRA 3 years ago. This year, she took the full amount of her Roth IRA as a distribution to help her purchase her first home. Because the distribution was made before the 5-year period, it is a nonqualified distribution and the return is out of scope.

a. True
b. False

Question 3: Amy contributed to a Roth IRA for 5 years. In year 6 (at age 60), she took a distribution from her IRA. The entire distribution is excluded from her taxable income.

a. True
b. False

SIMPLE and SEP IRAs

Distributions from SIMPLE and SEP IRAs are in scope because they are taxable and are generally reported on the return just like taxable traditional IRA distributions. As discussed later in the Other Taxes lesson 27, the additional tax for an early distribution may be higher for a SIMPLE distribution.

Transfers, rollovers, and conversions

Taxpayers are permitted to move funds between qualified retirement accounts, with some restrictions. We use "funds" to include monetary and nonmonetary assets, such as securities. For this discussion, we group these movements into three types:

- Transfers move funds between accounts of the same type. The most common is a transfer of funds by the trustee of an IRA directly to the trustee of a different IRA but the same type of IRA (traditional or Roth). The IRS may refer to these as rollovers in places, but they are really just a transfer.
- We'll use the term rollover to refer to transfers between accounts of the same or different types, such as from an employer retirement account to an IRA. A rollover also includes a distribution in which the taxpayer receives the funds and then deposits them in another qualified account within 60 days. Generally, the pre-tax or after-tax attribute of the funds in the old account carry to the new account.

EXAMPLE

Assume a withdrawal of $100,000 from a retirement plan, $80,000 in pre-tax amounts and $20,000 in after-tax amounts. One possibility would be:

- *A direct rollover of $80,000 in pretax amounts to a traditional (non-Roth) IRA or a pretax account in another plan,*
- *A direct rollover of $10,000 in after-tax amounts to a Roth IRA, and*
- *A distribution of $10,000 in after-tax amounts to the account owner.*

- A conversion moves funds from an account funded with pre-tax money to an account funded with after-tax money. We see this most often with a Roth IRA conversion but it can also happen within an employer plan.

A trustee-to-trustee transfer between like accounts generally does not trigger a 1099-R so it does need not be reported on the return. There is no limit to the number of such transfers in any given year.

A direct rollover, say from an employer plan to an IRA, will trigger a 1099-R with a code indicating that it is a rollover, typically G (for pre-tax plans) or H (for Roth Plans). Once a 1099-R is issued, it must be reported on the return. There is no limit to the number of direct rollovers in any given year.

A rollover where the funds pass through the hands of the taxpayer will trigger a 1099-R that appears to be for a normal or early distribution. The taxpayer must redeposit the rollover funds into the same or another qualified account within 60 days in order for the distribution to be nontaxable and for no early distribution additional tax to apply. If the taxpayer fails the 60-day requirement and the self-certification procedure described later does not apply, the distribution will be partially or fully taxable. There is a limit of one distribution that is rolled over per twelve months — regardless of the number of accounts the taxpayer holds.

In a Roth conversion, funds taken from a traditional IRA or a pre-tax employer plan are deposited into a Roth account. The funds withdrawn are taxable, but there is no early distribution additional tax (1099-R, box 7, code 2). If taxes are withheld from the distribution, the taxpayer has the option of using “own funds” to top up the net amount received to the full amount of the distribution for deposit into the Roth account.

Distributions from SIMPLE IRAs in the first two years (distribution code S) can only be rolled over tax-free into other SIMPLE IRAs. Taxable SIMPLE IRA rollovers are out of scope.

Roth nonelective contributions and designated Roth matching contributions

Starting 2024, an employer retirement plan may provide for Roth nonelective or matching contributions. The contribution amounts are taxable to the employee to make them after-tax contributions. IRS has directed employers to use Form 1099-R to report these taxable amounts and to use code G in box 7; the amount of the taxable distribution (box 2a) will be the same as the gross distribution (box 1). Since the taxable amount is determined, simply enter the information into the software.

Exception to 60-day rollover rule

A qualified plan loan offset distribution (code M in Form 1099-R, box 7) is due to a plan termination or severance from employment. Instead of the usual 60-day rollover period, the taxpayer has until the due date, including extensions, for filing the federal income tax return for the taxable year in which the offset occurs to complete the rollover.

Exercises (continued)

Question 4: Andrew changed jobs and received Form 1099-R from his previous employer. The gross distribution amount in Box 1 is $11,200. Andrew deposited the entire $11,200 into his IRA within 30 days of receiving the check (rollover).

Which of the following statements is true?

a. The entire distribution is includible as income
b. The entire distribution is excludible from income
c. The distribution is eligible for the ten-year tax option
d. The distribution is eligible to be taxed at a special rate

Self-certification procedure

IRS has designed a self-certification procedure to help recipients of retirement plan distributions who inadvertently miss the 60-day time limit for a proper rollover to individual retirement arrangement (IRA) or another retirement plan. Eligible taxpayers can qualify for a waiver of the 60-day time limit and avoid possible

taxes and penalties on early distributions if they meet certain circumstances. Taxpayers who missed the time limit will ordinarily qualify for a waiver if one (or more) of these listed circumstances applies:

- An error was committed by the financial institution making the distribution or receiving the contribution.
- The distribution was in the form of a check and the check was misplaced and never cashed.
- The distribution was deposited into and remained in an account that the taxpayer mistakenly thought was a retirement plan or IRA.
- Taxpayer's principal residence was severely damaged.
- One of the taxpayer's family members died.
- Taxpayer or a family member was seriously ill.
- Taxpayer was incarcerated.
- Restrictions were imposed by a foreign country.
- A postal error occurred.
- The distribution was made on account of an IRS levy and the proceeds of the levy have been returned.
- The party making the distribution delayed providing information that the receiving plan or IRA required to complete the rollover despite reasonable efforts to obtain the information.
- The distribution was made to a state unclaimed property fund (Revenue Procedure 2020-46)

Ordinarily, the IRS, plan administrators, and trustees will honor a taxpayer's truthful self-certification that they qualify for a waiver under these circumstances. Even if a taxpayer does not self-certify, the IRS now has the authority to grant a waiver during a subsequent examination.

See Rev. Proc. 2016-47 and Rev. Proc. 2020-46 for more information and a sample self-certification letter.

The IRS encourages eligible taxpayers wishing to transfer retirement plan or IRA distributions to another retirement plan or IRA to consider requesting that the administrator or trustee make a direct trustee-to-trustee transfer, rather than doing a rollover. Doing so can avoid some of the delays and restrictions that often arise during the rollover process.

In the case of a failed rollover, the consequence is not only that the distribution is taxable; in addition, the deposit of the funds into an IRA may be treated as an excess accumulation subject to a different penalty. For more information, refer to the Other Taxes lesson 27.

Qualified charitable distributions

A qualified charitable distribution (QCD) is an otherwise taxable IRA distribution that is not taxable. To qualify, the distribution must be made directly from a traditional IRA to an organization eligible to receive tax-deductible charitable contributions (referred to as a 501(c)(3) charity). The taxpayer must be at least age 70½ when the distribution is made. The taxpayer must have the same type of acknowledgement of the contribution that is needed to claim a deduction for a charitable contribution.

If the taxpayer is required to take a minimum distribution (RMD), a QCD counts towards the taxpayer's RMD. The benefit to the taxpayer is that AGI does not include the IRA distribution that qualifies as a QCD. A lower AGI has multiple benefits, including possibly lower Medicare premiums. Of course, no double benefit is allowed so there is no charitable contribution deduction on Sch A for the QCD.

The taxable distribution amount in box 2a of the 1099-R will reflect all the distributions for the year and will need to be reduced by the amount of the QCD.

The maximum annual exclusion for QCDs is subject to inflation adjustment as shown in the Important Changes lesson. Any QCD in excess of the exclusion limit is included in income as any other distribution. On a joint return, a spouse aged 70½ or older can also have a QCD and exclude up to the annual limit.

Reduced QCD for IRA deduction after age 70½

Beginning in tax years after December 31, 2019, a new rule denies QCD treatment if the taxpayer is also making deductible contributions to their traditional IRA. The amount of QCDs that a taxpayer can exclude from income is reduced by the excess of:

- the aggregate amount of IRA contributions the taxpayer deducted for the taxable year and any prior year that the taxpayer was age 70½ or older over
- the amount of such IRA contributions that were used to reduce the excludible amount of QCDs.

Starting with tax year 2020, taxpayers should calculate the excludible amount of their QCD. Each spouse must complete a separate worksheet if married filing jointly. The Tax-Aide tax law paper IRA Deduction After Age 70½ and Reduction to QCD contains a worksheet and instructions that should be used for taxpayers who are affected by this provision.

If a QCD is reduced due to an IRA deduction, the taxpayer will show that amount as a taxable distribution. That is, QCD treatment is denied for that amount. But since there is no QCD benefit for that amount, the taxpayer may claim a charitable contribution deduction for the donation if itemizing.

Employer retirement plans

A qualified retirement plan established by an employer provides retirement benefits for employees and their beneficiaries. Employees typically do not pay taxes on plan assets, including earnings on those assets, until the assets are distributed. Employer qualified plans are of two basic types:

- Defined contribution — The employer and/or the employee contribute funds to the plan during the working years. The benefits that a retiree receives are limited to the amount in their account. A 401(k) feature allows the employee to contribute a portion of their current pay to their account in the plan on a pre-tax basis. The employer may or may not match the employee's contribution.
- Defined benefit — The employer funds a defined benefit plan by whatever amount is actuarily determined necessary to provide the benefits promised by the plan. In a defined benefit plan, a retiree is usually entitled to a certain percentage of their compensation while they were working. For example, a defined benefit plan may provide that a fully-vested retiree is entitled to 70% of the average of their highest 10 years' compensation. The term "pension plan" is reserved for defined benefit plans. Because defined benefit plans pay out over the life of the retiree (and survivor maybe), these benefits are also referred to as an annuity.

In any employer plan, if the employee makes after-tax contributions to the plan, they have basis in the plan and can recover that cost by reducing the taxable amount of the distributions they receive.

Employer plans may also have a Roth feature called a designated Roth. The rules discussed above for Roth IRAs generally apply to employer plan Roth accounts: contributions are made with after-tax dollars and benefits are not taxable if the distribution is qualified.

Refer to the *Transfers, Rollovers, and Conversions* discussion above. They can also occur within or between employer plans with similar consequences.

*In discussing employer retirement plans, **pre-tax** means that the taxpayer was not taxed on the income that was contributed to the plan. This includes a salary-reduction plan, like a 401(k), where the employee's taxable compensation is reduced and thus the employee gets tax benefit for their contribution.*

***After-tax** means that the taxpayer paid tax on the income that was contributed to the plan. This often occurs with governmental plans where an employee contribution is required but it is not eligible for salary-reduction treatment. In this case, the taxpayer has basis in their plan and does not have to pay tax on that amount again when it is received.*

Private annuities

Individual annuities can be purchased from various sources, including insurance companies. Usually, the individual pays a certain amount and the annuity company commits to pay benefits to the individual over their life. The rules for employer plan distributions generally apply to annuities and since the purchase price of the annuity was made with after-tax funds, the annuitant can recover their cost by reducing the taxable amount of distributions received.

Fully taxable retirement benefits and annuities

In general, retirement or annuity payments are fully taxable, if any of the following is true:

- Taxpayers did not pay any part of the cost of their pensions, benefits, or annuities
- Employers did not withhold part of the cost from the taxpayers' pay while they worked
- Employers withheld part of the cost from the taxpayer's before-tax pay while they worked

Sue worked for a software development company for 20 years. She retired and began receiving pension income the same year. Sue never contributed to the pension plan while she was working; her employer made all of the contributions. Her pension is fully taxable.

Partially taxable retirement benefits and annuities

If a taxpayer made after-tax contributions toward their retirement plan, they have basis in that plan and can recover that basis a bit at a time as they get distributions from the plan. Two methods used to figure the taxable portion of each pension or annuity payment are the general rule and the simplified method. Unless an exception applies, retirees must use the simplified method for annuity payments from a qualified plan. If a taxpayer tells you they have been using the general rule to figure the taxable portion for past years, their tax return is out of scope.

If the taxpayer's annuity starting date is before July 2, 1986, the general rule has to be used unless the Three-Year Rule was used.

When the 1099 form indicates the taxable amount was not computed, there is no taxable amount, and there is an amount for employee contributions, you will need to compute the taxable portion using the simplified method. To calculate the taxable portion of a pension or annuity using the simplified method, you will need certain information:

- The cost in the plan (total employee contribution on Form 1099-R)
  - If there is more than one plan, a simplified method calculation is needed for each separately.
- The taxpayer's age on the date the annuity began (and the spouse's age if joint/survivor annuity was selected)
  - Once the exclusion computation is made, it does not change for subsequent events, such as divorce, marriage, or death.
  - Upon the death of the primary annuitant, the survivor continues with the exclusion as computed.
- Total of tax-free amounts from previous years
  - The total amount excluded cannot be more than the taxpayer's basis in the plan.

Use the Annuity/Pension Exclusion Calculator on the Tax-Aide Colorado Resource Toolbox website so that you have an accurate calculation. It will also print out the full schedule of annual exclusions so you'll know when the cost has been fully recovered.

Joe elected a joint/survivor annuity when he retired and started receiving his pension on July 1, 2015. Joe was born March 5, 1950 and his wife, Mary, was born on July 23, 1953. Here is how they compute their combined ages for the Simplified Method.

	Joe	Mary	Combined
Date born	3/5/1950	7/23/1953	
Date annuity started	7/1/2015	7/1/2015	
Age when annuity started	65	61	126

Note that Mary had not reached her 62nd birthdate by the day the annuity started.

To ensure the taxable portion of the pension is calculated correctly, the age of the taxpayer(s) at the annuity start date, not their age for the tax year, must be used when determining the total number of expected monthly payments.

Melvin retired from a manufacturing plant. While he was working at the plant, his employer withheld money from each paycheck on an after-tax basis and sent it to the Engineer's Pension Fund. Melvin will receive a monthly pension payment for the rest of his life. Melvin will use the Simplified Method to determine the tax-free part of monthly payments.

What about nonqualified annuities?

A nonqualified annuity is signified by code D in box 7 (along with a numeric code) on Form 1099-R. If the taxable amount is not shown in box 2a, the simplified method cannot be used for the amount in box 9b,

employee contribution. The return is in scope only if Box 2a contains the taxable amount. When AGI exceeds the following amounts, the nonqualified annuity is subject to the net investment income tax and the return is out of scope:

- $200,000 if single or head of household
- $250,000 if married filing jointly or qualifying surviving spouse
- $125,000 if married filing separately.

You don't have to memorize these thresholds, they are at the beginning of the Tax-Aide Scope Manual. And the software will automatically generate the net investment income tax Form 8960.

Exercises (continued)

Question 5: Dotty worked for the local tire plant for 32 years. She retired in June and receives a monthly pension of $1,679. (She received six payments for July through December.) Dotty never contributed to the pension plan; her employer made all of the contributions. How much of her pension is taxable?

a. $12,074
b. $11,074
c. $10,074
d. $1,679

Disability pension income

Generally, taxpayers who retire on disability must include all of their disability payments in income. Disability payments are taxed as wages until the taxpayer reaches the **minimum** retirement age. This can have quite an impact because when disability pay is treated as wages, it might affect the earned income credit, additional child tax credit, and the taxpayer's ability to make an IRA contribution.

After the taxpayer reaches the minimum retirement age, disability payments are treated as pension income. Minimum retirement age is generally the earliest age at which taxpayers may receive a pension, whether or not they are disabled. This age is specified in the retirement plan documents by the employer and varies from employer to employer. The taxpayer will know the minimum retirement age; if not, they will need to get it for you.

Employers may report disability income on one of the following forms:

- Form W-2, if the taxpayer has not reached the minimum retirement age set by the employer
- Form 1099-R, with code 3 if the taxpayer has not reached the minimum retirement age for the plan, or with code 7 if the taxpayer has reached the minimum retirement age

Some employers report qualified disability income on Form 1099-R with Distribution Code 3 in Box 7 regardless of the taxpayer's age. You must confirm the employer's minimum retirement age. If the taxpayer is under the retirement age, additional software entries are needed.

If the taxpayer has basis in their disability plan, it is recovered once the disability pension is no longer treated as wages, not before. Also, see the next section for the public safety officer exclusion.

Exercises (continued)

Question 6: Annie Jo is 47 years old and has retired on disability from her job. She receives a monthly payment from her former employer's pension plan to which Annie Jo had not contributed as reported on her Form 1099-R with code 3 in box 7. She has not reached the minimum retirement age set by her company's pension plan. How should she report her disability income on her Form 1040?

a. Other income not subject to self-employment tax

b. Pensions and annuities
c. Taxable pensions and annuities
d. Wages

Retired public safety officers

A public safety officer (PSO) includes a law enforcement officer, firefighter, chaplain, or member of a rescue squad or ambulance crew. Eligible PSOs can elect to exclude from their eligible retirement plan's distribution up to $3,000 to pay the premiums:

- for accident, health (including Medicare even if actually paid from Social Security benefits), or long-term care (LTC) insurance
- for the taxpayer, spouse or a dependent.

An eligible PSO is one who retired because of disability or because they reached the normal retirement age. An eligible retirement plan is the employer plan from which the taxpayer retired as a public safety officer.

If the PSO's benefits are treated as wages due to disability, the wage amount can be reduced for the PSO exclusion for premiums as above.

If both spouses are eligible retired PSOs, then each can exclude up to $3,000, but do not double count any premiums.

The full amount of LTC premiums can be used for the exclusion. The LTC premium is not limited based on the age of the insured as it is for deduction purpose, e.g. Sch A itemized deductions.

The amount of premiums used for the exclusion cannot be used again as an itemized deduction or for self-employed health insurance deduction purposes.

Alberto retired as a PSO and paid $7,600 for his LTC insurance. He can use up to $3,000 to reduce the taxable amount of his eligible retirement plan distribution. The balance of $4,600 could be a deduction, subject to the limit based on his age.

Previously, the premiums had to be paid directly by the pension plan. Since Dec. 29, 2022, direct payment by the plan is not required.

Public safety officers entitled to the PSO exclusion are not the same as the public safety employees who can claim an exception for an early distribution penalty. The latter includes more individuals.

Other retirement income issues

There are a few other issues related to reporting retirement income that you may encounter. Some of the following distributions are subject to various additional taxes that are computed on Form 5329. If an exception is met, the additional tax does not apply. Form 5329 and the exceptions are covered in the Other Taxes lesson 27. They are discussed here since they could impact the current year's tax return.

Early distributions

An early distribution is a withdrawal from a retirement fund by a taxpayer who is under age 59½ either from an employer plan or an IRA. Early distributions can be subject to an additional 10% tax. The additional tax applies to the taxable portion of the distribution or payment.

If the distribution code is 2, 3, or 4, the taxpayer does not have to pay the additional tax. When the distribution code on Form 1099-R is 1, the taxpayer will not be subject to the additional 10% tax if an exception applies. The exceptions to the early distribution additional tax are covered in the Other Taxes lesson 27.

Required minimum distributions

To avoid an additional tax for excess accumulation, participants in retirement plans must take a required minimum distribution (RMD) by a specified start date and every year thereafter:

- Beginning in 2023, the **start year** is the year in which the taxpayer reaches age 73 or retires (for plans other than IRAs), whichever is later.
    - For 2020, 2021, and 2022, the start year was the year the individual reached age 72.
    - Prior to 2020, the start year was the year the individual reached age 70½.
- The required **start date** is April 1 of the calendar year following the start year.

For traditional IRAs, only the age requirement applies; it does not matter whether the taxpayer has retired. The trustee or administrator of the qualified plan should contact the taxpayer at the appropriate time to begin their RMD. The RMD rules do not apply to Roth IRAs.

After the starting year for RMDs, taxpayers must receive the minimum distribution for each year by December 31 of that year. If no distribution is received during the taxpayer's starting year, the required minimum distributions for two years must be received the following year, one of which must be taken by April 1.

If the taxpayer reaches age 73 in 2024, their start year is 2024. The required start date for their first RMD is April 1, 2025. They must take their second RMD by December 31, 2025.

If the taxpayer reached age 73 in 2023, they were 72 in 2022 and as such their first RMD was due by April 1, 2023, and their second RMD was due by December 31, 2023.

The RMD rules for **inherited** retirement accounts depend on the relationship and age of the beneficiary and are beyond our scope. Refer taxpayers to their trustee if they have questions about the RMD rules for their inherited account.

If the taxpayer does not receive the minimum distribution, an additional tax may be imposed. This additional tax and a limited waiver for some inherited accounts are discussed in the Other Taxes lesson 27.

Peter turned 73 on August 20, 2023. Peter's start year is 2023 for his IRA. Peter can take his first RMD from his traditional IRA during 2023 or, at the latest, by April 1, 2024. His second RMD by December 31, 2024.

Ralph turned 73 on March 15, 2023 and retired on June 30, 2024.

For his traditional IRA, Ralph's start year is 2023 and the (latest) RMD start date April 1, 2024. His second RMD is due by December 31, 2024.

For his company's 401(k) plan, Ralph's start year is 2024 and the (latest) RMD start date is April 1, 2025. His second RMD is due by December 31, 2025.

This RMD information is provided to help you answer any questions a taxpayer may ask about RMDs. The amount of an RMD should have been calculated by the plan administrator or IRA trustee. RMD distributions are reported on Form 1099-R and included on the return using the procedures previously discussed. Of course, you may want to alert taxpayers turning age 73 or retiring of the need for RMDs.

Withdrawal of excess IRA contributions

An excess IRA contribution is the amount contributed to a traditional and/or Roth IRA during the year that is more than the smaller of the:

- Maximum IRA amount for the year based on the taxpayer's age, or
- Taxable compensation for the year, with these exceptions:
  - Medicaid waiver payment income that is excluded from gross income counts as compensation for a nondeductible IRA.
  - Combat pay that is excluded from gross income counts as compensation for an IRA contribution or deduction.

The taxpayer may not know that a contribution is excess until the tax return is completed after the end of the year. In this situation, the excess amount, with any earnings on that amount, must be withdrawn by the due date of the return (including extensions). If the excess amount is not withdrawn by the due date of the return, the taxpayer will be subject to an additional 6% tax on this amount and the return is out of scope.

The withdrawn excess contribution is not included in the taxpayer's gross income if both of the following conditions are met:

- No deduction was allowed for the excess contribution
- All interest or other income earned on the excess contribution is withdrawn by the due date of the return, including extensions

However, taxpayers must include the earnings on the excess contribution as income on the return. This income is reported on the return for the year in which the excess contribution was made. The withdrawal of interest or other earnings associated with the excess contribution is no longer subject to the additional 10% tax on early distributions. If the taxpayer is subject to an additional tax due to excess IRA contributions, their tax return is out of scope.

Lump-sum distributions

A lump-sum distribution is the distribution or payment within one tax year of an employee's entire balance from all qualified pension, stock bonus, or profit-sharing plans that the employer maintains.

Lump-sum distributions are reported on Form 1099-R like any other pension distribution. Some lump-sum distributions qualify for special tax treatments. If Form 1099-R indicates a distribution code of A, it is a lump-sum distribution qualifying for special tax treatments and the return is out of scope.

Exercises (continued)

Question 7: Taxpayers who withdraw excess contributions and earnings on the excess contributions by the due date of the tax return are not subject to an additional 6% tax on the excess contribution.

a. True
b. False

Question 8: Helen turned 73 on March 17, 2023. She has not yet retired. She has never taken any distribution from her traditional IRA accounts. Assuming that her RMD amount for each year is $1,479, Helen is required to:

a. Take a distribution of $1,479 by April 1, 2023.

b. Take a distribution of $1,479 by December 31, 2023.
c. Take a distribution of $2,958 by December 31, 2023.
d. Take a distribution of $1,479 by April 1, 2024, and another $1,479 by December 31, 2024.

Question 9: Trevor turned 73 on February 14, 2024. He retired in 2023. Trevor is required to take his first RMD from his employer's retirement plan by _____.

a. April 1, 2023
b. April 1, 2024
c. April 1, 2025
d. April 1, 2026

What is a loss on termination of annuity?

These situations are out of scope. The information provided here is for awareness.

When you see that Form 1099-R, Box 1, has a gross distribution amount, Box 2a may have $0, and the total distribution box checked, the account is closed. If Box 5 has a number equal to or larger than Box 1, the taxpayer has not recovered all their basis in the annuity (cost of the contract). This can happen when a taxpayer cashes out an annuity or other termination of a plan.

The taxpayer may claim a deduction for the unrecovered investment in the contract as a miscellaneous itemized deduction not subject to 2% of AGI floor if the distribution is due to death of annuitant. Otherwise, the loss is subject to the 2% of AGI floor for which no deduction is available for tax years 2018 through 2025 (there may be a possible state tax deduction).

Special retirement distribution provisions

Certain distributions may be repaid or receive other tax-advantaged treatment. Generally, if repaid in the same year, the repayment is treated as a rollover that is **not** subject to the once-in-12-months rule. If the repayment occurs in a subsequent year, an amended return would be needed to claim a refund of taxes paid.

Check the Tax-Aide Intake Booklet, to see if taxpayer indicated a contribution or repayment to a retirement account. You will need to confirm the provision that allows repayment.

A qualified individual may repay part or all of their eligible distributions to an eligible retirement plan (within certain time limits), but not an amount in excess of the amount of the distribution. The repayment can be to the same plan or a different plan, such as an IRA, that is willing to accept the repayment. Generally, the repayment must be completed within three years beginning with the day after the date that the distribution was received. Repayment of a first-time homebuyer distribution has a different time limit as noted below.

The maximum amount that can be repaid is the gross amount of the eligible distribution, notwithstanding any taxes that may have been withheld.

Qualified birth or adoption

A qualified birth or adoption distribution is any distribution from an applicable eligible retirement plan if made during the 1-year period beginning on the date on which a child was born or the date on which the legal adoption of the child was finalized. A qualified birth or adoption distribution is limited to $5,000 per adoption or birth. In addition, an eligible adoptee is any individual (other than the child of the taxpayer's spouse) who has not reached age 18 or is physically or mentally incapable of self-support.

A taxpayer who received a qualified birth or adoption distribution can make one or more contributions to an eligible retirement plan that accepts rollover contributions. A qualified distribution due to the birth or adoption of a child may be repaid within 3-years starting the day after the distribution. Taxpayers with qualifying birth or adoption distributions prior to December 29, 2022 have until December 31, 2025 to complete the repayment. The repayment is treated as a rollover that is not subject to the once-in-12-months rule.

Terminally ill

Beginning in 2023, distributions to a person who is terminally ill may be repaid within 3 years, similar to the birth or adoption distribution rule. An individual is terminally ill if they can be reasonably expected to die within 84 months. Also, the 10% early distribution additional tax does not apply.

Victim of domestic abuse

Beginning in 2024, domestic abuse victims may distribute the lesser of $10,000 (subject to inflation adjustment) or 50% of accrued benefit from an eligible retirement plan without the 10% early distribution additional tax (specific definitions and timing apply, see Publication 575). The distribution may be repaid within three years from the date of distribution.

Emergency expenses

Beginning in 2024, the 10% additional tax on early distributions for emergency personal expense distribution of as much as $1,000 is waived. Emergency personal expenses are unforeseeable or immediate financial needs relating to a necessary personal or family emergency. The distribution may be repaid within three years from the date of distribution.

First-time homebuyer

A distribution taken that qualified for the first-time homebuyer exception to the early distribution penalty may be repaid if the purchase of the home could not be completed due to a disaster. In this situation, the taxpayer has 180 days after the disaster to complete the repayment. The repayment is treated as a rollover that is not subject to the once-in-12-months rule.

Qualified reservists

Military reservists may be able to recontribute a qualified plan distribution. There are specific rules and reporting for any repayment. This is discussed in the Income - Military Members lesson 16.

Disaster distributions

SECURE 2.0 extended the 3-year repayment option to various disaster-related distributions. Taxpayers also have the option of spreading a disaster-related distribution over 3 years as discussed below for COVID distributions. Generally, distributions due to a disaster must be reported on Form 8915-F if eligible for special treatment. Form 8915-F is out of scope, except for COVID distributions. During the interview with the taxpayer, use NTTC Casualty Loss Screening Tool to determine whether you can assist the taxpayer.

Coronavirus-related distributions

*This information is for the **extremely rare** situation that a COVID distribution was received on December 31, 2020. The taxpayer would have until January 1, 2024 to recontribute any portion of the COVID distribution that had not already been repaid.*

The CARES Act of 2020 provided for three special rules for up to $100,000 of coronavirus-related distributions from eligible retirement plans to qualified individuals for 2020: exception to the additional tax on early distributions; distributions may be included in income over a 3-year period (2020, 2021 and 2022); and, to the extent the distribution is eligible for tax-free rollover treatment, the distribution may be repaid within 3 years after the day after the date of distribution. If the retirement distribution recipient was not a qualified individual in 2020, none of these provisions apply.

Each spouse who was a qualified individual would have filed a separate Form 8915-E in 2020 to identify their coronavirus-related distributions.

If a taxpayer says they repaid their COVID distribution on January 1, 2024, an amended return will be needed. Confer with your Coordinator since the return will have to be prepared and reviewed by Counselors who were certified for the applicable year or years.

When to adjust withholding

Taxpayers may choose to have income tax withheld from their retirement distributions. Be sure to enter any amount of federal (and state) income tax withheld on Form 1099-R. After the completion of the return, if the taxpayer owes $1,000 or more on the tax return, you should discuss their withholding and estimated tax options with them. This is covered in more detail in the Refund and Amount of Tax Owed lesson 30.

Taxpayers who receive a very large refund may make better use of their funds if tax withholding is lowered. Explain ways they can reduce their withholding.

Summary

This lesson helped you identify, calculate, and report the taxable portion of retirement income received by the taxpayer. It reviewed the types of retirement income and the forms used to report them.

You learned when taxpayers of retirement age are required to take a minimum distribution from a retirement plan and when they may need to adjust their withholding.

A taxpayer may be able to repay some or all of various qualified distributions. Generally, the time limit is three years from the date of distribution.

Where to find more information

NTTC's IRA Deduction After Age 70½ and Reduction to QCD

Pub 590-B, Distributions from Individual Retirement Arrangements (IRAs)

Pub 590-A, Contributions to Individual Retirement Arrangements (IRAs)

Rev. Proc. 2016-47, as modified by Rev. Proc. 2020-46 (self-certification – missed rollover)

Pub 575, Pension and Annuity Income

Pub 721, Tax Guide to U.S. Civil Service Retirement Benefits

Pub 939, General Rule for Pensions and Annuities

What situations are out of scope for the Tax-Aide program?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Taxpayers subject to additional tax due to excess IRA contributions
- Roth IRA distributions that are not qualified distributions
- IRA rollovers that do not meet the tax-free requirements as intended by the taxpayer and the self-certification procedure does not apply
- Taxpayers who used the General Rule to figure the taxable portion of pensions and/or annuities for past years
- Form 1099-R, distribution code A (lump-sum distribution qualifying for special tax treatments) and other rarely seen distributions codes on Form 1099-R as specified in the Tax-Aide Scope Manual
- Disaster distributions received in the current year (Form 8915-F)
- Retirement income from a foreign country unless certified in International, other than German or Canadian social security - see Income – Social Security Benefits lesson 14
- Foreign accounts or holdings requiring the filing of FINCEN114 or Form 8938
- Deceased taxpayers who incurred a loss on termination of an annuity

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: b. False. In addition to Roth IRAs, nondeductible contributions to traditional IRAs are also not taxed when they are distributed.

Answer 2: a. True. Mary's distribution was not made after the 5-year period beginning with the first taxable year she made a contribution to her Roth IRA. The distribution is not a qualified distribution and is out of scope.

Answer 3: a. True. Amy's distribution can be excluded from her taxable income because it was made more than five years after the beginning of the taxable year of her first contribution and it was made on or after age 59½.

Answer 4: b. Andrew can exclude the entire distribution from income because it was rolled over into an IRA within the allowed 60-day period.

Answer 5: c. Dotty's entire pension amount of $10,074 (6 x $1,679) is fully taxable because she has never paid income taxes on her employer's contribution to her pension.

Answer 6: d. Because Annie Jo has not reached the minimum retirement age set by her employer, you should report her disability income as wages on her Form 1040.

Answer 7: a. True. Taxpayers must withdraw excess contributions and any earnings by the due date of the return (including extensions) to avoid the additional 6% tax on the excess contribution.

Answer 8: d. Helen turned 73 in 2023, which is her required start year.

Answer 9: c. Trevor turned 73 in 2024, which later than the year he retired. That makes 2024 his required start year. He can delay his first RMD until April 1, 2025. He must take his second RMD by December 31, 2025.

Income – Sch K-1, Royalties, and Land Rents

Introduction

It is important to ensure that all income is accurately reported on the return. Ask taxpayers if they rented out their home or other real estate during the tax year, they received royalties, or if they received a Sch K-1 from an estate, trust, partnership, or S corporation.

This lesson does not apply to taxpayers who are in the business of renting properties. Refer to the Income – Military Members lesson 16 for residential rentals.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1040, Sch E
- Sch K-1 (Form 1041 & Instructions) (trusts and estates)
- Sch K-1 (Form 1065 & Instructions) (partnerships)
- Sch K-1 (Form 1120S & Instructions) (S Corporations)
- Form 1099-Misc (miscellaneous income)

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify Sch K-1 income items that are in scope
- Determine how to report Sch K-1 income items
- Determine how the various types of royalty income must be reported
- Determine how land rents are reported

Sch K-1 income, deductions, credits, etc.

Sch K-1 is used to report the taxpayer's share of income, other distributions, deductions, and credits from partnerships, S corporations, and some estates and trusts. It is important to correctly report this income to avoid notices or correspondence from the IRS. These entities are referred to as flow-through entities because the income is not taxed to the entity; it is taxed to the partner, S Corp shareholder, or trust/estate beneficiary.

Sch K-1 may report information that is not needed for an in-scope return, such as investment income or foreign tax credit per-country detail. It is not necessary to enter that information into the software. Items of taxable income, expense, or credits on a Sch K-1 other than those listed in this lesson makes the tax return out of scope.

The estate, trust, partnership, or S corporation may have a fiscal year that is not a calendar year. Such an entity will use the forms for the year in which its fiscal year begins (that is, the prior year).

How and where can income be reported?

Income reported on Sch K-1 will be included on the taxpayer's return in various places depending upon the type of income. Income reported on Sch K-1 that is in scope includes:

- Interest income
- Dividend income
- Qualified dividends income
- Section 199A dividends
- Net short-term capital gains and losses (Sch D, line 5)
- Net long-term capital gains and losses (Sch D, line 12)
- Unrecaptured section 1250 gain
- Tax-exempt interest income
- Royalty income (Sch E)

An income, loss, or credit amount on a K-1 other than those listed above make the return out of scope, such as business income or loss, rental income or loss, other income, etc.

Ronald came to your site to have his return prepared. He received a Form 1041, Sch K-1. There is an amount of $200 in Part III, box 4b, 28% rate gain. After reviewing the Tax-Aide Scope manual, you inform Ronald you cannot prepare his return because his return is out of scope.

You will enter the items into the respective K-1 input screen of the software. The software will carry the amounts to the appropriate form or schedule. Refer to your NTTC 4012.

Foreign taxes reported on Sch K-1 may be within scope. See the Foreign Tax Credit lesson 23 for more information.

Additional information may be present in various parts of Sch K-1 for which you may need to look up the codes on the back of the form. These include creditable foreign taxes, exempt interest income, and Sec. 199A dividends. Other codes and Sch K-3 provide information that does not need to be entered in the software for in-scope returns. Refer to your NTTC 4012, Tab D.

Royalties reported on 1099-MISC or Sch K-1

The first thing to do is find out what the royalty is for during the interview because not all royalties are in scope.

Royalties from mineral interests

Royalties from a nonworking mineral interest (such as oil, gas, or hard minerals) are reported on Sch E. This royalty income is in scope only when the source document of the royalty income is Sch K-1 or Form 1099-MISC (or substitute form) with no associated expenses. However, depletion allowances and other income, deductions, credits, etc., are in scope when SPEC has provided training for such items.

Royalties from a working or operating mineral interest constitute a business and are out of scope. If you see operating expenses on the royalty statement, ask the taxpayer if it is a working interest.

Royalties from a taxpayer's work

Royalties from the taxpayer's own services are reported on Sch C if from a business. The determination of whether the royalty is from a business is made when the right to receive the royalty occurs. Current-year self-employment income includes business income received by cash-basis individuals, even though the income may be attributable in whole or in part to work or services performed in earlier years. If the taxpayer was in the business when the royalty was generated, the royalty is reported as business income subject to self-employment tax even though the taxpayer may no longer have that business. You will need to make sure business royalties are reported on Sch C.

Other royalties

Other royalties, such as inherited royalties or royalties from nonbusiness activities, can be reported as other income (not subject to self-employment tax) on Sch 1 or on Sch E. The software assumes Sch E if you use the 1099-MISC input screen.

How do I handle land rents?

A taxpayer may rent out vacant land, that is, land that has no depreciable improvements. Tax-Aide scope allows land rents to be reported on Sch E, although it does not allow expenses to be claimed on Sch E. Instead, allowable mortgage interest or property taxes can be claimed on Sch A if itemizing deductions.

Exercise

Answers are at the end of the lesson.

Question 1: Mario's home sits on a large lot and he rents out a section to a neighbor who maintains bees. There are no improvements to that area of his lot. How should Mario report the income and property taxes associated with the rented piece of his home's property?

a. Since his home is personal, he does not need to report the rent he collects. He can deduct his property taxes on Sch A if he itemizes.
b. Mario must report rental income collected during the year and claim his property tax on that part of his lot on Sch C and pay self-employment tax on the net profit.
c. Mario reports the rental income collected during the year on Sch E. Following Tax-Aide scope, all his property taxes can be claimed on Sch A if he itemizes his deductions.

Summary

Taxpayers receive Sch K-1 (Form 1065, Form 1041, or Form 1120S) reporting their share of income from flow-through entities. Only the income items covered in this lesson are in scope. Sch K-1, page 2, lists the appropriate forms and schedules where the taxpayers' income from these sources should be reported.

Royalties on Sch K-1 (Forms 1065 and 1120S or on Form 1099-MISC) are in scope. Mineral royalties are reported on Sch E. Royalties for personal services, such as an author or composer, are reported on Sch C when it constitutes a business and are in scope. Refer to the Income – Business lesson 9. Other royalties, such as inherited royalties, are reported as other income on Sch 1 and are also in scope.

Land rents are reported on Sch E and in scope but related mortgage interest or property taxes can only be claimed on Sch A if itemizing due to scope limits.

Where to find more information

Pub 17, Your Federal Income Tax

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Income reported on Schs K-1 (other than what is listed in this lesson)
- Deductions, credits, and other items reported on Schs K-1 (other than listed above)
- Royalty income reported on Form 1099-MISC when there are associated expenses
- Royalty income from a mineral working interest (only nonworking interests are in scope)
- Taxpayers who filed or need to file Form(s) 1099

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answer

Answer 1: (c) All taxable income must be reported and rents are reported on Sch E. No allocation of the property taxes is needed since scope denies claiming any expenses on Sch E for land rents.

Income – Governmental Payments

Introduction

This lesson will help you assist taxpayers who have state or local income tax refunds, unemployment compensation benefits, or who received other state payments reported on Form 1099-G.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1099-G (governmental payments)

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine the amount of a state or local income tax refund that is taxable
- Identify unemployment compensation income
- Determine how to report unemployment compensation on the tax return
- Determine how to report other items shown on Form 1099-G

Generally, the governmental agency will report amounts that are taxable to the recipient. However, if the payment is taxable because it was a refund or recovery of a prior deductible item, the payment is taxable only to the extent that the taxpayer received tax benefit for the deduction. That is a key aspect of the first item discussed — state or local income tax refunds.

What are state or local income tax refunds?

Taxpayers who receive a refund of state or local income taxes may receive Form 1099-G reporting their refund amount(s). Not everyone must include the refund in their taxable income. Only taxpayers who itemized and received a federal income tax benefit for deducting their state or local income taxes are required to include their state/local tax refunds in income.

- Taxpayers who claimed the standard deduction on the tax return for the year they received a refund of state or local income taxes do not have to include the refund in their taxable income.
- Taxpayers who itemized and deducted the state sales tax instead of the state income tax withheld or paid do not have to include the refund in their taxable income.
- Some taxpayers could not deduct all their state income taxes because of the annual cap on state and local taxes deduction.

Tax-Aide volunteers can use the Taxable Refund and Recovery Calculator from the Tax-Aide Colorado Resource Toolbox to compute the taxable amount of a tax refund or other recovery in more complicated situations, such as when the prior year had nonrefundable credits that were not used because there was not enough tax to sop up the credit. Had the deduction not been claimed in that prior, there may have been no tax benefit so that the recovery of that item is not taxable.

If the state tax refund situation is straight forward, the worksheet found in the tax software can be used. Be sure to compute and enter the amount of sales tax that could have been deducted in the prior year. Use the IRS sales tax calculator at https://apps.irs.gov/app/stdc/ to compute the prior year sales tax amount.

Refunds of state or local taxes for years prior to the preceding year are in scope for Tax-Aide if it can be readily determined to be wholly taxable or wholly not taxable. For example, it is wholly nontaxable because the standard deduction was claimed in prior years. Or, the taxpayer agrees that the refund is wholly taxable.

Nancy itemized her deductions on last year's federal return. She included the income taxes paid to her state on Sch A. During the current tax year, she received a state refund of the overpaid portion of those taxes. When filing her current year tax return, she must use the state tax refund worksheet to see how much of the refund to include in her federal taxable income.

Exercises

Answers are at the end of the lesson.

Question 1: A taxpayer who itemized their deductions in the prior year must always include any income tax refund in their return as taxable.

a. True

b. False

What is unemployment compensation?

Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or of a state in the U.S. In most cases, unemployment compensation is taxable. If taxpayers contribute to a governmental unemployment compensation program or a governmental paid family leave program and the contributions are not deductible, amounts received under the program are not included as unemployment compensation until the taxpayers recover their contributions. If the taxpayer has already deducted all of the contributions to the program, the entire amount received under the program is taxable and will be reported as such.

Where can I get unemployment compensation information?

Begin with the unemployment question on the Tax-Aide Intake Booklet. Ask the taxpayer for any Form(s) 1099-G, Certain Government Payments, that document unemployment compensation payments from each government entity.

In most states, taxpayers can elect to have federal income taxes withheld from their unemployment compensation benefits. Be sure to review Form 1099-G, Box 4, for any federal income tax withheld.

What if the taxpayer did not get the unemployment benefits shown on 1099-G?

Generally, taxpayers must include in income all unemployment compensation received. If the Form 1099-G shows the wrong amount of unemployment compensation, the taxpayer should contact their state unemployment agency to correct it. Form 1099-G may include payments made fraudulently to others. The taxpayer should report the amount of unemployment benefits they actually received.

What if the taxpayer repaid some of their unemployment benefits?

If the taxpayer repaid unemployment compensation received in the same tax year, the software will subtract the amount repaid from the total amount received and enter the difference on Sch 1 (Form 1040). Refer to the NTTC 4012 for the software entries.

If the unemployment compensation repaid in the current tax year was included in income in a prior year:

- and the amount of repayment is $3,000 or less, no deduction or credit is available.
- and the amount of repayment is more than $3,000, the return is out of scope.

Reporting amounts on Form 1099-G

State and local income tax refunds

First, confirm whether any part of the refund is taxable. If any part of the refund is or could be taxable, the worksheets in the software or on the Tax-Aide Colorado Resource Toolbox will help you with this computation. The taxable portion of the refunds is reported on Form 1040, Sch 1.

Unemployment compensation

The total unemployment compensation received (Box 1) is reported on Form 1040, Sch 1.

RTAA payments

RTAA payments (reemployment trade adjustment assistance) are shown in Box 5 of Form 1099-G. These are reported as other income on Form 1040, Sch 1, not unemployment.

Taxable grants

Taxable grants shown in box 6 are also generally reported as other income on Form 1040, Sch 1, unless the income relates to a business activity and should therefore be included as income on Sch C. If the grant should be included on Sch E, Sch F (farm), or Form 4835 (farm rental), the return is out of scope.

Other payments

Form 1099-G may also report agriculture payments, market gain, or have box 8 checked indicating the state payments are trade or business income, which are also out of scope.

Taxes withheld

The amount of withholding from Form 1099-G, Box 4 should be reported on the Federal income tax withheld from Forms 1099 line of Form 1040.

Summary

This lesson explained:

- How to determine if any part of a state or local income tax refund is taxable
- How to identify and report unemployment compensation
- How to report repayments of unemployment compensation
- How to report other amounts shown on Form 1099-G.
- Taxpayers who itemized deductions in the previous year and received a tax benefit from deducting state or local income taxes may have to report part or all of their refund as income. Taxpayers generally receive Form 1099-G reporting their state or local tax refund.

Where to find more information

Pub 17, Your Federal Income Tax

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness:

- State or local income tax refunds received during the current tax year for a year other than the previous tax year, except as noted in this lesson
- Taxpayers who repaid during the current tax year more than $3,000 of unemployment benefits that were taxed in a prior tax year
- Taxpayers who received taxable grants that should be reported on Sch E, Sch F, or Form 4835

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise Answer

Answer 1: False. If sales tax was deducted in the prior year (not income tax), none of the refund would be taxable. If income tax was deducted, use the state tax refund calculator to determine the portion of the refund that is taxable.

Income – Social Security Benefits

Introduction

This lesson will help you assist taxpayers who receive Social Security and equivalent railroad retirement benefits. These benefits may or may not be taxable.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form SSA-1099 (Social Security)
- Form RRB-1099 (railroad tier 1 Social Security equivalent)

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine the taxable portion of Social Security and railroad tier 1 benefits
- Determine the most advantageous method of reporting lump-sum Social Security benefits
- Report Social Security and railroad tier 1 benefits on the tax return

Social Security benefits

Social Security benefits include old-age, survivor, and disability insurance (OASDI) benefits. Social Security benefits are paid as monthly retirement, survivor, and/or disability benefits. Certain government retirees who receive a pension from work are not covered by Social Security or entitled to reduced Social Security benefits. The rules for benefits eligibility are complex. Taxpayers should be referred to the Social Security Administration if they have questions about their benefits.

Supplemental Security Income (SSI) is not the same as Social Security. SSI is never taxable.

Canadian or German social security

Canadian or German social security benefits are treated as U.S. Social Security benefits for tax purposes and are in scope for Tax-Aide. Taxpayers should provide the U.S. dollar amount to be reported. That should be the gross amount, before any currency conversion costs. Be careful to not confuse Canadian social security with other types of Canadian retirement income. Refer to the NTTC 4012 for the specific benefits that qualify as U.S. Social Security treatment. Check your state's rules as they may differ.

Tax returns including foreign retirement income other than Canadian or German social security require International certification by the preparer and the reviewer. Extra caution is needed to determine whether the retirement account is subject to FBAR or FATCA reporting and, if so, the return is out of scope.

Form SSA-1099

Social Security benefits are reported on Form SSA-1099. Box 5 shows the amount of net benefits.

Taxpayers who did not receive Form SSA-1099, or have misplaced it, may be able to get an instant printout of benefits from their personal “my Social Security” account on the Social Security Administration website at SSA.gov. Or taxpayers may call toll-free to request a benefit statement to be sent by mail. Social Security no longer provides benefit verification letters in their offices.

Railroad retirement benefits (RRBs)

Railroad Retirement Benefits (RRBs) are benefits paid to railroad employees working in jobs that are covered by the Railroad Retirement Act (RRA). The RRA benefits have two components: tier 1 (Social Security equivalent benefits) and tier 2 (treated as a qualified employee plan). Tier 1 railroad retirement benefits are reported on the blue Form RRB 1099. The tier 2 benefits are reported on the green Form RRB 1099-R and were discussed in the prior Income – Retirement lesson 11.

Form RRB-1099

Tier 1 railroad retirement benefits are equal to the Social Security benefit that a railroad employee or beneficiary would have been entitled to receive under the Social Security system. These benefits are called "Social Security equivalent benefits" and, for tax purposes, are treated like Social Security benefits. They are shown on the blue Form RRB-1099. Box 5 shows the net Social Security equivalent benefits for tier 1.

Jacob is a retired railroad switchyard operator. Using the Tax-Aide Intake Booklet, the volunteer determined Jacob received Railroad Retirement Benefits. He received Form RRB-1099 (blue form) and Form RRB-1099-R (green form). The amount from Form RRB-1099 will be added to any amount of Social Security benefits that he may have received from other employment.

When are benefits taxable?

Part of the following benefits received by the taxpayer may be taxable:

- Social Security benefits, including Canadian or German social security
- Railroad retirement benefits, tier 1 (Social Security equivalent portion)

The taxable amount, if any, of a taxpayer's Social Security benefits depends upon filing status and other reportable income. Generally, if Social Security (or Social Security equivalent) benefits were the taxpayer's only source of income, the benefits are not taxable and the taxpayer may not be required to file a federal income tax return.

A portion of the benefits is taxable if total income (including tax-exempt interest), plus one-half of the benefits received, is more than $25,000 for single and head of household or $32,000 for married filing jointly. If the taxpayer is married filing separately and lived with their spouse at any time during the year, 85% of the benefits is automatically taxable.

The taxable portion of Social Security benefits is never more than 85% of the net benefits the taxpayer received. In many cases, the taxable portion is less than 50%.

Taxpayers can use Form W-4V, Voluntary Withholding Request, to request withholding from Social Security benefits.

Wanda and Dan are both retired and will file a joint return. Wanda received Form SSA-1099 with an amount of $4,300 appearing in Box 5. Dan retired from the railroad, and Box 5 of his Form RRB-1099 shows an amount of $6,800. Wanda and Dan will use the combined benefits of $11,100 and only one calculation to see if any of their benefits are taxable.

The tax software will perform all the calculations to determine the taxable amount based on other information on the return.

The amounts reported on SSA-1099 or RRB-1099 for Medicare premiums (Part B and D) may be claimed as a self-employed health insurance deduction if the taxpayer or spouse is filing Sch C (see lesson 17) or used for the PSO exclusion (see lesson 11). Otherwise, enter the total Medicare premiums on the Social Security input screen so they flow to Sch A in case the taxpayer is itemizing deductions. Additionally, be sure to enter any federal income tax withholding.

Exercises

Answers follow the lesson summary.

Question 1: Hank comes to your site to get some help with his tax return. He is upset because his neighbor told him that he would have to pay tax on all his Social Security benefits this year. After talking to Hank, you learn that his wife died several years ago. This tax year, he sold all his stock and moved into senior housing. The sale of the stock created $31,896 of taxable income for Hank. His neighbor told him, with that much income, the entire $11,724 of his Social Security benefits would be taxable. What is the maximum taxable amount of Hank's benefits?

a. $31,896
b. $20,172
c. $11,724
d. $9,965

Lump-sum Social Security benefit payments

Some taxpayers may have received a lump-sum benefit payment. This payment could be for the current tax year and for prior tax years. Box 3 of the taxpayer's Form SSA-1099 or Form RRB-1099 will include the lump-sum payment. The form will also show the year, or years, for which the payment is made. The additional information will be shown in Description of Amount in Box 3 on Form SSA-1099 or in Boxes 7–9 on Form RRB-1099.

Do not confuse this type of lump-sum benefit payment with the lump-sum death benefit that both the SSA and RRB pay to many of their beneficiaries ($250). No part of the lump-sum death benefit is subject to tax.

When figuring the taxable portion of Social Security benefits, two options are available for lump-sum benefit payments:

- The **first option** allows the taxpayer to report the whole payment the year it was received. When the taxpayer chooses this option, simple enter the total Social Security benefits as usual.
- The **second option** is to treat the payment for the prior year as if received in the earlier year or years and is referred to as the lump-sum election method. This is done by figuring whether any part of these benefits would have been taxable based on the earlier year's income. Any part that is taxable would have been taxable is then added to any taxable benefits for the current year and included on Form 1040. The taxpayer can elect this method if it lowers the taxable benefits.

Last year, Jane applied for Social Security disability benefits but was told she was ineligible. She appealed the decision and won. This year, she received a lump-sum payment of $6,000, of which $2,000 was for last year and $4,000 was for the current year. Jane also received $5,000 in Social Security benefits in the current year, so her Form SSA-1099 shows benefits paid of $11,000. Jane had other taxable income in both the previous year and the current year. She should figure her taxable benefits under the lump-sum election method to see if her tax is lower.

Will the lump-sum election method lower taxable benefits?

First, test to see if the first option (including all the benefits in the current year) increases tax. If so, enter the needed information for the second option. You will need copies of the taxpayer's returns for the prior year(s) to which the lump-sum benefit relates.

The software will use the lump-sum method if it is advantageous to do so, in which case, only the current year income will be adjusted. You do not file amended returns for the earlier years.

Once the taxpayer elects the lump-sum method on their return, the election can only be revoked with the consent of the IRS.

Summary

This lesson explained when taxpayers' Social Security benefits and railroad retirement Tier 1 benefits are taxable. Generally, if Social Security benefits were the taxpayer's only source of income, the benefits are not taxable and the taxpayer is not required to file a federal income tax return. If the taxpayer received Social Security benefits and other income, the Social Security Benefits Worksheet found in the Form 1040 Instructions is completed by the software to calculate the taxable portion.

There are two options to compute the taxable portion of lump-sum Social Security benefits. The taxpayer may report the whole payment in the year it was received or treat the payment as received in the applicable earlier

year or years to compute the amount of lump-sum payment that is taxable in the current year. By entering the needed information, the software will use the best option.

Where to find more information

Pub 17, Your Federal Income Tax

Pub 915, Social Security and Equivalent Railroad Retirement Benefits

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise Answers

Answer 1: d. $9,965 or 85% of the net benefits is the maximum amount that could ever be taxable.

Income – Other

Introduction

This lesson will help you recognize other types of income and how to report them. Part I of the lesson is for all certifications.

Part II of this lesson is for those pursuing the optional International certification and will help you report income earned from worldwide sources. To do this, you need to be able to identify the type of income and, if reportable, convert it to the equivalent U.S. dollar value of the foreign currency. This lesson will also cover the foreign earned income exclusion and, to a limited extent, the housing exclusion and housing deduction reported on Form 2555, Foreign Earned Income.

Generally, International certification is required for foreign income items. There is a limited exception for Canadian and German social security as discussed in the Income – Social Security Benefits lesson 14.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

For International candidates:

- Form 2555 & Instructions (foreign earned income)

Optional:

- Form W-2G (gambling)
- Form 1099-NEC
- Form 1099-MISC (miscellaneous)
- Form 1099-Q (education plans)
- Form 1099-QA (ABLE)
- Form 1099-LTC (long-term care)

Objectives

At the end of this lesson, using your resource materials, you will be able to determine:

- Other types of income that may be taxable.
- How to report other types of income.
- How to report credit card cancellation of debt income.
- The amount of excludible main home cancellation of debt income.

International certification candidates will also be able to determine:

- How to report income earned from worldwide sources.
- Who is eligible for the foreign income exclusion, housing exclusion or housing deduction.
- How to determine what income is eligible for the exclusions.
- How to calculate the excludible amount.

Part I: Other income

Income that does not have its own line on Form 1040 is generally reported on Form 1040, Sch 1.

Even if the taxpayer does not receive an income document from the payer, the taxpayer is required to report the income if it is taxable. Refer to the Income Quick Reference Guide in the NTTC 4012, Tab D, to confirm whether the income is taxable or nontaxable. If, consult the NTTC 4012, Tab D, Income, you are unsure about sources of other income or whether an item is taxable, check with your Coordinator or a more experienced Counselor.

Use the interview techniques and tools discussed in earlier lessons to ensure that all taxable income has been included. The following are types of other income that our sites may see more often.

Income might not be reported to taxpayers on tax forms. Question taxpayers closely to ensure that they are reporting all worldwide income.

Gambling winnings

The taxpayer may receive one or more Forms W-2G reporting gambling winnings. Prizes reported on Form 1099-MISC may also represent gambling, for example a charity raffle.

Total gambling winnings must be reported as other income. The amount wagered for the winning can reduce the gross income amount, but not below zero. The amount wagered may be very small (e.g. $1 scratch off lotto) so the taxpayer may not bother to reduce the winnings for the amount wagered.

If the taxpayer also had gambling losses, the losses can only be deducted on Sch A if the taxpayer itemizes. For tax years through 2025, gamble-related expenses may be added to losses if itemizing (limited to overall winnings). See the Deductions lesson 19.

The IRS provides rules that allow a taxpayer who maintains detailed gambling records to use a per-session rule. With such detailed session records, a taxpayer can report the net win sessions as income. The net loss sessions are claimed as an itemized deduction up to the amount of winnings. Tax returns for taxpayers who wish to claim gambling activity using the per-session method or as a business (Sch. C) are out of scope.

Medical trial participation pay

A taxpayer may receive Form 1099-MISC for payments for participating in a medical trial. Taxpayers are generally not considered to have a business of participating in such trials. Report the income on Sch 1. Reimbursements that the taxpayer receives for costs incurred in such trials would not be reported on 1099-MISC and the expenses are not deductible.

Cash for keys program

Cash for Keys Program income, which is taxable, is income from a financial institution, offered to taxpayers to expedite the foreclosure process. The taxpayers should receive Form 1099-MISC with the income in Box 3.

Qualified Medicaid waiver payments

These are the same rules as were discussed in the earlier Wages lesson 8. The difference is that some states report these payments on a 1099 form instead of on a W-2.

Medicaid waiver payment income (MWP) are payments made by a state-certified Medicaid provider to an individual who is a care provider to an eligible person (usually an elderly or disabled relative) living in the same home as the care provider. MWPs may be excluded from the care provider's taxable income. If the care provider and the care recipient do not live together in the same home, the payments are fully taxable.

A taxpayer who excludes MWP from gross income may choose to include, or not include, the MWP in the calculation of earned income for earned income credit and additional child tax credit purposes. The taxpayer must make that choice for all their MWP and cannot pick and choose.

If both spouses have MWP, each may elect to include or not include all their respective MWP in earned income. Tax-Aide volunteers can use the Medicaid Waiver Payments Guide for a complete discussion and software entries in this rare situation.

If the caregiving income does not qualify as MWP, it should be included on Sch C if the taxpayer is in the business of providing such services. Otherwise, the income reported on Form 1099 is reported as other income and not treated as earned income.

Strike benefits

Strike pay comes in three forms: a payment for all strikers, whether or not they belong to a union; a return of dues specifically paid into a union strike pay fund by the employee; or money for union employees from the savings account of the Union, not tied to any prepaid funding arrangements and not available to non-union strikers. The payer will report the taxable amount on Form 1099-MISC, Box 3.

Strike benefits are not subject to self-employment (SE) tax (and should NOT be reported on Sch C). However, strike benefits are earned income for earned income credit eligibility.

Election or poll workers

Generally, election workers are properly classified as employees and may receive a W-2 for their pay if it exceeds a certain amount. If the pay is less than the reporting threshold, the taxpayer may receive a 1099 form

or no tax form. The income is taxable and treated as earned income for earned income credit and additional child tax credit purposes. It is not self-employment income and should not be reported on Sch C. Refer to the Election Workers tax law paper for software entries.

Form 1099-K reporting nontaxable proceeds

Taxpayers who receive monies through a third-party processor may receive Form 1099-K even if they do not have a business. For example, selling excess household goods through an online platform for less than their original cost or when a friend reimburses another friend for their share of a dinner tab may generate a 1099-K. The taxpayer should work with the third-party processor to have a corrected 1099-K issued. The amount of proceeds reported that are not properly included as taxable may need to be shown on the return on Sch 1.

Health savings account distributions

Generally, taxpayers will pay medical expenses during the year without being reimbursed by their medical insurance until the plan's annual deductible is reached. The taxpayer may have a health savings account (HSA) debit card that they use to pay such bills or the taxpayer can receive tax-free distributions from their HSA to pay or be reimbursed for qualified medical expenses incurred in the current or prior year. Distributions exceeding those expenses are taxable and subject to an additional 20% tax. Only medical expenses incurred after the taxpayer establishes the HSA can be used to offset an HSA distribution.

For HSA purposes, qualified medical expenses include the medical expenses of the taxpayer, their spouse, or a dependent at the time the expense was incurred. It does not matter whether the taxpayer has self-only or family coverage.

Qualified medical expenses also include those for any other person who could have been claimed as a dependent on the taxpayer's return except that:

- The person filed a joint return
- The person had gross income of the exemption amount or more, or
- The taxpayer or spouse (if filing jointly) could be claimed as a dependent on someone else's tax return

For this purpose, a child of parents who are divorced, separated, or living apart for the last 6 months of the calendar year is treated as the dependent of both parents whether or not the custodial parent releases claim to the child as their dependent.

Qualified medical expenses are expenses that generally would qualify for the medical and dental expenses deduction. Examples include unreimbursed expenses for doctors, dentists, and hospitals. Additional items that are qualified medical expenses for HSA purposes include the cost of:

- Home testing for COVID-19
- Personal protective equipment for the primary purpose of preventing the spreading COVID-19 (such as masks, hand sanitizer and sanitizing wipes)
- Menstrual care products (tampons, pads, liners, cups, sponges or other similar product)
- Over-the-counter products and medications

Health insurance premiums are not included as qualified medical expenses except for some long-term care, COBRA, coverage while unemployed, or Medicare premiums (see Pub 969 for full information).

Vikki's doctor suggested she take some exercise classes. Vikki signed up for yoga, swimming classes, and a health club. Since these are for general health improvement, they cannot be considered as qualified medical expenses.

For recordkeeping requirements on HSA distributions see Pub 969, Distributions from an HSA.

Taxpayers are not required to take annual distributions from their HSA. However, taxpayers who have taken HSA distributions will receive Form 1099-SA, Distributions from an HSA, Archer MSA, or Medicare Advantage MSA, from their HSA trustee and must be reported on their return. Only HSAs are in scope.

Deceased HSA owner

The surviving spouse of the HSA owner can take the HSA as their own if they are the beneficiary. HSA distributions to someone other than a deceased owner's spouse are out of scope.

Mistaken distributions

If amounts were distributed during the year from an HSA because of a mistake of fact due to reasonable cause, the account beneficiary may repay the mistaken distribution no later than the April tax return due date following the first year the account beneficiary knew or should have known the distribution was a mistake. Under these circumstances, the mistaken distribution is not included in gross income, is not subject to the additional 20% tax, and the repayment is not subject to the excise tax on excess contributions. See the instructions for Form 1099-SA for further information.

HSA rollovers

A rollover is a tax-free distribution to the taxpayer of cash or other assets from one HSA that the taxpayer contributes to another HSA. The contribution to the second HSA is called a rollover contribution. These contributions:

- Are not included in taxpayers' income
- Are not deductible
- Do not reduce taxpayers' contribution limit

The taxpayer must roll over the amount within 60 days after the date of receipt, and may only make one rollover contribution to an HSA during a one-year period. A trustee-to-trustee transfer is not a rollover and not subject to the once in 12-month rule (similar to IRAs).

Completing Form 8889, Part II

Form 8889, Part II, is used to report distributions from an HSA. Taxpayers receive tax-free distributions from an HSA to pay or be reimbursed for qualified medical expenses. The taxpayer will have to tell you what types of expenses were paid or reimbursed with the distribution.

Form 1099-SA reports distributions to a taxpayer. Box 5 will indicate whether the distribution is from an HSA, Archer MSA, or a Medicare Advantage MSA. The code in Form 1099-SA, Box 3, identifies the distribution the taxpayer received. Code 1 is a normal distribution. Refer to Form 1099-SA for an explanation of the other codes.

If distributions are not returned as a mistaken distribution, not rolled over, or not offset with qualified medical expenses, the amount withdrawn will be included in income and reported on Form 1040. HSA distributions included in income are subject to an additional 20% tax unless the account beneficiary:

- Dies
- Becomes disabled (see Form 8889 instructions)
- Turns age 65

ABLE account distributions

A qualified ABLE program is a program established and maintained by a state agency under which a person may make cash contributions to an ABLE account to pay for the qualified disability expenses of an eligible individual (the designated beneficiary). Qualified beneficiaries can have only one ABLE account. Contributions can be made by any person, are limited in amount, and are not deductible for federal income tax purposes – although the beneficiary may be eligible to claim the retirement saver's credit (discussed in the Miscellaneous Credits lesson 25).

Form 1099-QA, Distributions from ABLE Accounts, reports distributions from an ABLE Account. Distributions that do not exceed the qualified disability expenses of the beneficiary during the taxable year are excluded from the beneficiary's gross income. For this purpose, qualified disability expenses include: education; housing; transportation; employment training and support; assistive technology and personal support services; health, prevention and wellness, financial management, and administrative services; legal fees; expenses for oversight and monitoring; and funeral and burial expenses.

If total distributions from an ABLE account exceed the qualified disability expenses of the beneficiary, the excess is included in the beneficiary's gross income and is subject to an additional tax of 10%. Taxable distributions from ABLE accounts are out of scope.

Educational savings account distributions

Form 1099-Q reports gross amount of distributions from education accounts, which can be tax free to the extent of qualified education expenses incurred during the tax year. Generally, qualifying education expenses include: tuition, fees, books, supplies, and equipment that are required by the school; special needs services; room and board if at least half-time; and computers and related services. Qualified education expenses are reduced by tax-free education assistance.

Distributions can be used to pay for qualified postsecondary, secondary, or elementary expenses with some limitations.

Tax-free distributions also include rollovers to another qualified education program or to an ABLE account with 60 days (limited to one per 12 months).

Refer to Pub 970 for qualifying expenses and other rules related to each type of account.

Distributions reported on Form 1099-Q are excluded from gross income and do not need to be reported on the taxpayer's return provided they do not exceed the beneficiary's qualified education expenses for the year. If there is an excess distribution, the part of the excess that represents earnings that have accumulated tax free in the account is taxable and subject to an additional tax. Such taxable distributions are out of scope.

An American opportunity credit or lifetime learning credit can be claimed in the same year the beneficiary takes a tax-free distribution from a QTP or Coverdell ESA, as long as the same expenses are not used for both benefits.

Long-term care benefits

Long-term care benefits are either reimbursements for actual expenses incurred or a per-diem allowance as shown on Form 1099-LTC. In either case, they will generally be less than the long-term care costs paid during the year. As such, the benefits will not be taxable. Form 8853, Section C, should be completed for per diem payments to confirm that no part of the per diem payment is taxable. Forms 1099-LTC showing reimbursements do not need to be entered in the software as they will never be taxable.

Form 1099-LTC may also report accelerated death benefits in box 2. If the insured was certified by a physician as terminally ill (box 5 of the form), the benefits are fully excludible. If certified as chronically ill, the benefits are treated the same as paid under a qualified long-term care insurance contract.

If Form 1099-LTC reflects multiple payees under the insurance contract, the return is out of scope.

Disaster payments

Taxpayers who receive payments as compensation following a disaster may or may not be taxed on those payments. Qualified disaster relief payments as described in Pub 525 are not taxable and are in scope if the return is otherwise in scope after using the Casualty Loss Screening Tool.

Olympic and other prize money

The value of Olympic and Paralympic medals and the amount of United States Olympic Committee (USOC) prize money received for participating in the Olympic or Paralympic games may be nontaxable. The prize money should be reported in box 3 of Form 1099-MISC.

If AGI is not more than $1,000,000 ($500,000 if married filing separately), the prize money is not taxable. After entering the 1099-MISC, another entry is need to subtract it with an adjustment to income on Sch 1 line 24c.

Expense recoveries

Reimbursement in a later year for medical or other expenses deducted in an earlier year must be reported as income up to the amount previously deducted as medical or under another provision. However, do not report as income the amount of reimbursement received that did not reduce the tax for the earlier year.

You can use the Taxable Refund and Recovery Calculator from the Tax-Aide Colorado Resource Toolbox to calculate the taxable amount of a recovery. You will need information from the return of the year in which the prior deduction was claimed.

In 2024, Carla received a reimbursement from her health insurer of $500 for medical expenses she paid in the 2023. Carla did not itemize her deductions in 2023. None of the reimbursement is taxable.

Cancellation of debt income (CODI)

CODI – nonbusiness credit card debt

A debt is a financial obligation which a taxpayer is liable to pay. These include auto loans, credit card debt, medical care, professional services, mortgages, home equity loans, and more. Generally, if a debt for which a taxpayer is personally liable is canceled or forgiven, the taxpayer must include the canceled amount in income. There is no income from canceled debt if the cancellation or forgiveness of debt is a gift or bequest.

Use the Tax-Aide Intake Booklet, to determine if the taxpayer received one or both of Forms 1099-C, Cancellation of Debt, or 1099-A, Acquisition or Abandonment of Secured Property.

Taxability of canceled debt

Taxpayers often question the taxability of canceled debt because they did not receive money in hand. In situations where property is surrendered, such as a repossession, taxpayers feel that by giving up the property they are relieved from any further obligation. Explain that the benefit to the taxpayer is the relief from personal liability to pay the debt to the extent that the debt was not paid off with money or property.

Generally, when debt is canceled the lender will issue Form 1099-C, which is then reported as income by the recipients on their tax return. Only the cancellation of nonbusiness credit card debt is in scope. If the credit card debt related to business activities, the return is out of scope.

Form 1099-C

Generally, if a taxpayer receives Form 1099-C for canceled credit card debt and was **solvent** (assets greater than liabilities) immediately before the debt was canceled, all the canceled debt will be included on the tax return as other income.

Sometimes, Form 1099-C will show an interest amount in Box 3. Because only **nonbusiness** credit card debt income is in scope, any interest on the account would not have been deductible. The amount shown in Box 3 is included in Box 2; therefore, the full amount shown in Box 2 should be reported as other income.

John made a deal with his credit card company to pay $2,000 on his $7,000 balance, and the company agreed to take it as payment in full. In January of the current year, John received a Form 1099-C from his credit card company reporting $5,000 (the amount of debt canceled). John was solvent immediately before the debt was canceled. John must include the entire $5,000 as other income on his tax return.

Lenders and creditors are required to issue Form 1099-C if they cancel a debt of $600 or more. If the debt canceled is less than $600, some lenders or creditors may send a letter or some other form of notification to the taxpayer. Generally, taxpayers must include all canceled amounts (even if less than $600) in income.

The discharge of certain student loan debt in tax years 2021 through 2025 is excluded from gross income. If excludible, the lender will not issue Form 1099-C.

A credit card issuer generally holds the credit card holder harmless following fraudulent charges on their credit card. The credit card holder has no cancelation of debt income and no Form 1099-C should be issued.

Publication 4731, Screening Sheet for Nonbusiness Credit Card Debt Cancellation, located in the NTTC 4012, Tab D, Income, provides step-by-step guidance for you to determine if the cancellation of credit card debt is within scope.

Insolvency

If a taxpayer had nonbusiness credit card debt canceled but the cancellation occurred during bankruptcy or the taxpayer was insolvent immediately before the cancellation, all or part of the debt can be excluded. Insolvency is a condition in which the fair market value (FMV) of all one's assets is less than one's liabilities. However, these situations are out of scope.

For purposes of determining insolvency:

- **Assets** include the value of everything owned (including assets that serve as collateral for debt and exempt assets which are beyond the reach of creditors under the law, such as an interest in a pension plan and the value of a retirement account).
- **Liabilities** are amounts owed and include:
  - The entire amount of recourse debts
  - The amount of nonrecourse debt that is not in excess of the FMV of the property and is security for the debt

You can print the Insolvency Determination Worksheet in the NTTC 4012, Tab D, Income, for the taxpayer. It is up to the taxpayer to determine if they are considered insolvent.

Taxpayer Interview and Tax Law Application

Here is how a volunteer might address the issue with Michelle regarding who has a 1099-C for canceled credit card debt.

Sample Interview

Volunteer Says…	Michelle Responds…
I notice you received a 1099-C from a credit card company.	Yes, I negotiated with them to cancel $3,000 of my debt.
Yes, I can see Form 1099-C shows $3,000 of debt discharged.	I could only afford to pay them $1,000 so it really helped me.
Do you think your total debts at the time exceeded your assets?	I'm not sure, but it's certainly possible.
Please fill out this Insolvency Determination Worksheet to help us determine whether you were insolvent when the debt was forgiven.	OK.

Michelle's Insolvency Determination Worksheet:

Assets (FMV)		Liabilities	
Home	$120,000	Mortgages	$180,000
Car	$15,000	Home equity loans	$50,000
Recreational vehicles, etc.		Vehicle loans	$18,000
Bank accounts	$1,000	Personal signature loans	
IRAs, 401Ks, etc.	$60,000	Credit card debts	$3,000

Assets (FMV)		Liabilities	
Jewelry		Past-due mortgage interest, real estate taxes, utilities, and child care costs	
Furniture	$2,000		
Clothes	$1,550		
Misc.		Student loans	
Other assets		Other liabilities	
Total Assets:	$199,550	Total Liabilities	$251,000
Total Assets minus Total Liabilities = ($51,450) Negative amount equals insolvency Positive amount equals solvency			

Continuing the Interview: Volunteer Says…	Michelle Responds…
According to the worksheet, you were insolvent. I am afraid I can't help you further. We volunteers are not trained to compute the nontaxable portion of canceled credit card debt so we can't complete your return.	Oh, that's disappointing, but I understand.

If assets and liabilities are close to equal (or the taxpayer simply does not want to attempt the worksheet), the taxpayer has the option of including the entire canceled debt as taxable income rather than going somewhere else to get help to claim insolvency.

Exercises

Question 1: Greg was released from his obligation to pay $5,000 of personal credit card debt. The credit card company sent Form 1099-C showing canceled debt of $5,000. Greg is fairly certain he has more debt than he has assets. Should you provide tax return preparation assistance to Greg?

a. Yes, since the entire $5,000 in canceled debt is considered income and reported on Sch 1.

b. No, because it appears Greg is insolvent, which might mean some of the canceled credit card debt would be nontaxable. That makes Greg's return out of scope.

Question 2: Kay was released from her obligation to pay personal credit card debt. She owed $10,000 to her credit card company, which agreed to accept $2,500 as payment in full. Before paying the credit card company, it was determined Kay was solvent (assets greater than liabilities) and not in bankruptcy. The credit card company issued Kay a Form 1099-C, reporting $7,500 as the amount of debt discharged. Based on the information above, can you assist Kay at your site?

a. Yes

b. No

Question 3: Review the information in Question 2 about Kay's canceled debt. If you are able to assist Kay, what amount would be reported on Kay's Sch 1 in regards to the canceled debt?

a. $0

b. $10,000

c. $2,500

d. $7,500

CODI – principal residence

Cancellation of qualified debt on a taxpayer's main home is in scope. Cancellation of nonqualified debt or canceled debt on any other property are out of scope.

State tax laws may differ.

Refer to Pub 4731-A, Screening Sheet for Foreclosures/Abandonments and Cancellation of Mortgage Debt, to ensure that the tax return being prepared is in scope. This screening sheet is reproduced in the NTTC 4012.

- Use Part I of the screening sheet for taxpayers with Form 1099-A for a foreclosure or abandonment of their principal residence
- Use Part II of the screening sheet for taxpayers with Form 1099-C, or both Forms 1099-A and 1099-C resulting from cancellation of debt on a home mortgage loan

Recourse vs. nonrecourse debt

There are two types of debts: recourse and nonrecourse. A recourse debt holds the borrower personally liable. All other debt is considered nonrecourse.

In general, recourse debt (loans) allows lenders to collect what is owed for the debt even after they've taken the collateral (home, car, etc.). Lenders have the right to garnish wages or levy accounts in order to collect what is owed.

A nonrecourse debt (loan) does not allow the lender to pursue anything other than the collateral. For example, if a borrower defaults on a nonrecourse home loan, the bank can foreclose on the home only. The bank generally cannot take further legal action to collect the money owed on the debt. Whether a debt is recourse or nonrecourse may vary from state to state. Several states do not allow recourse loans on main homes.

If a lender cancels a debt and issues Form 1099-C, the lender will indicate on the form if the borrower was personally liable (recourse) for repayment of the debt. For more information on abandonments see Pub 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments.

Cancellation of debt income

Recourse debt holds the borrower personally liable for any amount not satisfied by the surrender of secured property.

- If a lender forecloses on property subject to a recourse debt and cancels some or all of the debt in excess of the fair market value (FMV) of the property, the canceled portion of the debt is treated as ordinary income from cancellation of indebtedness. This amount must be included in gross income unless it qualifies for an exception or exclusion.
- In addition to this cancellation of indebtedness income, the taxpayer may realize a gain or loss on the disposition of the property; this amount is generally the difference between the FMV of the property at the time of the foreclosure and the taxpayer's basis in the property once the foreclosure is completed.

Nonrecourse debt means the borrower is not personally liable for the debt. The entire amount of debt is satisfied by the surrender of the secured property regardless of the FMV at the time of surrender.

- There is never cancellation of debt income for a nonrecourse debt. There may be a capital gain or loss on the disposition of the property (abandoned, foreclosed upon, subject of a short sale, or repossessed by the lender).
- In determining the gain or loss on the disposition of the property, the balance of the nonrecourse debt at the time of the disposition of the property is included in the amount realized (generally the selling price).

EXAMPLE

Jason lost his home to foreclosure because he could no longer make his mortgage payments. At the time of foreclosure, he owed a balance of $170,000 to the lender and the FMV of the property was $140,000. The unpaid debt was canceled.

If Jason is personally liable for the debt (recourse loan), he has $30,000 of ordinary cancellation-of-debt income. He will report the disposition of his home with the selling price of $140,000.

If Jason is not personally liable for the debt (nonrecourse loan) he has no ordinary cancellation-of-debt income. He will report the disposition of his home with the selling price would be $170,000.

	Recourse Debt	Nonrecourse Debt
Borrower is…	Personally liable	Not personally liable
Canceled portion of debt is generally…	Treated as ordinary income and included in gross income (unless it qualifies for an exception or exclusion)	Not applicable. Nonrecourse debt is satisfied by the surrender of the secured property regardless of the FMV at the time of surrender.
Gain or loss on disposition of the property	Generally determined by the difference between the FMV of the property and the adjusted basis	The amount realized includes the balance of the nonrecourse debt at the time of the disposition of the property. This is true even if the FMV of the property is less than the outstanding debt.

Exceptions and exclusions

Some canceled or forgiven debts may be eliminated from income by applying exceptions, or reduced by applying exclusions to the general rule. **Exceptions are applied before exclusions.**

Exceptions may allow the taxpayer to eliminate the following types of canceled debt from income:

- Amounts otherwise excluded from income (e.g., gifts and bequests)
- Certain student loans, in addition to the general exclusion noted above for tax years 2021 through 2025 (e.g., doctors, nurses, and teachers serving in rural or low-income areas)
- Deductible debt (e.g., home mortgage interest that would have been deductible on Sch A)
- Price reduction after purchase (e.g., debt on solvent taxpayer's property is reduced by the seller; basis of property must be reduced)

For more information on exceptions, refer to Pub 4681.

There are several **exclusions** from the general rule for reporting canceled debt as income. Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, must be filed with the taxpayer's return to show the amount of the canceled debt excluded.

The exclusions are:

- Discharge of debt through bankruptcy
- Discharge of debt of insolvent taxpayer
- Discharge of qualified farm indebtedness
- Discharge of qualified real property business indebtedness
- Discharge of qualified principal residence indebtedness

The issues involved in exclusions can be complex. The only type of exclusion that is in scope is discharge of qualified principal residence indebtedness.

Exclusion for discharge of qualified principal residence indebtedness

Taxpayers may exclude from income certain debt forgiven or canceled on their principal residence. If the canceled debt qualifies for exclusion from gross income, the debtor may be required to reduce tax attributes (certain credits, losses, and basis of assets) by the amount excluded.

If a property was taken by the lender (foreclosure) or given up by the borrower (abandonment), the lender usually sends the taxpayer Form 1099-A, Acquisition or Abandonment of Secured Property. Form 1099-A will have information needed to determine the gain or loss due to the foreclosure or abandonment.

If the debt is canceled, the taxpayer will receive Form 1099-C, Cancellation of Debt. If foreclosure/abandonment and debt cancellation occur in the same calendar year, the lender may issue only Form 1099-C, including the information that would be reported on Form 1099-A.

If form 1099-C has event code A indicating bankruptcy, or if an amount is included for interest, the tax return is out of scope.

Qualified principal residence indebtedness

Qualified principal residence indebtedness includes:

- Any debt incurred in acquiring, constructing, or substantially improving a principal residence that is secured by the principal residence
- Any debt *secured by the principal residence resulting from the refinancing of debt* incurred to acquire, construct, or substantially improve a principal residence, but only to the extent that the amount of debt does not exceed the amount of the refinanced indebtedness

A principal residence is generally the home where the taxpayer lives most of the time. A taxpayer can have only one principal residence at a time.

Exclusion limit

The maximum amount that can be treated as qualified principal residence indebtedness for discharges after 2020 and through 2025 is $750,000 ($375,000 if married filing separately).

Canceled qualified principal residence indebtedness cannot be excluded from income if the cancellation was for services performed for the lender or on account of any factor not directly related to a decline in the value of the residence or the taxpayer's financial condition.

Criteria for canceled principal residence debt

Volunteers may assist taxpayers who meet the following requirements:

- The home was never used in a business or as rental property
- The debt was not canceled because the taxpayer filed bankruptcy
- The taxpayer is not in bankruptcy when they come to the site for assistance
- Form 1099-C does not include an amount for interest
- The debt must be a mortgage used only to buy, build, or substantially improve the taxpayer's primary residence, i.e., this money was not used to pay off credit cards, medical/dental expenses, vacations, etc.
- The mortgage was secured by the taxpayer's primary residence
- The mortgage was not more than $750,000 ($375,000 if married filing separately)

Bob refinanced his personal residence and used the loan proceeds from the equity in his home to build a new master bedroom suite on the main level of his house. This debt is qualified principal residence indebtedness.

Tom refinanced his personal residence and used the loan proceeds from the equity in his home to pay off credit cards and buy a car. This debt is not qualified principal residence indebtedness.

Exercises (continued)

Use Pub 4731-A, Part II, in the NTTC 4012 to answer the following questions.

Question 4: Angie had to give up her principal residence and produced Form 1099-C for the cancellation of the $60,000 of mortgage debt. Angie explains that she did not file for bankruptcy, but she lost income by no longer being able to rent out an upstairs bedroom and bath. Angie also verified that the mortgage loan was used entirely to purchase the home and was secured by the home.

Should you assist Angie with her return?

a. Yes
b. No

Question 5: You've gone through Fred's documents and noticed a Form 1099-C showing canceled debt of $50,000.

Using Pub 4731-A, Part II, as a guide, you learned Fred lost his job and could no longer make his mortgage payments. The bank foreclosed on Fred's home. Due to the housing market slump, the value of Fred's home had declined, and his mortgage balance was more than the fair market value of the home. The bank sold Fred's home and canceled the remaining debt ($50,000) not covered by the sale price.

Upon further questioning, you learned Fred had refinanced his home two years ago using the equity in the home. He took cash out of his equity to pay off some credit cards and take a trip to Las Vegas.

Should you assist Fred with the preparation of his return at the VITA site?

a. Yes
b. No

Foreclosures and capital gain or loss

If a taxpayer fails to make payments owed on a loan secured by property, the lender may foreclose on the loan or repossess the property. The foreclosure or repossession is treated as a sale from which the taxpayer may realize a gain or loss. This is true even if the taxpayer voluntarily returns the property to the lender.

Figure the gain or loss from a foreclosure or repossession the same way as the gain or loss from a sale. Gain is the amount realized from the disposition minus the adjusted basis of the property disposed. A loss is realized when the adjusted basis of the property exceeds the amount realized. The gain or loss must be reported on the return and is subject to the rules for a sale of residence as previously discussed in the Income – Capital Gain or Loss lesson 10.

Generally, the amount realized on a foreclosure is considered to be the selling price. But this selling price depends, in part, on whether the debt was recourse debt or nonrecourse debt as discussed above. In addition, the taxpayer may also have ordinary income from the cancellation of debt.

You can use this worksheet from Pub 4681 (Table 1-1) to figure the ordinary income from the cancellation of debt and the gain or loss from a foreclosure or repossession.

Part 1. Complete Part 1 only if you were personally liable for the debt (even if none of the debt was canceled). Otherwise, go to Part 2.	
1. Enter the amount of outstanding debt immediately before the transfer of property reduced by any amount for which you remain personally liable immediately after the transfer of property	
2. Enter the fair market value of the transferred property	
3. **Ordinary income from the cancellation of debt upon foreclosure or repossession.*** Subtract line 2 from line 1. If less than zero, enter zero. Next, go to Part 2	
Part 2. Gain or loss from foreclosure or repossession.	
4. Enter the **smaller** of line 1 or line 2. If you didn't complete Part 1 (because you weren't personally liable for the debt), enter the amount of outstanding debt immediately before the transfer of property	
5. Enter any proceeds you received from the foreclosure sale	
6. Add line 4 and line 5	
7. Enter the adjusted basis of the transferred property	
8. **Gain or loss from foreclosure or repossession.** Subtract line 7 from line 6	
* The income may not be taxable. See chapter 1 for more details.	

Part 1: If the taxpayer is personally liable for the debt (recourse debt), and the amount of outstanding debt (mortgage) is more than the home's FMV, the difference is treated as cancellation of debt income (part 1 of the worksheet above) excludible only if it qualifies.

- If the canceled debt qualifies as excludible from gross income, the exclusion is reported on Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness
- If the canceled debt does not fully qualify for exclusion, some or all of the canceled debt would be reportable as ordinary income on Form 1040, Sch 1 and the tax return is out of scope

Form 982 must be filed with the taxpayer's return to report the excluded amount of discharged indebtedness and the reduction of certain tax attributes. Refer to the NTTC 4012. If the taxpayer kept ownership of the home, the basis adjustment to the principal residence for the excluded canceled debt must be reflected on the form.

If Part 2 is a gain, it may qualify for the gain on main home exclusion ($250,000 or $500,000 for married filing jointly taxpayers and some surviving spouses) previously discussed in the Income – Capital Gain or Loss lesson 10 (Sale of Home). If Part 2 is a loss, it is not deductible. Generally, the taxpayer's gain or loss from a foreclosure or abandonment is reported on Form 8949 and Sch D.

Mortgage workouts and Form 1099-C

Homeowners whose mortgage debt is partly forgiven through a loan modification, or workout, which allows them to continue owning their residence, will receive Form 1099-C reporting the amount of debt discharged. Because the taxpayer kept ownership of the home, there is no disposition and no gain or loss to be reported.

However, if the canceled debt meets the requirements of qualified principal residence indebtedness, Form 982 must be completed to report the amount excluded from gross income and the reduction of tax attributes.

Taxpayers who are not personally liable for the debt (nonrecourse debt) do not have ordinary income from the cancellation of the debt unless the lender:

- Offered a discount for the early payment of the debt, or
- Agreed to a loan modification that resulted in the reduction of the principal balance of the debt

If a lender offers to discount (reduce) the principal balance of a loan that is paid off early, or agrees to a loan modification (workout) that includes a reduction in the principal balance of a loan, the amount of the discount or the amount of the principal reduction is canceled debt whether or not the taxpayer is personally liable for the debt. The amount of the canceled debt must be included in income unless the exceptions or exclusions discussed earlier apply.

Reporting a foreclosure and canceled debt

Frank bought his home on May 14, 2017. His basis in the home was $200,000. After he lost his job last year, he was not able to make the payments. The bank foreclosed in June of the current tax year, and Frank moved out. At the time of the foreclosure, the fair market value of the home was $125,000 and the principal balance of the mortgage was $195,000. All of the debt was incurred to purchase the home. Frank received Form 1099-C for the amount of debt canceled by his bank.

Frank has qualified principal residence indebtedness. His tax return should include Form 8949 and Sch D to show the basis of the home disposed of through foreclosure and a nondeductible personal loss. His Form 982 will exclude the debt cancellation ($70,000 as the excess of mortgage canceled over the FMV of the home) from income.

Reporting a mortgage workout

The facts are the same as the previous example. If Frank had been able to negotiate a workout with his mortgage lender (reducing the amount he owed on the mortgage and staying in the home), he would not have completed Form 8949 and Sch D because he had not disposed of his home.

Assume Frank's lender agreed to reduce his mortgage debt from $195,000 to $175,000. The lender issued Frank a Form 1099-C showing $20,000 of canceled debt. Frank's Form 982 would be completed, but the amount of debt forgiven (or his basis in the home, whichever was smaller) would need to be entered on the form, and his basis in the home would be decreased by that amount.

Exercises (continued)

Question 6: You are working with Robert. Following up to an answer on the Tax-Aide Intake Booklet, you ask Robert if he underwent foreclosure or had to give up his home during the tax year. Robert confirmed that he did, and produced Form 1099-A. Robert also confirmed that he did not receive Form 1099-C. Examining the 1099-A, you note the balance of principal outstanding was $234,000. What should you do next?

a. Ask the questions on in the screening sheet, Pub 4731-A.
b. Ask enough probing questions to determine if Robert had a gain or loss on the foreclosure.
c. Tell Robert his return is out of scope.
d. Complete Form 982.

Question 7: Mary purchased her main home in June 2004 for $175,000. She lost her job and was no longer able to make her mortgage payments. In July of the current tax year, Mary moved out of the home to live with relatives. On July 15, the bank foreclosed on the home. On November 15, the bank discontinued its collection activity and canceled the remaining debt. The fair market value at the time of foreclosure was $100,000 because of the poor housing market, but Mary still owed $150,000 on the mortgage. None of the loan proceeds were used for any purpose other than to buy, build, or substantially improve the principal residence. Mary never used the home for business or rental purposes and has not filed for bankruptcy. Based on this information, what should you do?

a. Tell Mary her return is out of scope.
b. Report a loss of $50,000 on Sch D.
c. Report $50,000 debt canceled on Form 982.
d. Include the debt cancellation amount as ordinary income.

Question 8: After Tom became ill and could not work full time, he and his wife, Grace, were having difficulty making their mortgage payments. Rather than go through the expense of a foreclosure, the lender agreed to reduce the principal on their loan and refinance it with a better interest rate and lower payments. The principal balance before November 1 of the current tax year workout was $130,000, and the lender reduced the loan to $110,000. None of the loan proceeds were used for any purpose other than to buy, build, or substantially improve the principal residence. The home has never been used for business or as rental property, and the taxpayers have not filed for bankruptcy.

Based on this information, what should you do?

a. Tell Tom and Grace that their return is out of scope.
b. Report the reduction in the basis of the home on line 10b of Form 982.
c. Report the $20,000 as a loss on Sch D.
d. Include the debt cancellation amount in ordinary income.

Question 9: Gene bought his home in 2003. His basis in the home was $210,000. He lost his job in January of the current tax year and was not able to make the mortgage payments. The bank foreclosed in August and Gene moved out. At the time of the foreclosure, the fair market value was $145,000 and the principal balance of the mortgage was $185,000. All of the debt was incurred to purchase the home, it was never used for business or as a rental property, and Gene has not filed for bankruptcy. Gene has a Form 1099-C. Gene is personally liable for repayment of the debt.

How should the foreclosure and loss be reported?

a. Report the $40,000 debt cancellation on Form 982, line 10b
b. Report the $40,000 debt cancellation on Form 982, line 2, only
c. Report the $40,000 debt cancellation on Form 982, line 2, and the foreclosure on Form 8949 and Sch D
d. Report the $40,000 debt cancellation on Form 1040, Schedule 1

Part I: Other income summary

Taxable income from all sources is entered on Form 1040. Taxpayers are sometimes alarmed at how high their total income is. If this happens, reassure the taxpayer that the return is not finished yet! It is very likely that adjustments, deductions, and credits will considerably reduce the total tax owed.

Other income includes any taxable income for which there is not a specific line identified on Form 1040. This income is reported Form 1040, Sch 1.

Taxpayers who receive tax forms for HSA distributions (Form 1099-SA), ABLE (Form 1099-QA), education savings account (Form 1099-Q), or long-term care (Form 1099-LTC) payments may have additional reporting requirements and/ or taxable income.

If a taxpayer receives Form 1099-C for canceled credit card debt and was solvent immediately before the debt was canceled, all the canceled debt will be included on the tax return as other income.

Taxpayers who had qualified home mortgage debt canceled or reduced may be able to exclude up to $750,000 ($375,000 if married filing separately) of their cancellation of debt income. The amount reported as proceeds on a disposition of the home depends on whether the debt was recourse or nonrecourse.

Where to find more information

Pub 17, Your Federal Income Tax

Pub 969, Health Savings Accounts and Other Tax-Favored Health Plans

IRS on Medicaid waiver payments

Pub 970, Tax Benefits for Education

Pub 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- HSA distributions to a beneficiary of a deceased HSA owner, other than the decedent's spouse
- Distributions from an ABLE account in which the funds were not fully used for qualified disability expenses
- Distributions from Educational Savings Accounts which were more than the amount of the qualified expenses
- Cancellation of debt and the taxpayer filed bankruptcy or was insolvent immediately before the debt was canceled
- Cancellation of debt on a residence other than a qualified principal residence
- Cancellation of debt for a principal residence that was used in a business or as rental property
- Cancellation of debt when Form 1099-C for cancellation of residential debt includes an amount for interest

Exercise answers

Answer 1: b. Greg is fairly certain that he has more debt than he has assets, which means he is insolvent. His return is out of scope.

Answer 2: Yes. Kay was solvent and not in bankruptcy, and the credit card company issued her a Form 1099-C.

Answer 3: d. Kay would report $7,500 on her Sch 1.

Answer 4: b, No. Because Angie used part of the home as rental property, all the canceled debt may not qualify to be excluded from income. The rules involving mortgage debt exclusions are complex and Angie's return is out of scope.

Answer 5: b, No. Fred's situation is out of scope since a portion of his refinanced debt was used for purposes other than to buy, build, or substantially improve his principal residence.

Answer 6: a. You should use Pub 4731-A, Part I to determine if Robert had a gain or loss on the foreclosure. If the taxpayer receives a Form 1099-C, you would use the screening sheet to determine if the related tax issues are in scope.

Answer 7: c. You would need to complete Form 8949, Sch D, and Form 982. Although there is a loss, it cannot be deducted. The mortgage debt cancellation is not included in income on the tax return because it is covered by the qualified principal residence indebtedness exclusion on Form 982.

Answer 8: b. You would complete Form 982 and report the reduction in the basis of the home. The $20,000 in debt cancellation can be excluded as qualified principal residence indebtedness on Form 982 and is not counted as income on the tax return. Form 8949 and Sch D are not required because Tom and Grace did not dispose of the home.

Answer 9: c. Form 982, Form 8949, and Sch D should be completed. When a residence that is security for a mortgage is abandoned or foreclosed upon, it is treated as having been sold. This results in the foreclosure being reported on Form 8949 and Sch D as sale of home.

If you are pursuing International Certification, continue with the rest of this lesson. Otherwise proceed to the next lesson in your training plan.

Part II: Worldwide income

U.S. citizens and U.S. resident aliens are required to report worldwide income on a U.S. tax return regardless of where they live and even if the income is taxed by the country in which it was earned. Filing requirements are the same as for U.S. citizens and U.S. resident aliens and apply whether income is from within or outside the U.S.

In the current year, Alfredo Kendall earned $40,000 while working in Dallas, Texas, for Dade Corporation. In September of this year, he transferred to their office in Stuttgart, Germany. While in Germany, he earned $30,000 (U.S. dollars). All of Alfredo's wages, including the income he earned in Germany, is included in his gross income. His Form 1040 will show $70,000 in wages.

U.S. citizens and U.S. resident aliens living abroad may be able to claim tax benefits such as the foreign earned income exclusion or the foreign tax credit. This part of the lesson covers the foreign earned income exclusion. The foreign tax credit will be covered in another lesson.

Income is treated the same on the return regardless of the country from which it is derived. Similar income earned inside or outside the U.S. is generally taxed in the same way on the return. Likewise, income earned in the U.S. and not taxed will be treated in the same way if earned outside the U.S. The lines on which income is reported on Form 1040 are the same whether the U.S. citizen or U.S. resident alien is living within or outside U.S. boundaries. See the Income – Military Members lesson 16 for information regarding Combat pay.

Foreign income might be reported to taxpayers on forms or in ways that are not used in the United States. Question taxpayers closely to ensure that they are reporting all worldwide income. Review the income records to ensure that includible amounts are accurate and complete.

Taxpayers with foreign income, bank accounts, or assets may have additional filing responsibilities, which are out of scope. See Sch B instructions for foreign bank accounts or trusts and Form 8938 Statement of Specified Foreign Financial Assets for additional information.

Exercises (continued)

Question 10: Marta Bremer, a U.S. citizen, lives in Mussbach, Germany. Her income includes $22,000 in wages earned in Germany. She earned $300 in interest from her U.S. bank. What is Marta's total income?

a. $0
b. $22,300
c. $300
d. $22,000

Question 11: Mary Carleton, a U.S. citizen, lives in Belgium. Her income includes $10,000 in wages from her Belgian employer, $200 in interest from her U.S. bank, $8,000 in gambling winnings, and $7,000 in child support payments from her ex-spouse. What is Mary's gross income?

a. $8,000
b. $10,200
c. $18,200
d. $25,200

How do I convert foreign income to U.S. dollars?

Exchange rates

All amounts on the U.S. tax return must be stated in U.S. dollars. Taxpayers may provide the U.S. dollar amount to report. If they don't, you can convert income that taxpayers received in foreign currency into U.S. dollars using the appropriate exchange rate. U.S. exchange rates are stated in two ways:

- Units of foreign currency to one U.S. dollar: 0.74855 Euro = 1 U.S. dollar
- U.S. dollars to one unit of the foreign currency: 1.33592 U.S. dollar = 1 Euro

Exchange rates shown here are for example only. Use the exchange rates in effect when the income was received.

To convert a sum of money into U.S. dollars, **divide** the amount of foreign currency by the exchange rate for the foreign currency to one U.S. dollar.

Ryan received 3,000 Euros (€3000) on a day that the exchange rate was 0.74855 Euros to one U.S. dollar. Based on this exchange rate, the value of Ryan's €3000 is: €3000 ÷ 0.74855 = $4,007.75

In other words:

$$\frac{\text{Amount of foreign currency}}{\text{Exchange rate of foreign currency to one U.S. dollar}} = \text{Amount in U.S. dollars}$$

$$\frac{\text{3,000 Euros}}{\text{0.74855}} = \$4{,}007.75$$

Exercises (continued)

Question 12: Caryn received 200 Euros on a day that the exchange rate was .75514 Euros to one U.S. dollar. In U.S. dollars, she would have ____.

a. $264.85
b. $377.57
c. $115.03
d. $11.50

Question 13: Given an exchange rate of .7000, how much is 36,000 Euros worth in U.S. dollars?

a. $252.00
b. $25,200.00
c. $51,428.57
d. $61,614.00

Which exchange rate should I use?

The exchange rate for a particular currency is likely to change every day. Use the exchange rate prevailing when the taxpayer receives the pay or accrues the item. The exchange rate is determined by the date of transaction, which is either the date on the check or the date the money is credited to the taxpayer's account. If there is more than one exchange rate, use the one that most properly reflects the income.

However, the taxpayer can use the average annual exchange rate if:

- Foreign income was received evenly throughout the year, and
- The foreign exchange rate was relatively stable during the year

Taxpayers may use the monthly average exchange rates if they earned foreign income evenly for one or more months, but less than twelve months.

Edward Hall worked in Dallas for Lubbock Incorporated from January until September. On September 29, he was transferred to Lubbock's Mexico City office, where he will be working for three more years. In Mexico, he is paid in Mexican pesos. Because he did not receive his salary in Mexican pesos evenly throughout the year, he cannot use the annual average exchange rate for Mexican pesos for the income he received in pesos. If he does not know the exchange rate at the time he received the funds, he can use the monthly average exchange rate for October, November, and December.

Where to obtain exchange rates

In mid-January, the IRS distributes exchange rates for various currencies to its worldwide offices, including the prior year's average annual exchange rate information. Exchange rates can be found at irs.gov by typing "foreign currency rates" in the search box.

Because taxpayers should use the rate that most closely reflects the value of the foreign currency at the time they receive the income, taxpayers may use an exchange rate that is different from the rates posted in IRS worldwide offices if they find it to be a true representation.

Foreign income exclusions or deductions

Certain taxpayers can exclude income earned in, and while living in, foreign countries. The maximum amount of the foreign earned income exclusion is indexed to inflation annually. The current year amount can be found in the Important Changes lesson in this publication. The foreign earned income exclusion **does not** apply to wages and salaries of U.S. military members and civilian employees of the U.S. government.

If the taxpayer qualifies to exclude foreign earned income, the excludible amount will be reported as a negative amount on the other income line of Form 1040, Sch 1. Since the foreign earned income would have been reported on Form 1040 as taxable wages or as self-employment income, the exclusion (negative amount) will reduce the total income calculated. The method of calculating the tax when the taxpayer elects the foreign earned income exclusion is based on the Foreign Earned Income Tax Worksheet. The tax software will do this calculation automatically.

If a taxpayer elects to exclude foreign earned income, they cannot claim the earned income credit or the refundable portion of the additional child tax credit. In calculating the child and dependent care credit, earned income does not include foreign income that has been excluded.

In addition to the foreign earned income exclusion, an exclusion or a deduction from gross income can also be claimed for the housing amount. To be eligible, the tax home must be in a foreign country and the taxpayer must qualify for the exclusions and deduction under either the bona fide residence test or the physical presence test.

The housing exclusion applies only to amounts considered paid for with employer-provided amounts. The housing deduction applies only to amounts paid for with self-employment earnings.

Refer to Pub 54 and the Form 2555 instructions for more information.

When do I choose the foreign income exclusion?

The foreign earned income exclusion is voluntary. It is not always an advantage to claim the exclusion. If taxpayers wish to claim the exclusion, they must file Form 2555 with a timely return (including extensions). If the taxpayer is not eligible for, or chooses to not claim, the foreign earned income exclusion, foreign income taxes paid on this income may be eligible for the foreign tax credit. See the Foreign Tax Credit lesson 23 for more information.

Once the taxpayer chooses to exclude foreign earned income, the choice remains in effect for that year and all later years until revoked. The taxpayer may revoke the exclusion for any tax year by attaching a statement to the return. 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.

What are the eligibility requirements?

To claim the foreign earned income exclusion, taxpayers must:

- Demonstrate that their tax home is in a foreign country
- Meet either the bona fide residence test or the physical presence test
- Have income that qualifies as foreign earned income

The requirements are applied separately to each individual. If a married couple is working overseas, each spouse must meet all requirements to qualify for the exclusion. If they do qualify, each is entitled to an exclusion of up to the maximum amount for the current year.

What is considered foreign?

The terms foreign, abroad, and overseas do not include:

- Puerto Rico
- Wake Island
- U.S. Virgin Islands
- The Commonwealth of the Northern Marianas
- Guam
- The Midway Islands
- American Samoa
- Johnston Island
- Antarctic region

Exercises (continued)

Question 14: Miranda has lived in Puerto Rico since 2003. Is she eligible for the foreign earned income exclusion?

a. Yes
b. No

How do I determine the tax home?

To claim the foreign earned income exclusion, the taxpayer's tax home must be in a foreign country. The tax home is defined as the country in which the taxpayer is permanently or indefinitely engaged to work as an employee or a self-employed individual, regardless of where the family home is maintained.

For taxpayers who work abroad but do not have a regular place of business because of the nature of the work, their tax home is the place where they regularly live. The tax home for members of the U.S. Armed Forces is the permanent duty station, either land-based or on a ship.

John and Mary are both in the Armed Forces and have been permanently stationed in Germany since August 2007. Their tax home for the current year is Germany.

Exercises (continued)

Question 15: Alan has lived and worked in China since August 16, 2005. China is his tax home.

a. True
b. False

What is a regular place of abode?

For purposes of the foreign earned income exclusion, if taxpayers work overseas for an indefinite period of time, and their regular place of abode is the U.S., the taxpayers cannot designate the foreign country as the tax home.

"Regular place of abode" is defined as one's home, habitation, domicile, or place of dwelling. It does not necessarily include one's principal place of business.

If the taxpayer maintains a place of business, or is assigned to overseas employment in a foreign country for an indefinite period, and does not maintain a regular place of abode in the U.S., the tax home is overseas and the taxpayer may be eligible for the foreign earned income exclusion.

How do I determine whether the U.S. is the taxpayer's regular place of abode?

Ask three questions to determine whether a U.S. home is the taxpayer's regular place of abode:

1. Did you use your home in the U.S. as a residence while you worked at your job in the U.S. just before going abroad to your new job, and did you continue to maintain work (e.g., contacts, job seeking, leave of absence, ongoing business) in that area in the U.S. during the time you worked abroad?
2. Are your living expenses duplicated at your U.S. and foreign homes because your work requires you to be away from your U.S. home?
3. Do you have a family member or members living at your U.S. home, or did you frequently use your U.S. home for lodging during the period you worked abroad?

If the answer to two of the questions is "no," the taxpayer is considered to be indefinitely assigned to the new location abroad and is eligible for the foreign earned income exclusion.

If the answer to all three questions is "yes" and the job duration is for less than one year with the taxpayer returning to the U.S. home, the taxpayer is considered "temporarily away" from home. In this case, the taxpayer does not qualify for the foreign earned income exclusion, but may qualify to deduct away-from-home expenses.

If the answer to two of the three questions is "yes," with the same expectation of job duration and return to the U.S. home, the location of the tax home depends on the facts and circumstances.

Henry is a member of the Armed Forces. He was assigned to a post in Japan last year. This assignment was for an indefinite period that exceeds one year. Margaret, his wife, accompanied him to Japan and has foreign earned income. They have not used their home in the U.S. as a place of residence for over a year. Therefore, their tax home for this year is Japan.

Exercises (continued)

Question 16: Stan is employed on an offshore oil rig in the territorial waters of a foreign country and works a 28-day on/28-day off schedule. He returns to his family residence in the U.S. during his off periods. Does Stan's employment satisfy the tax home test?

a. Yes
b. No

What is the period of stay requirement?

The period of stay is the amount of time the taxpayer stays in the foreign country. To meet the period of stay requirement, the taxpayer must be either:

- A U.S. citizen or U.S. 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
- 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

What is the bona fide residence test?

To meet the bona fide residence test, taxpayers must show that they have set up permanent quarters in a foreign country for an entire, uninterrupted tax year (even though they intend to eventually return to the U.S.). Simply going to another country to work for a year or more is not enough to meet the bona fide residence test. A taxpayer must establish a residence in the foreign country.

A brief trip to the U.S. will not prevent the taxpayer from being a bona fide resident, as long as the intention to return to the foreign country is clear.

Charles is a military spouse who has lived and worked in England since 2006. His mother still lives in the U.S. Charles came to the U.S. for two weeks this year to be with his mother after she had surgery. Charles' trip to the U.S. does not affect his status as a bona fide resident of a foreign country.

Exercises (continued)

Question 17: Zach, a U.S. citizen, has homes in the U.S. and in Spain, where he has worked for the last two years. Zach's spouse, who is also a U.S. citizen, lives with him in Spain. Zach visits the U.S. occasionally. Does Zach meet the bona fide residence test in Spain?

a. Yes

b. No

What is the physical presence test?

If the taxpayers do not meet the bona fide residence test, then they may qualify under the physical presence test rules. To qualify, the taxpayers 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. If any part of the taxpayer's travel is not in any foreign country and takes less than 24 hours, they are considered to be in a foreign country during that part of travel. See Pub 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad, physical presence test section for additional information.

If a taxpayer left England by ship at 10:00 p.m. on July 6 and arrived in Lisbon at 6:00 a.m. on July 8, the taxpayer would lose July 6, 7, and 8 as full days because the trip took more than 24 hours. In this example, if the taxpayer remained in Lisbon, the first full day would be July 9.

Figuring the 12-Month Period

Any 12-month period may be used if the 330 full days in a foreign country fall within that period. If necessary, more than one period may be used, including periods that overlap.

See Pub 54 for clarification on the physical presence rules and for the waiver in cases of war, civil unrest, or similar conditions.

What income qualifies for exclusion?

To qualify for the exclusion, income must be earned income for services 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.

Self-employment income earned in a foreign country is eligible for the exclusion. However, if capital investment is an important part of producing the income, no more than 30% of the profits is treated as earned income. If no services are provided, none of the income is treated as earned income.

See the list in Tab I of the NTTC 4012 for a basic list of what is earned or unearned income. Refer to Pub 54 for a thorough discussion of earned and unearned income and the special rules applied for purposes of the exclusions or deduction.

Alisa, a U.S. resident, is a member of the Armed Forces and has lived in Japan since 2010. Her military pay is not eligible for the foreign earned income exclusion. In her spare time, she is a self-employed DJ in Tokyo. The income from her self-employment may qualify for the exclusion.

What are sources of foreign earned income?

To qualify for the exclusion, services must be performed in a foreign country. Where the payments come from or where they are deposited is not a factor in determining the 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 foreign earned income.

Earl works and lives in the Bahamas. During the tax year, he worked 49 weeks in the Bahamas. He attended a business meeting in Florida for one week, and was on vacation for two weeks. One-fiftieth or 2% of his wages are not foreign earned income because of the week spent working in Florida.

Ron and his wife Amy, both U.S. citizens, have lived in England for two years. Ron is in the military and Amy works in a pastry shop in a nearby town. Ron's military income does not qualify for the foreign earned income exclusion but Amy's wages from the company in England does qualify. The source of Amy's income is England.

Exercises (continued)

Question 18: 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?

a. Yes

b. No

Taxpayer interview and tax law application

Look at the following sample interview for taxpayers Hudson and Hope Howard.

Sample Interview

Volunteer Says…	Hope Responds…
	Will we be able to exclude any of my income on our tax return? I worked for Bavaria Advertising in Munich this past year and made $24,000 in U.S. dollars. I heard that you don't have to pay taxes on income earned in a foreign country and I've never done this before.
That is possible. First, we will have to determine if you meet the requirements. Were you working as a military or civilian employee of the U.S. government?	No, Bavaria Advertising is a foreign company owned by a family right there in Munich.
Great. That would qualify, but Hudson's military pay won't. Let's see. You are a U.S. citizen. You earned wages in a foreign country and the total was less than the maximum amount. You have no self-employment income or business/moving expenses and since you lived on base, you won't have a foreign housing exclusion.	Yeah, that all sounds right.
Now we have to determine if you meet the bona fide residence or physical presence test and if your tax home is in a foreign country.	It sounds complicated to me.
Don't worry, I just need to ask you a few questions. How long did you say you were in Germany?	We moved on base in Germany on March 3, 2011 and just returned to the states on January 10 this year.
No problem then. You were living in Germany for the entire year so you are considered a bona fide resident this tax year. Since your home and place of employment were both	1567 Albion Street, Munich.

Volunteer Says…	Hope Responds…
in Germany, you meet the tax home test. Now, what was your address while you were living in Germany?	
What did you do for Bavaria Advertising?	I was a copywriter.
Do you have Bavaria Advertising's address?	I sure do; it is right here on this statement.
Were you present in the U.S. during this tax year? I have to enter the dates on this form.	Not this year. But we did come home for the holidays last year.

Part II: Worldwide income summary

U.S. citizens and resident aliens are taxed on worldwide income. They must file a U.S. tax return even if all the income is from foreign sources, and even if they pay taxes to another country.

When taxpayers living abroad receive income in foreign currency, the amounts reported on the return must be converted into U.S. dollars. Use the exchange rate prevailing when the taxpayer receives the pay or accrues the item. If there is more than one exchange rate, use the one that most properly reflects the income.

If the taxpayers are eligible to, and wish to, exclude some or all of their foreign earned income, then Form 2555 must be completed. The excludible amount will be entered as a negative number on Sch 1 to offset income reported as wages or self-employment income.

Where to find more information

Pub 17, Your Federal Income Tax

IRS: taxability of long-term disability benefits

Pub 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad

Exercise answers

Answer 10: b. Marta's gross income includes her wages and interest, both of which should be reported on her tax return.

Answer 11: c. Mary's gross income includes her wages, interest, and gambling winnings, all of which should be reported on her tax return. Her child support payments are her only nontaxable income.

Answer 12: a. Dividing 200 Euros by the .75514 exchange rate comes to $264.85.

Answer 13: c. Dividing 36,000 Euros by the .7000 exchange rate comes to $51,428.57.

Answer 14: b, No. Miranda is not eligible for the foreign earned income exclusion because Puerto Rico is not a foreign country.

Answer 15: a, True. Generally, the tax home is the country in which taxpayers maintain their place of business. Because Alan works in China, it is considered to be his tax home. For taxpayers who do not have a regular place of business because of the nature of the work, their tax home is the place where they regularly live.

Answer 16: b, No. Stan is considered to have a residence in the United States and does not satisfy the tax home test in the foreign country. He is not eligible for the foreign earned income exclusion.

Answer 17: a, Yes. Since Zach went to Spain to work and has established a permanent residence there with his spouse, he meets the bona fide residence test.

Answer 18: b, No. Social Security benefits, pension, and dividends do not qualify as earned income; therefore, Juanita does not qualify for the foreign earned income exclusion.

Income – Military Members

If you are pursuing Military certification, continue with this lesson. Otherwise, proceed to the next lesson in your training plan.

Introduction

This lesson will help you address income items received by current and former members of the U.S. Armed Forces that are in scope.

Generally, the at-risk and passive activity issues in this lesson are beyond Tax-Aide's scope. These issues are referenced for those assisting military members living abroad who have limited access to resources and professional preparers.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012
- Pub 3

Optional:

- Pub 525
- Pub 527
- Pub 555
- Pub 925

Objectives

At the end of this lesson, using your resource materials, you will be able to determine:

- Which income items received by members of the U.S. Armed Forces are reportable on the tax return
- The status of any medical separation pay or pay related to service in a combat zone
- The period of suspension related to the sale of a main home
- The proper reporting of qualified reservists' retirement plan distributions that are repaid
- The proper reporting of a residential rental held by an active Military taxpayer

What are the types of military income?

U.S. Armed Forces members receive many different types of pay and allowances. Taxable amounts will be included on the member's Form W-2, box 1. Your state may or may not follow the federal rules.

What income is includible?

The taxable items listed in the NTTC 4012, Tab D, Income, Table 1, are included in gross income. All includible military income will generally be shown on Form W-2, Box 1, and reported on Form 1040 as wages.

If the amount shown on Form W-2, Box 1, differs from the last Leave and Earnings Statement for the current tax year, advise the taxpayer to contact the local accounting and finance or payroll office for an explanation.

What income is excludible?

Excludible income does not have to be reported as income on the tax return. The exclusion applies whether the item is furnished in kind, or is a reimbursement or an allowance.

The items listed in the NTTC 4012, Tab D, Income, Table 2, are excluded from gross income. For example, the Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS) can be excluded from gross income as a qualified military benefit. Excludible income will not be included in the amount on Form W-2, Box 1. Combat zone and qualified hazardous duty area pay will not be included in box 1, but will be shown because, as discussed later, it can be used to increase certain tax credits.

If U.S. Armed Forces members were provided a commuter highway vehicle (such as a van) by their employer, refer them to Pub 525, Taxable and Nontaxable Income, and to a professional tax preparer.

Exercises

Answers follow the lesson summary. Use the Armed Forces Gross Income charts in the NTTC 4012, Tab D, to answer these questions.

Question 1: Enlistment and reenlistment bonuses are excluded from a service member's income.

- **a.** True
- **b.** False

Question 2: Which of the following items is excludible from U.S. Armed Forces members' income?

- **a.** Hazardous duty pay
- **b.** Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS) income
- **c.** Basic pay
- **d.** Hardship duty pay

Homeowners Assistance Program (HAP)

HAP was created to compensate qualified military and civilian employee homeowners when base closures negatively impact the real estate market or when they were required to permanently relocate during the home mortgage crisis. These payments for qualified military base realignments and closures are generally excluded from income.

What is military separation with disability severance pay?

Disability severance pay has varying effects on a service member's income and taxes. U.S. Armed Forces members who have been separated from the military after years of service or for medical reasons are given severance pay, which is generally taxable as wages.

If the member receives disability severance pay and is later awarded Veteran's Affairs (VA) disability benefits, 100% of the disability severance benefit may be excluded from income. The VA makes the determination that the member is entitled to medical disability benefits, and the determination process can take several months, and sometimes years.

What is VA disability compensation?

VA disability compensation is a monetary benefit paid to veterans who are disabled because of injury or disease incurred or aggravated during active military service. The veteran's service must have been terminated through separation or discharge under honorable conditions. 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. The VA does not issue Form W-2, Form 1099-R, nor any other document for nontaxed veteran's disability benefits.

What happens after a service member receives a letter of determination?

Once the VA sends a letter of determination, all future pension payments from the government are offset by the disability amount paid directly from the VA. Disability payments received directly from the VA are not taxable and are not included on Form W-2 or Form 1099-R.

Although pension payments made before the letter of determination was issued have already been taxed, the letter exempts from taxes the same amount of previous pension payments. U.S. Armed Forces members who have already filed a tax return and reported that pension income should file Form 1040-X, Amended U.S. Individual Income Tax Return, and attach a copy of the letter of determination.

Exercises (continued)

Question 3: Disability payments sent directly from the VA to the discharged service member _____.

a. Are taxable
b. Appear on the taxpayer's Form W-2 or 1099-R
c. Are not included on the taxpayer's Form W-2 or 1099-R
d. May begin before the VA issues the letter of determination

Anita Zapata was an active-duty service member who was separated due to a medical condition, and began receiving her military pension in February of the previous tax year. Here are the payments she reported on that year's tax return:

Payments	***Amount***
• *Service pension*	*$33,000*
• *Active duty pay*	*$ 5,000*

In the current tax year, the VA determined that she was retroactively entitled to a VA disability pension of $837 each month from the date of her discharge (February of the previous tax year). She can amend her tax return to exclude $9,207 ($837 x 11 months) of the pension she received.

She must attach a copy of her letter of determination to the amended return. Her current tax year Form 1099R will not include the nontaxable VA disability retirement payments received during that year.

What is a 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 becomes a combat zone and ceases to be a combat zone on the dates the President designates by Executive Order. Pub 3 lists the specific areas and dates.

A taxpayer serving in a combat zone may qualify for relief from certain IRS compliance actions, such as audits or enforced collections, until 180 days after the taxpayer has left the zone. Taxpayers qualifying for such combat zone relief may notify the IRS directly of their status through a special e-mail address: combatzone@irs.gov. They should provide name, stateside address, date of birth, and date of deployment to the combat zone. They should not include any Social Security numbers in an e-mail. This notification may be made by the taxpayer, spouse, or authorized agent or representative.

Hazardous duty areas are determined by Congress. 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 for federal income tax purposes.

Members in the military with combat pay may:

Choose to include excluded combat pay in earned income for EIC (lesson 29), ACTC (lesson 24), and child/dependent care credit (lesson21) purposes.

Be able to contribute to an IRA with extended time within which to make the contribution – see the Military Adjustments to Income lesson 18.

Have additional time within which to file their returns – see Military Finishing and Filing the return lesson 32.

What is the combat zone exclusion?

Combat zone pay is pay received by a member of the U.S. Armed Forces who serves in:

- Combat zone

- A qualified hazardous duty area, or
- An area outside either of the above

The entitlement to the pay must have fully accrued in a month during which they served in the combat zone or were hospitalized due to wounds, disease, or injury incurred while serving in the combat zone. 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.

The following section is to help you understand when pay is considered excludible as combat pay. You will not be making any decisions about what is excludible. The information on the military member's Form W-2 indicates the amount of combat pay with a code Q. If military members feel the amount is incorrect, refer them to the local accounting and finance or payroll office for clarification. Do not change any amounts on Form W-2 when entering them in the tax software.

What qualifies as service in a combat zone?

Service in a combat zone includes periods that military members are absent from duty because of illness, wounds, or leave. If, as a result of serving in a combat zone, military members become prisoners of war or are missing in action, they are considered to be serving in the combat zone as long as they remain in that status for military pay purposes.

When does service outside a combat zone qualify as service inside a 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
- Qualifies a member for hostile fire/imminent danger pay due to dangers or risks from the combat zone

Military pay received for this service will qualify for the combat zone exclusion if the other requirements are met.

What is nonqualifying presence in a 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 two points that are outside a combat zone
- Presence in a combat zone solely for a member's personal convenience

Sgt. Bobby Osage was not assigned to a combat zone but he performed duty that qualified for hostile fire pay. He can exclude that income.

U.S. service 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.

Exercises (continued)

Question 4: Which of the following may qualify as service in a combat zone?

a. Temporary duty in a combat zone
b. Traveling through a combat zone between two points outside of the combat zone
c. Presence in a combat zone while on leave from a duty station located outside the combat zone
d. Direct support of a qualified hazardous duty area but not entitled to hostile fire/imminent danger pay

What is the amount of the combat zone exclusion?

Enlisted members, warrant officers, or commissioned warrant officers who serve in a combat zone during any part of a month (even one day) can exclude all of that month's military pay, including awards and reenlistment

bonuses for which the member becomes eligible while in the combat zone. Military pay earned while hospitalized due to wounds, disease, or injury incurred in the combat zone can also be excluded.

Commissioned officers (including limited duty officers) may exclude pay according to the rules for enlisted members. However, the amount of the exclusion is limited to the highest rate of enlisted pay plus the amount of imminent danger/hostile fire pay received for each month during any part of which they served in a combat zone or were hospitalized as a result of their combat zone service.

Taxpayer interview and tax law application

Here's how a volunteer might help taxpayers with combat pay in a sample interview:

Volunteer Says…	Mrs. Fannin Responds…
Let's talk for a minute about where your husband was stationed.	My husband was in a combat zone for part of the year. Do I need to tell you the dates or anything?
The combat pay is not taxable, but it's shown on your husband's W-2, here in Box 12, with code Q. I will enter that into the system with the rest of the W-2 information, because combat pay can increase some tax credits. I can show on the tax return that he was in the combat zone, but I don't need to know the exact dates.	Ok.

What are the laws regarding community property?

The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. The states of Tennessee and South Dakota have passed elective Community Property Laws. Special rules apply to married taxpayers who file separately or who were divorced during the tax year and their ***domicile*** is in a community property state. For military members residing in these states, the key word is domicile, which describes someone's legal, permanent residence. It is not always where the person presently lives.

Married taxpayers who choose to file separately, when subject to community property rules, have to figure community income and separate income for state and federal income tax purposes.

How do community property laws affect Armed Forces pay?

Whether an item is subject to community property laws depends on whether the payment is classified as active pay or retired/retainer pay:

- State community property laws apply to active military pay. Generally, the character of the pay as separate from community income is determined by the marital status and/or domicile of the service member and spouse while the member is on active military service.
- Armed Forces retired or retainer payments may be subject to community property laws.

Sale of main home suspension period

In determining whether the ownership and use tests were met for the exclusion of gain from the sale of a main home, there are special rules for members of the Armed Forces, intelligence personnel, and Peace Corps volunteers in the application of the five-year period. See "Five-year Test Period Suspension" in the Income – Capital Gain or Loss lesson 10.

Qualified plan repayments

Qualified reservist repayments

A reservist (as defined above) who was ordered or called to active duty after September 11, 2001 may be able to contribute (repay) amounts to an IRA. The amount that can be repaid cannot be more than the qualified reservist distributions (defined below) received. These repayment contributions can be made even if they

would cause total contributions to the IRA to be more than the general limit on contributions. To be eligible to make these repayment contributions, the qualified reservist distribution must have been received from an IRA or from a section 401(k) or 403(b) plan or a similar arrangement.

A distribution is a qualified reservist distribution if the following requirements are met.

- The individual was ordered or called to active duty after September 11, 2001.
- The individual was ordered or called to active duty for a period of more than 179 days or for an indefinite period because they are a member of a reserve component.
- The distribution is from an IRA or from amounts attributable to elective deferrals under a section 401(k) or 403(b) plan or a similar arrangement.
- The distribution was made no earlier than the date of the order or call to active duty and no later than the close of the active-duty period.

The total of qualified reservist repayments cannot be deducted, cannot be more than the qualified reservist distributions, and must be made not later than the date that is 2 years after the individual's active-duty period ends. The repayment of qualified reservist distributions doesn't affect the amount that can be deduct as an IRA contribution.

The repayment cannot be deducted and is instead treated as basis in the IRA. The repayment amount is included with nondeductible contributions on line 1 of Form 8606.

Charlie is on active duty and contributed the maximum to his traditional IRA ($7,000) for 2024. Based on his income and filing status, he gets a full deduction on his return.

In 2023, Charlie received a $3,000 qualified reservist distribution from his traditional IRA, which he would like to repay this year. Charlie can contribute a total of $10,000 to his IRA made up of the maximum deductible contribution of $7,000 and a $3,000 qualified reservist repayment. Because Charlie is making a nondeductible qualified reservist repayment ($3,000), he must file Form 8606 with his return showing $3,000 on line 1 of Form 8606.

Residential rental

Members of the military may rent out their home while they are away at a permanent duty station. These situations are in scope with some caveats and special rules. Short-term rentals that are properly reportable as a business on Sch C are not in scope.

Special attention is needed for a year during which the taxpayer uses the home as their residence (that is, for more than 14 days). This is usually the first year and the last year of their deployment.

Residential rentals are in scope with Military certification when the taxpayer is active military only.

Renting personal property, such as equipment or vehicles, is out of scope.

If the taxpayer used the dwelling as a home and rented the unit for **fewer than 15 days** in the current tax year, do not report the rental income and do not deduct any rental expenses. If the taxpayer itemizes deductions on Sch A, the taxpayer can deduct allowable qualified home mortgage interest and property taxes.

What is rental income?

Generally, payment received for renting a room or a home to a tenant is rental income reportable on Sch E. U.S. citizens and resident aliens must report rental income, regardless of whether the rental property is located in the U.S. or in a foreign country. Gross rental income may include other payments in addition to the normal and ordinary rents received, such as:

- Advanced rent
- Security deposits, if it represents rental income
- Payments for breaking a lease

- Expenses paid by the tenant
- Fair market value of property or services received instead of rental payments

A cost-sharing arrangement, such as a roommate, is not a rental arrangement.

The security deposit is not included in income when the taxpayer plans on returning the deposit at the end of the lease. However, if the security deposit is intended to serve as the last month's rent, then it should be included in income when received.

The taxpayer's method of accounting affects when the rental income is reported. The cash method reports income when received and expenses when paid; most individuals use this method. The accrual method reports income when earned and expenses when incurred and is out of scope.

It is important that property be rented at fair rental value. If a property is rented at less than fair rental value, the income and expenses are reported in a different manner than discussed in this lesson. Tax returns for taxpayers who rent their property at less than fair rental value are out of scope.

What qualifies as a rental expense?

Taxpayers who reside in homes they own may be able to itemize and deduct mortgage interest and property taxes on Sch A. However, when a taxpayer rents out a home, those become rental expenses along with certain other operating expenses. Taxpayers who do not use the rental home as their residence may deduct all of the rental expenses, even if they exceed income.

Mortgage interest

Mortgage interest or points on a loan used to buy or improve the property is deductible as a rental expense. Interest is normally paid in arrears (on the first day of the month after the month in which the interest accrued). Taxpayers cannot claim a deduction for interest paid in advance.

If the residence (or a portion of the residence) was used as rental property for any part of the year, the taxpayer must allocate the property tax and mortgage interest deductions between Sch A (personal use) and Sch E (rental). That allocation can be based on a percentage of time (4 months as a residence and 8 months used as rental) or based on an area (1,500 sq. ft. as a residence and 500 sq. ft. as the rental portion).

- Personal use as a residence means use for more than the greater of:
  - 14 days
  - 10% of the days rented at fair value

Generally, mortgage interest expense allocated to the rental is fully deductible. Mortgage interest allocated to personal use may be limited as discussed later in the Deductions lesson 19.

Points paid for the use of money are interest and deductible over the life of the loan. Similarly, loan origination cost can also be amortized over the life of the loan. As with deprecation, the taxpayer needs to provide the deductible amount of these items for you to include them on Sch E.

Tax returns for taxpayers with rental-related interest expenses other than mortgage interest are out of scope.

Tax returns for taxpayers who received a Mortgage Credit Certificate are out of scope.

Property taxes

For rental expense purposes, property taxes have the same meaning as for an itemized deduction. If any part of the property tax is designated for local benefits that increase the value of the property, such as streets and sidewalks, that portion of the tax is added to the basis of the property rather than deducted as an ordinary rental expense or an itemized deduction. If part of the property tax bill includes services (such as trash removal), the part allocated to the rental is claimed on Sch E (the personal part would not be deductible at all).

Paul Kingman lived in his home through September, when he was transferred overseas. He rented his home beginning in October. The total amount of Paul's mortgage interest for the tax year was $2,400 and his property taxes were $600. Report nine months (January–September) of mortgage interest and property taxes as itemized deductions on Sch A, that is, $1,800 and $450, and the other three months (October–December) as expenses on Sch E, that is, $600 and $150.

Exercises (continued)

Question 5: John Princeton was transferred overseas and began renting out his residence on September 1 of the tax year. How much of his mortgage interest and property taxes should be reported on his Sch E?

a. All of it
b. Eight-twelfths (2/3 or 67%)
c. Four-twelfths (1/3 or 33%)
d. None of it

Insurance expense

The property insurance that taxpayers pay on their residence is deductible as a rental expense for the time it is considered rental property. If the residence is rented for part of the year, only the amount that covers the rental period is deductible. If a portion of the residence is rented, the deductible portion must be allocated and deducted on Sch E.

Insurance premiums paid more than one year in advance cannot be deducted in one year; instead, advanced premium payments are prorated over the period covered by the policy. The portion deductible in the current year is that amount that covers the current year. The remainder is spread out over the life of the insurance coverage.

Travel expenses away from home

Taxpayers can deduct ordinary and necessary travel and transportation expenses of traveling away from home if the primary purpose of the trip is to collect rental income or to manage, conserve, or maintain the rental property. If the travel was in or outside of the U.S., taxpayers should substantiate the pleasure vs. business portions of the trip and allocate the expenses accordingly.

Taxpayers who use their personal automobile for rental-related trips may use either the standard mileage rate or the actual expense method for business mileage. However, only the standard mileage rate method is in scope. The standard mileage method multiplies the miles driven for business by a standard rate. The standard rate includes all expenses of operating the vehicle. Parking, tolls, and the business use portion of interest on a car loan can be added to the standard mileage deduction. See the Important Changes lesson, for the current year standard mileage rate. Taxpayers may use the standard mileage rate only if they meet one of these requirements:

- The vehicle was owned and used the standard method the first year the vehicle was placed into service or
- The vehicle was leased and used the standard method for the life of the lease

The actual expense method figures the deduction based on a variety of factors, including gasoline, oil, repairs, insurance, and rentals and may even involve depreciation or the value of a vehicle provided by the taxpayer's employer. The actual expense method is out of scope.

Transportation expenses incurred to travel between a taxpayer's home and rental property generally constitute nondeductible commuting costs unless the home is the taxpayer's principal place of business.

Repairs and improvements

Taxpayers often misunderstand when an expense qualifies as a repair or an improvement. A repair keeps the property in good operating condition; the cost is a current year deduction. An improvement adds to the life or

material value of the property, prolongs its useful life, or adapts it to new uses. This cost must be depreciated over the recovery period for the improvement. The total cost of an improvement includes material, labor, and installation.

Similar to business expenses on Sch C discussed in the Income – Business lesson 9, taxpayers can elect to include as expenses repairs, improvements, or purchased items that might otherwise have to be capitalized on their tax return. Items that cost $2,500 or less can be expensed immediately by using the de minimis election in the regulations. When the taxpayer makes this election, it applies to all eligible items paid during the year. Note that this is not a Section 179 expense election, which is shown on Form 4562, Depreciation and Amortization. Instead, the expense is shown as repairs or other expense on Sch E.

Taxpayers cannot deduct the cost of their own labor when making repairs.

See the table below for examples of repairs and improvements.

Repairs (Deductible)	Improvements (Depreciable)
Painting	Adding a room
Fixing gutters	Installing a new fence
Repairing driveways	Putting in plumbing or wiring
Replacing window glass	Replacing a hot water tank
Repairing the roof	Putting on a new roof
Repairing appliances	Replacing/adding major appliances

Depreciation

The cost of property with a useful life of more than one year and used in a trade or business or held for the production of income (such as rent) is recovered by deducting an expense called depreciation.

Depreciable property includes buildings, machinery, furniture, equipment, vehicles, and any cost for additions or improvements to rental property. The value of land, however, is not depreciable; therefore, the cost of clearing, grading, planting, or other land improvements are also not depreciable.

Depreciation allows the taxpayers to deduct some of the cost of the property each year on their tax return. The annual amount of depreciation on property reduces the taxpayers' basis in that property. Taxpayers should claim the correct amount of depreciation expense every year. Even if they did not deduct the depreciation expense during any tax year, they must still reduce their basis in the property by the amount of depreciation that they should have deducted.

The factors that determine the depreciation amount are:

- Depreciation method used
- Basis of the property
- Recovery period for the property

The most common depreciation methods for determining depreciation are:

- Straight line or declining balance for property placed in service before 1981
- ACRS (Accelerated Cost Recovery System) for property placed in service after 1980, but before 1987
- MACRS (Modified Accelerated Cost Recovery System) for property placed in service after 1986

Generally, the basis for depreciation is the purchase price of the property, including the cost of improvements, but not including the value of the land. 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. The total of the yearly expense deductions for depreciation can never total more than the basis of the depreciable property.

Taxpayers must complete and attach Form 4562, Depreciation and Amortization, for rental activities only if claiming depreciation on property placed in service during the year. Form 4562 would be required also for special depreciation allowances, including Section 179 immediate write-off, but these are out of scope.

You are not expected to compute depreciation for the taxpayer. Instead, taxpayers should figure the depreciation on their own worksheet and provide you with a depreciation expense amount to include on their Sch E. Do not attach these computations to the return, but taxpayers should keep them in their records for future reference.

Other deductible rental expenses

In addition to the items discussed above, deductible rental property expenses include these items listed on Sch E:

- Advertising
- Cleaning and maintenance
- Commissions paid for collecting rental income
- Legal and professional fees
- Property management fees
- Utilities
- Other rental-related expenses, such as rental of equipment, long distance phone calls, and condominium/ cooperative maintenance fees

When a tenant does not pay the rent, a cash-basis landlord cannot take a deduction for the unpaid rent. Taxpayers cannot take a deduction for a payment they did not include in income.

Exercises (continued)

Question 6: All of the following are examples of deductible rental expenses except _____.

a. Carpet cleaning fees
b. Charges for phone calls made to the property manager
c. Gas and electric bills paid for the rental property
d. Repairs made to the homeowner's personal residence

Question 7: Which of the following rental expenses must be recovered by taking depreciation?

a. Home insurance premiums
b. Painting
c. Installing a backyard fence at a cost of $3,500
d. Repairing a broken furnace

Qualified business income deduction (QBID)

When the residential rental qualifies as a business, the net profit from the rental can be used for the QBID. QBID is discussed in the Deductions lesson 19. If the taxpayer wants to claim that their rental is a business, the return is out of scope.

How do I handle rental property that the taxpayer also uses?

When the rental property is a portion of the taxpayer's residence, the rental expenses must be determined separately from the taxpayer's personal expenses.

Expenses that apply to only the rental part of a property are direct business expenses and should be reported in full on Sch E. The cost of installing a second phone line strictly for a tenant's use, for example, is deductible

as a rental expense. However, the taxpayer cannot deduct any part of the cost of the first phone in a partially-rented property, even if tenants use it.

Expenses that benefit the entire property (indirect expenses) must be allocated between rental use and personal use; the rental portion is reported on Sch E.

If deductions are itemized, the personal portion of qualified home mortgage interest and property tax may be reported on Sch A. The taxpayer can choose any reasonable method to allocate the expenses. The most common methods are based on the number of rooms in the dwelling or on the total area of the dwelling. On Sch E, report expenses that apply exclusively to the rental portion and the applicable percentage of expenses that benefit the entire house.

Gloria rents one room in her 1,200 square foot house to a tenant. The rental room measures 10 feet by 12 feet (120 square feet, or 10% of the total house). This is how she would report these items:

- *For the rental on Sch E:*
  - *100% of the cost to wallpaper the tenant's room*
  - *10% of mortgage interest, property taxes, utilities, and depreciation*
- *For the personal portion on Sch A:*
  - *90% of the mortgage interest*
  - *90% of the property taxes*

Expenses related to days of personal use do not qualify as rental expenses. The taxpayer must allocate the expenses based on the number of days of personal use to total use of the property.

Charles used his rental property for personal use 7 days and rented it for 63 days. As a percentage 7 = 10% of 70 total days (7 personal days + 63 rented days). In most cases, 10% of Charles' expenses are not rental expenses and cannot be deducted on Sch E.

Exercises (continued)

Question 8: For taxpayers who rent part of a property in which they live, which expenses are reported only on Sch E and not on Sch A?

a. Home insurance and mortgage interest
b. Property taxes and repairs
c. Utilities and home insurance
d. Depreciation and property taxes

How should taxpayers report rental expenses that exceed their rental income when they live in the home for part of the year?

If taxpayers rented out a dwelling unit that they also used for personal purposes during the year, they may not be able to deduct all the expenses for the rental part. A dwelling unit (the unit) means a house, apartment, condominium, or similar property. A day of personal use is any day, or part of a day, that the unit was used by:

- The taxpayer for personal purposes,
- Any other person for personal purposes, if that person owns part of the unit (unless rented to that person under a "shared equity" financing agreement),
- Anyone in the taxpayer's family (or in the family of someone else who owns part of the unit), unless the unit is rented at a fair rental price to that person as their main home,
- Anyone who pays less than a fair rental price for the unit, or
- Anyone under an agreement that lets the taxpayer use some other unit

For this purpose, the taxpayer's family includes brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants.

However, taxpayers who used a dwelling unit as their main home may not have to count all that time as “days of personal use.” Do not count as personal use any day the taxpayer:

- Spends working substantially full time repairing and maintaining the unit, even if a family member used it for recreational purposes on that day, or
- Used the unit as the taxpayer’s main home before or after renting it or offering it for rent, if the taxpayer rented or tried to rent it for at least 12 consecutive months (or for a period of less than 12 consecutive months at the end of which the taxpayer sold or exchanged the home).

However, this special rule doesn’t apply when dividing expenses between rental and personal use.

On February 28, Trent moved out of the house he had lived in for six years because he was deployed overseas. He rented his house at a fair rental price from March 15 last year to May 14 this year. On June 1 this year, he returned from his deployment and moved back into his house. Because he rented his property for 12 or more consecutive months, his use of the house is not counted as personal use. Since these days are not counted as days of personal use, the limitations on deductions do not apply. He will, however, still allocate expenses between the rental use and personal use periods.

Are there any limitations?

There are limitations based on whether the taxpayer used the dwelling unit as a home and it meets the personal use test. The personal use test is met if the taxpayer used the unit for personal purposes in the current tax year **more than the greater of:**

- 14 days or
- 10% of the total days it was rented to others at a fair rental price

If the taxpayer did not use the dwelling unit as a home, the taxpayer can deduct all the expenses for the rental part, subject to the at-risk rules and the passive activity loss rules.

If the taxpayer used the dwelling as a home and rented out the unit **at** least 15 days in the current tax year, the taxpayer may not be able to deduct all of the rental expenses. The taxpayer can deduct all of the following expenses for the rental part on Sch E:

- Mortgage interest
- Real estate taxes
- Casualty losses (out of scope)
- Other rental expenses not related to the taxpayer’s use of the unit as a home, such as advertising expenses and rental agents’ fees

If there is rental income left after deducting these expenses, the taxpayer can deduct other expenses, including depreciation, up to the amount of remaining income. The taxpayer can carry over to the following tax year the unused expense amounts.

How do I handle rental losses?

Deducting all rental expenses and depreciation from the rent received may result in a net loss. Rental losses are not always fully deductible. There are two restrictions on how much a loss can offset other sources of income:

- At-risk rule
- Passive activity rules

What is the at-risk rule?

The at-risk rule places a limitation on the amount the taxpayer can deduct as losses from activities often described as tax shelters. Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount the taxpayer has at risk in the activity at the end of the tax year.

What are the passive activity rules?

The passive activity rules state that passive activity losses can be deducted only from passive activity income. Passive income does not include salary, dividends, or other investment income but is generally attributed to such things as rental income. Therefore, losses that exceed rental income (the passive activity) are not deductible. However, some losses may be deductible if an exception is met.

The limits on deducting rental losses are affected by the degree to which renting out the property is a passive activity or involves active participation:

- Passive rental activity means receiving income mainly from the use of property rather than for services.
- Active participation means making significant management decisions, such as approving rental terms, repairs, expenditures, and new tenants. Taxpayers who use a leasing agent or property manager could be considered active participants if they retain final management rights.

Exception

Rental activities are generally considered passive activities. For this reason, rental losses are not fully deductible. However, an exception to the passive activity rule provides that taxpayers who actively participate in the rental activity can use up to $25,000 of their rental losses to offset any other nonpassive income ($12,500 for married taxpayers filing separately and living apart for the entire year). Examples of nonpassive income are salaries, wages, commissions, tips, self-employment income, interest, dividends, annuities, and some royalties. This deduction is reduced if the taxpayer's adjusted gross income (AGI) exceeds certain limits.

What is active participation?

It is considered active participation when taxpayers own at least 10% of the rental property and make management decisions in a significant and bona fide sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditure, and similar decisions.

Exercises (continued)

Question 9: Which restriction limits the deductibility of rental loss to the amount of rental income?

a. Phaseout of offset
b. Passive activity rules
c. Active participation rule

How are passive rental losses reported?

Taxpayers use Form 8582, Passive Activity Loss Limitations, to figure the amount of any passive activity loss allowed for the current tax year. Form 8582 summarizes losses and income from all passive activities.

Generally, taxpayers are not required to file Form 8582 if they have:

- Only one passive loss generated from a rental activity and
- MAGI of less than $100,000 (not more than $50,000 if MFS).

Completing Form 8582 is out of scope if you are required by the software to enter additional data in Form 8582. For example, if passive activity losses exceed $25,000 ($12,500 for married filing separately) and require a computation of unallowed passive activity losses, then the return is out of scope.

Summary

Special rules may govern whether certain income received by members of the U.S. Armed Forces is includible or excludible from taxable income reported on the return:

- Homeowners Assistance Program (HAP)
- Medical separation with disability severance pay
- Combat zone exclusion
- Community property laws

The 5-year test period for the exclusion of gain on a main home may be suspended for certain military members.

Qualified reservists' retirement plan distributions may be repaid with extended time if on active duty.

Rental income and deductible rental expenses are reported on Part I of Sch E, Supplemental Income and Loss. Volunteers must certify at the Military level to prepare a Sch E for residential rental income. Rental income and expenses are in-scope **only** for military families renting their personal residence.

Rental income and expenses are not reported if the taxpayer used the dwelling as a home and rented the unit for fewer than 15 days in the current tax year. If the taxpayer itemizes deductions on Sch A, the taxpayer can deduct allowable interest and taxes.

When renting out part of the property, certain expenses must be allocated between rental use and personal use. Some are reported on Sch A and some on Sch E.

Taxpayers who do not use a dwelling unit as a home (for personal purposes) should include all the rent in their income and deduct all the rental expenses. There are special rules and limitations if the taxpayer used the dwelling unit as a home and it meets the personal use test.

The passive activity rules state that passive activity losses can be deducted only from passive activity income. Taxpayers with rental losses may be required to file Form 8582, Passive Activity Loss Limitations. Because rental activities are generally considered passive activities, rental losses are not fully deductible. However, taxpayers who actively participated in the renting of the property may deduct up to $25,000 of their rental losses, up to $12,500 for married taxpayers filing separately and living apart. This deduction is subject to phase-out rules if the taxpayer's AGI exceeds certain limits.

Where to find more information

Pub 3, Armed Forces' Tax Guide

Pub 525, Taxable and Nontaxable Income

Pub 527, Residential Rental Property

Pub 555, Community Property

Pub 925, Passive Activity and At-Risk Rules

Pub 946, How to Depreciate Property

What situations are out of scope?

The following issues covered in this lesson are out of scope. While this list may not be all inclusive, it is provided for your awareness.

- U.S. Armed Forces members who were provided a commuter highway vehicle (such as a van) by their employer
- Residential rental income and expenses for non-military taxpayers
- Taxpayers who rent their property at less than fair rental value

- Rental-related interest expenses other than mortgage interest or points
- The actual expense method for auto expense deductions
- Casualty loss
- Completing Form 8582 if volunteers are required to enter additional data in Form 8582 in the software
- Completing Form 4562 (allowable depreciation can be claimed directly on Sch E)
- Taxpayers who filed or need to file Form(s) 1099

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: b, False. The payments and withholdings for the enlistment and reenlistment bonuses are reflected on the service member's Form W-2.

Answer 2: b. The Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS) are both nontaxable income.

Answer 3: c. Once the VA sends the letter of determination, all pension payments are offset by the disability amount paid directly from the VA, which is not taxable and not included on any Form W-2.

Answer 4: a. Military members are considered to be serving in a combat zone if they are either assigned on official duty to a combat zone or they qualify for hostile fire/imminent danger pay while serving in direct support of a combat zone.

Answer 5: c. You would deduct four-twelfths (33%) of his mortgage interest and taxes on Sch E, and report the other 67% on Sch A.

Answer 6: d. Repairs made to the homeowner's personal residence are not deductible as rental expenses. However, the other expenses are deductible, along with repairs made to rental property, legal and professional fees, and property management fees.

Answer 7: c. The fencing adds value to the property and would have to be capitalized and depreciated.

Answer 8: c. The rental portions of utilities, home insurance, repairs, and depreciation are rental deductions on Sch E, but the personal portions are not a deductible expense reported on Sch A. Taxpayers who rent out part of a property allocate mortgage interest and property taxes separately on both schedules.

Answer 9: b. Passive activity losses can be deducted only from passive activity income. Taxpayers who are not active participants may not deduct rental losses that exceed rental income.

Adjustments to Income

Introduction

This lesson covers the Adjustments to Income section of Form 1040, Schedule 1. Taxpayers can subtract certain expenses, payments, contributions, fees, etc. from their total income. The adjustments, subtracted from total income on Form 1040, establish the adjusted gross income (AGI).

Some items in the Adjustments to Income section are out of scope. This lesson will cover all in-scope topics. Additional adjustments to gross income for expenses of members of the Military are covered in the next lesson.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1040 Instructions
- Form 1040, Sch SE (self-employment tax)
- Form 8606 (basis in IRA)
- Form 8889 & Instructions (HSAs)
- Form 1098-E (student loan interest)

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify which adjustments are within our scope
- Calculate and accurately report the adjustments to income that are within our scope

Possible adjustments to income

To identify the adjustments to income that taxpayers can claim, you will need to ask the taxpayers if they had the types of expenses listed on the Adjustments to Income section of Sch 1. Review the taxpayers' answers on their Tax-Aide Intake Booklet.

During the tax year did the taxpayer or spouse:

- Pay qualified educator expenses?
- Receive income from self-employment?
- Have self-employed health insurance?
- Pay a penalty for early withdrawal of savings?
- Pay alimony?
- Make contributions to a traditional IRA?
- Make a contribution to a health savings account?
- Pay student loan interest?
- Receive income from jury duty that was turned over to an employer?
- Have a Form W-2 Box 12 code H contribution to Sec 501(c)(18)(D) pension plan?

There are other adjustments to income, such as contributions to self-employed SEP, SIMPLE, and other qualified plans. These are out of scope.

How do I handle educator expenses?

Eligible educators can deduct up to $300 of qualified expenses paid during the tax year. If both the taxpayer and spouse are eligible educators, they can deduct up to $600, but neither can deduct more than their own expenses up to $300. The deduction amount is indexed for inflation, so future maximum deduction amounts may be higher.

Who is eligible?

If the taxpayer or spouse is an educator, probe a little deeper to see if they qualify for this adjustment. Ask questions such as:

- Are you or your spouse a teacher, instructor, counselor, principal, or aide in a school? (Cannot be a home school)
- What grade or grades do you teach? (Must be K-12)
- Were you employed for at least 900 hours during the school year? (Required minimum hours)

What expenses qualify?

If the taxpayer or spouse is an eligible educator, ask about their qualified expenses. Advise taxpayers that they must have receipts for verification if they get audited.

Expenses that qualify include:

- Books, supplies, equipment (including computer equipment, software, and services), and other materials used in the classroom
- The educator's own professional development expenses related to the curriculum in which the educator provides instruction
- Personal protective equipment, disinfectant, and other supplies used for the prevention of the spread of coronavirus.

Qualified expenses don't include expenses for home schooling or for nonathletic supplies for courses in health or physical education.

Gloria is a 5th and 6th grade teacher who works full-time in a year-round school. She had 1800 hours of employment during the tax year. She spent $262 on supplies for her students. Of that amount, $212 was for educational software. The other $50 was for supplies for a unit she teaches sixth graders on health. Only the $212 is a qualified expense. She can deduct $212.

Debbie is a part-time art teacher at an elementary school. She spent $185 on qualified expenses for her students. Because she has only 440 hours of documented employment as an educator during the tax year, she cannot deduct her educator expenses.

What other rules apply?

Probe to learn if the taxpayer or spouse received reimbursement that would reduce the amount of their educator expenses. For example, ask:

- Did you receive reimbursement that is not listed as income on Form W-2?
- Did you redeem U.S. Series EE or I Savings Bonds where the interest would be tax-free, such as redeeming savings bonds to pay educational expenses?
- Did you receive a nontaxable distribution from a qualified tuition program (QTP) or a distribution of nontaxable earnings from a Coverdell education savings account (ESA)?

Educator expenses are reduced by any of these applicable reimbursements.

How do I report this?

Educator expenses are reported in the adjustments to income section of Form 1040, Sch 1. Don't forget to reduce the total educator expenses by any reimbursements, nontaxable savings bond interest, nontaxable distribution from a QTP, or nontaxable distribution of earnings from an ESA.

Taxpayer Example

Bob teaches elementary school for more than 900 hours each year. His wife Janet teaches high school chemistry full time. Here is how a volunteer helped them determine if they can take the deduction for educator expenses.

Volunteer Says…	Janet & Bob Respond…

You've already mentioned that you both work full-time as teachers, so you may be able to deduct some of the money you spent on qualified educator expenses. Can you tell me how much you spent, or did you bring your receipts?	[Janet] Yes, all teachers keep careful records of their expenses. Here are my receipts and here are Bob's.
Can you tell me what you purchased? Janet, maybe you could go first.	[Janet] Sure. Three receipts are for quick reference cards for my chemistry students. And two are for special reagents the department doesn't stock.
Your receipts add up to $382. Now, we can count only the first $300 of educator expenses, but because you are married and filing jointly, you can deduct up to $300 for Bob. Bob, tell me about your expenses.	[Bob] These four receipts are for art supplies – paint and brushes, as you can see – and these two are for special papers and sculpting clay.
Yours total $263. Now, did either of you receive any reimbursement that is not shown on Form W-2?	[Janet] No, we paid these expenses out of our own pockets. [Bob] Wait, now that I think about it, I got reimbursed $50 for the clay.
That would bring your total down to $213.	[Janet] Can't we apply some of my excess expense to Bob and bring his total up to $300?
No, I'm sorry, each person's expenses have to stand alone.	[Janet] Okay.
Did you redeem U.S. series EE or I Savings Bonds during the tax year?	[Janet] No, we didn't. What if we had?
We would complete a form to see what percentage of the tax-free interest should be applied as a reimbursement. One more thing: did you receive distributions from a qualified tuition program or a Coverdell education savings account?	[Bob] No, neither of those.
Okay, we can claim $213 for Bob and the maximum $300 for Janet. That gives you a total of $513 on your joint return as a deduction for educator expenses. Any questions before we go on?	[Janet] No, I think we understand.
On the Tax-Aide Intake Booklet, indicate that the taxpayers are entitled to the educator expense adjustment.	

Self-employment tax

Self-employed taxpayers can deduct a portion of their self-employment tax from their income. Self-employment Tax is covered in the Other Taxes lesson 27.

The self-employment tax is automatically calculated on Sch SE by the software and the deductible portion is carried to the adjustments to income section on Form 1040, Sch 1.

Self-employed health insurance (SEHI)

Self-employed taxpayers who report a net profit on Sch C for the year may be able to deduct the cost of their health insurance paid as a deduction from their gross income. For an in-scope return, the health insurance policy can be either in the insured individual's name (taxpayer, spouse, dependent, or eligible child) or in the name of the business but must be paid by the taxpayer (or spouse if MFJ).

Medicare premiums voluntarily paid to obtain insurance in the taxpayer's name that is similar to qualifying private health insurance can be used to figure the deduction. The spouse's Medicare premiums qualify for the deduction when married filing jointly even though paid from the spouse's benefits. Be sure to include all health, dental, vision, supplemental, limited coverage, and long-term care (LTC) premiums paid by the taxpayer (or spouse if MFJ). LTC is limited to the deduction cap for Sch A, based on age.

Premiums paid by retired public safety officers in excess of the amount used to reduce their taxable retirement income can be used for the self-employed health insurance deduction.

When is SEHI not allowed?

The SEHI deduction is not allowed for any month in which the taxpayer (the business owner) was eligible to participate in a health plan subsidized by their employer, a spouse's employer, or an employer of the taxpayer's dependent or child under age 27 at the end of the tax year. Taxpayers cannot deduct payments for a qualified long-term care insurance contract for any month in which they were eligible to participate in an employer-subsidized long-term care insurance plan.

To determine whether the self-employed individual was eligible for subsidized coverage, consider only current employers. Retiree or COBRA coverage does not preclude the self-employed health insurance deduction.

Yvette's husband has subsidized COBRA coverage from his prior employer under which she could be covered but is not. Yvette has her own coverage in her name. She is not eligible for any other subsidized employer coverage. Yvette can use her premiums to determine her self-employed health insurance deduction.

Some taxpayers may receive reimbursements from their employers, prior employers, or insurance companies. Only unreimbursed costs qualify for the deduction.

Whose health coverage qualifies?

For this purpose, health coverage can be for the taxpayer, spouse, dependents, or the taxpayer's child under the age of 27 even though the child is not the taxpayer's dependent. A child includes a son, daughter, stepchild, adopted child, or foster child.

What is the limit on the self-employed health insurance deduction?

The self-employed health insurance deduction is limited to the net self-employment profit shown on the return reduced by the deduction for one-half of the self-employment tax.

Carson is single and has his own business. During the year, he paid qualified health insurance premiums of $3,000. His Sch C shows a profit of $5,500 and his self-employment tax deduction is $389 for a net profit of $5,111 ($5,500 – $389). The full $3,000 premium paid is deductible as self-employment health insurance because it is less than the net profit.

When the total health insurance costs exceed the self-employed health insurance deduction limit, a taxpayer can generally include any remaining premiums as an itemized medical expense deduction Form 1040, Sch A. In some situations, claim all health premiums as an itemized deduction may be more beneficial than the SEHI. Refer to the Schedule C Guidelines paper for more details and examples.

What if the insurance was purchased through the Marketplace?

Self-employed taxpayers who purchased their coverage from the Marketplace and are eligible for the premium tax credit are out of scope for Tax-Aide unless other insurance can be used for the SEHI. Ancillary coverage (e.g. dental) bought through the Marketplace can be used for SEHI since it is not qualified for PTC.

Early withdrawal of savings penalty

Taxpayers can adjust their gross income to deduct penalties they paid for withdrawing funds from a deferred interest account before maturity. This penalty is a forfeiture of interest that the account earned and is reported on Form 1099-INT, Interest Income, or Form 1099-OID, Original Issue Discount.

Gloria withdrew $5,000 early from a one-year, deferred-interest certificate of deposit. She had to pay a penalty of three months' interest. She can claim this penalty amount as an adjustment to income.

How do I handle alimony paid?

Alimony is a payment to a spouse or former spouse under a divorce or legal separation instrument. The payments do not have to be made directly to the ex-spouse. For example, payments made on behalf of the ex-spouse for expenses specified in the instrument, such as medical bills, housing costs, and other expenses can qualify as alimony. Alimony does not include child support or voluntary payments outside the instrument.

Pre-2019 divorces

The person paying alimony can deduct alimony payments as an adjustment to income; the person receiving alimony must treat it as income. A summary of the alimony requirements can be found in Tab E, Adjustments, in the NTTC 4012.

When conducting the interview, ask if the taxpayer paid alimony under a divorce or separation instrument. If so, explain that you need the exact amount, as well as the Social Security number of the recipient, because the recipient must report the payment to the IRS as income and the two amounts must agree. The date of the divorce, or a reasonable estimate, is also needed to complete Sch 1.

Post-2018 divorces

Alimony or separate maintenance payments made under a divorce or separation agreement (1) executed after 2018, or (2) executed before 2019, but later modified if the modification expressly states the repeal of the deduction for alimony payments applies to the modification, are no longer deductible. Alimony and separate maintenance payments received under such an agreement are not included in the gross income of the recipient.

Anthony was divorced in 2017. Under his divorce instrument, he paid his ex-wife $8,000 during the tax year. As a favor, he also made $4,000 in payments to cover part of her vehicle lease so she could keep steady employment. He can take the $8,000 as an adjustment to income. He cannot count the lease payments because those were payments not required by the divorce instrument.

Exercises

Answers are at the end of the lesson.

Question 1: Victoria divorced in 2007. Her divorce settlement states that she must pay her ex-husband $12,000 a year. She is also required to pay his ongoing medical expenses for a condition he acquired during their marriage. During the tax year, the medical expenses were $11,400. How much can she deduct as an adjustment to income?

- **a.** $12,000
- **b.** $11,400
- **c.** $23,400
- **d.** $600

How do I handle IRA contributions?

Individual Retirement Arrangements (IRAs) are personal savings plans that offer tax advantages to set aside money for retirement. This section discusses “traditional” IRAs. A traditional IRA is any IRA that is not a Roth or SIMPLE IRA (contributions to SIMPLE IRAs are out of scope). See Pub 590-A, Contributions to Individual Retirement Arrangements, for more information on all types of IRAs.

Some of the features of a traditional IRA are:

- Taxpayers may be able to deduct some or all of their contributions to the IRA (depending on circumstances).
- Generally, amounts held in an IRA, including earnings and gains, are not taxed until distributed.
- Contributions may be eligible for the retirement savings contributions credit.

Fred has a traditional IRA account and a Roth IRA account. During the tax year, Fred contributed $2,200 to his traditional IRA and $1,000 to his Roth IRA. The most Fred will be able to deduct as an adjustment to gross income is the $2,200 contribution to his traditional IRA.

Based on the Tax-Aide Intake Booklet, ask the taxpayer about any IRA contributions during the year or that they intend to make by the due date of the return.

Repayment of a prior distribution that is allowed to be repaid is not an IRA contribution. Refer to the Income - Retirement Income lesson 11.

What are the eligibility requirements for an IRA contribution?

The taxpayer, and the taxpayer's spouse if applicable, must meet these eligibility requirements in order to make an IRA contribution:

- Types of IRAs: verify the types of IRAs to which the taxpayer and spouse contributed. Only contributions to traditional IRAs are deductible. Contributions to a Roth IRA cannot be deducted.
- Age: there is no age limit for either traditional or Roth IRA contributions.
- Compensation: individuals must have taxable compensation (i.e., wages, self-employment income, commissions, taxable alimony, or taxable scholarships or fellowships shown in Box 1 of Form W-2).
- Time limits: The IRA must be set up and the contribution must be made by the due date for filing the return, not including extensions. Verify with the taxpayer and spouse that they made the contribution(s) (or will make them) by the due date of the return.

Be sure the taxpayer knows that if a contribution is reported on the tax return but is not made by the deadline, the taxpayer must file an amended return.

A taxpayer over the age of 70½ can make qualified charitable distributions (QCD) from their retirement account. A QCD may need to be reduced by deductible IRA contributions. This is covered in the Income – Retirement lesson 11.

How much can a taxpayer deduct for an IRA contribution?

Generally, you can deduct the lesser of:

- The contributions to your traditional IRA for the year, or
- The general limit reduced by Roth IRA contributions made for the same tax year

The deduction amount may be further reduced for taxpayers who participate in an employer's retirement plan when certain income levels are reached. This is discussed later in this lesson.

A taxpayer age 50 or older may contribute an additional catch-up amount.

What is the compensation requirement?

Taxpayers cannot make IRA contributions that are greater than their compensation for the year.

Compensation is generally the income a taxpayer has earned from working. Wages, salaries, tips, professional fees, bonuses, and other amounts received for providing personal services as an employee are compensation. Compensation also includes self-employment income, taxable alimony, and any amount which is included in the individual's gross income and paid to the individual to aid the individual in the pursuit of graduate or postdoctoral study. See Pub 590-A, for other types of compensation and items that are not considered compensation, such as deferred compensation reported on Form W-2, box 11.

If married taxpayers file a joint return, their combined IRA contributions cannot exceed their combined compensation, and neither spouse can contribute more than the general IRA limit to their own IRA.

Beginning in 2019, taxpayers can elect to increase their compensation for Medicaid waiver payments that are excluded from gross income for the purpose of ***nondeductible*** *IRA contributions that are eligible for the retirement savings credit.*

Sue and Gene are married and are both over 50 years old. Sue earned $70,000 and Gene earned $1,500. During the tax year, Sue contributed $3,500 to her traditional IRA and $2,000 to a Roth IRA, making her total contributions $5,500. To figure the maximum contribution to Gene's IRA, use a total

compensation of $66,000 (i.e., $71,500 – $5,500). If Sue and Gene file jointly, they can contribute up to the IRA limit to Gene's IRA even though his own compensation was just $1,500.

Although a person may have IRA accounts with several different financial institutions, the tax law treats all of their traditional IRA accounts as one single IRA. Inherited IRAs, however, are treated separately. A taxpayer cannot make a contribution to an IRA they inherited from someone other than a spouse. If a taxpayer inherits a traditional IRA from a deceased spouse, they can treat the account as their own and make contributions and rollovers into the inherited account. A surviving spouse who elects to transfer an IRA inherited from their spouse to their own IRA can make contributions to the transferred IRA.

Bill is 29. He has a traditional IRA account at City Home Savings Bank and another traditional IRA account through his stockbroker. He also opened a Roth IRA through his stockbroker. Bill can contribute to any or all of his accounts this year, but the combined contributions for the tax year cannot exceed the lesser of the general IRA limit or his compensation for the tax year.

Exercises (continued)

Question 2: Stan, an unmarried college student working part time, earned $4,500 during the tax year. What is the maximum he can contribute to an IRA?

a. $1,000
b. $3,500
c. $4,500
d. $5,500

Question 3: Bob and Carol are married and both are 55 years old. They both work and each has a traditional IRA. During the tax year, Bob earned $2,000, and Carol earned $50,000. If they file separate returns, what is the maximum that Bob can contribute to his IRA? $ _____.

Are there special rules for certain military personnel?

Combat pay that is excluded for income tax purposes can be treated as compensation for IRA contribution purposes. And, reservists may be able to repay certain qualified plan distributions. These topics are discussed in the Military Adjustments to Income lesson 18.

When can IRA contributions be deducted?

Deductions can be taken for contributions to traditional IRAs. The taxpayer's deduction for IRA contributions may be "phased out" (i.e., reduced or eliminated) depending on their income, filing status, and whether the taxpayer is covered by a retirement plan at work. The difference between the permitted contributions and the IRA deduction, if any, is the taxpayer's nondeductible contribution. Form 8606, Nondeductible IRAs, must be completed for any nondeductible traditional IRA contributions.

If taxpayers do not report nondeductible contributions, all of the contributions to a traditional IRA will be treated as having been deducted. This means all distributions will be taxed when withdrawn unless the taxpayer can show, with satisfactory evidence, that nondeductible contributions were made.

Form 8606 requires basis information in IRAs from prior years and is in scope for Tax-Aide.

How do I determine the deduction amount?

The factors that affect whether traditional IRA contributions are deductible include:

- Whether the taxpayer (or spouse, if filing a joint return) is covered by a retirement plan at work.
- The taxpayer's Modified Adjusted Gross Income (MAGI) before taking the deduction.

If the taxpayer or spouse is an active participant in an employer's retirement plan, the deduction amount will be reduced or eliminated if the MAGI on the tax return is above a certain limit. An active participant will have the

retirement box checked in box 13 on their W-2. For IRA deduction purposes, the software will compute the MAGI limit and print the IRS worksheet.

Refer to the Important Changes lesson for the deduction and MAGI limits for the year.

Retirement coverage at work

Ask if the taxpayer and/or spouse were covered by a retirement plan at work at any time during the tax year. If so, their deduction may be limited. Employees covered by a retirement plan will have Box 13 on Form W-2 checked.

Filing status and income

If the taxpayer or spouse was covered by an employer retirement plan, they may not be able to deduct the full amount. Notice that the income limitation amount may be different for each spouse on a joint return, but that the MAGI computation is the same. This is because if one spouse is covered by a retirement plan but the other is not, the noncovered spouse will have a higher income limit before their IRA deduction is phased out.

If the MAGI is greater than the income limits, the deduction cannot be taken. The contribution may still be made, it is just not deductible and Form 8606 must be completed if left in their traditional IRA.

A taxpayer who made a contribution to their traditional IRA that turns out cannot be deducted may wish to recharacterize the contribution. They would need to contact their IRA trustee and have the contribution recharacterized as to a Roth IRA. A Roth contribution can also be recharacterized as a traditional IRA contribution.

While recharacterizing a Roth conversion is no longer allowed, recharacterizing a contribution is still allowed when done by the due date of the return, including an extension.

How do I report the IRA deduction?

Enter the total contributions to traditional IRAs that were made (or will be made) for each spouse (on a joint return) by the due date of the return. The deductible amount is reported in the adjustments to income section of Form 1040, Sch 1.

What if the taxpayer has an excess IRA contribution?

An excess IRA contribution is an amount contributed to a traditional or Roth IRA that is more than the lesser of:

- The taxable compensation for the year, or
- General limit amount

The taxpayer may not know that a contribution is excessive until the tax return is completed. When this situation is identified, the excess amount, with any earnings on that amount, must be withdrawn by the due date of the return (including extensions). If the excess amount is not withdrawn by the due date of the return, including extensions, the taxpayer will be subject to an additional 6% tax on this amount. This additional tax is covered in the Other Taxes lesson 27.

When the taxpayer has modest compensation and traditional or Roth IRA contributions, confirm that the limit has not been exceeded.

The withdrawn excess contribution is not included in the taxpayer's gross income if, before the tax return is due, both of the following conditions are met:

- No deduction was allowed for the excess contribution.
- All interest or other income earned on the excess contribution is withdrawn.
- The taxpayer includes in gross income the interest or other income (or loss) that was earned on the excess contribution.

The taxpayer must report the income or loss on their return for the year in which the excess contribution was made. You may need to hold the return until the taxpayer can provide the amount of earnings or loss to report, if any.

Can an IRA contribution be returned?

A contribution can be withdrawn tax free by the due date of the return, with regard to an extension. The same rules apply as above for an excess contribution

If taxpayers timely filed the tax return without withdrawing a contribution that they made during the tax year, they can still have the contribution returned to them within 6 months of the due date of the tax return, excluding extensions. In this case, the contribution is treated as not having been made. If an IRA deduction was claimed, an amended return is required to remove the IRA deduction that was returned. If the original return reported an excess contribution additional tax, the amended return should also reflect that the additional tax no longer applies.

Form 1099-R

Taxpayers will receive Form 1099-R indicating the amount of the withdrawal. If the excess contribution was made in a previous tax year, the form will indicate the year in which the earnings are taxable.

Maria, age 35, made an excess contribution of $1,000, which she withdrew after year end but by the due date of her return. At the same time, she also withdrew the $50 income that was earned on the $1,000. She must include the $50 in her gross income (for the year in which the excess contribution was made). She does not have to report the excess contribution as income or pay the 6% excise tax. Maria receives a Form 1099-R for the year of withdrawal showing that the earnings are taxable for the prior year.

Health savings accounts contributions?

What is a health savings account (HSA)?

An HSA is a tax-exempt trust or custodial account that a taxpayer sets up with a qualified HSA trustee to use for medical expenses. Contributions are deductible as an adjustment to gross income. Distributions from an HSA are not taxable if the funds are offset by qualified medical expenses. A taxpayer must be an eligible individual to qualify to contribute to an HSA but does not need to be eligible in the year of distribution.

Individuals who qualify for an HSA

To be an eligible individual and qualify for an HSA, the taxpayer must meet the following requirements:

- Be covered by a high-deductible health plan (HDHP) on the first day of the month
- Not be covered by other health insurance (see Pub 969 for exceptions)
- Not be enrolled in Medicare (the individual can be HSA-eligible for the months before being covered by Medicare)
- Not be eligible to be claimed as a dependent on someone else's tax return (see Caution)

If another taxpayer is entitled to claim the individual as a dependent, the individual cannot claim a deduction for an HSA contribution. This is true even if the other taxpayer does not actually claim the dependent.

When you see code W on a Form W-2, the taxpayer is qualified for an HSA.

An employee covered by an HDHP and a health Flexible Spending Account (FSA) or a Health Reimbursement Arrangement (HRA) that pays or reimburses qualified medical expenses generally cannot make contributions to an HSA.

Contributions to an HSA

Anyone can contribute to an eligible individual's HSA. For an employee's HSA, the employee, employer, or both may contribute to the employee's HSA in the same year. For an HSA established by a self-employed (or unemployed) individual, the individual can contribute. Family members or any other person may also contribute on behalf of an eligible individual. Contributions to an HSA must be made in cash. Contributions of stock or property are not allowed. Amounts contributed to an HSA, except for employer contributions and qualified HSA funding distributions from IRAs, can be used as an adjustment to income for the account owner and must be made by the April due date of the return.

A taxpayer who ceases to be an eligible individual can continue to maintain and take distributions from an existing HSA, but can no longer make new contributions.

Employer contributions

Employer contributions (including an employee's contribution through a cafeteria plan) are allowed to be made to an employee's HSA. Generally, employer contributions are excluded from an employee's income. Employer contributions are reported on Form W-2, Box 12 using code W. An employee's contributions through a salary-reduction cafeteria plan are treated as an employer contribution and reported on Form W-2, Box 12. Taxpayers must reduce the amount they, or any other person, can contribute to their HSA by the amount of any contributions made by the taxpayer's employer (or treated as made by the employer) that are excludible from income. For example, if the employer contributed $1,000 to a taxpayer's HSA who had a self-only HDHP, the remaining contribution limit would be reduced by that $1,000.

Limits on HSA contributions

The amount the taxpayer or another other person can contribute to the taxpayer's HSA depends on the type of HDHP coverage the taxpayer has (individual or family), the taxpayer's age, the date the taxpayer became an eligible individual, and the date the taxpayer ceases to be an eligible individual. The maximum contribution amount may need to be computed on a monthly basis when the facts change during the year.

Eligible individuals who are 55 or older by the end of the tax year can increase their contribution limit up to $1,000 a year. This extra amount is the catch-up contribution allowed for an HSA. Refer to HSA contribution limits in the Important Changes lesson.

An employee covered by an HDHP and a health flexible spending account (FSA) or a health reimbursement arrangement (HRA) that pays or reimburses qualified medical expenses can't generally make contributions to an HSA. There are exceptions for (see Pub 969):

- Limited-purpose health FSA or HRA
- Suspended HRA
- Post-deductible health FSA or HRA
- Retirement HRA

Situations where the HSA contribution could be limited due to FSA or HRA participation are out of scope.

Last-month rule

If the taxpayer is an eligible individual on the first day of every month with the same coverage for the entire year, the full contribution amount is allowed. If the taxpayer was not an eligible individual for the entire year or changed their coverage during the year, the contribution limit is computed using either:

- Last-month rule, which allows eligible individuals to make a full contribution for the year even if they were not an eligible individual for the entire year. They can make the full contribution for the year if:
    - They are eligible individuals on the first day of last month of their taxable year. For most people, this would be December 1, and

- They remain eligible individuals during the testing period. The testing period runs from December 1 of the current year through December 31 of the following year (for calendar taxpayers).

OR

- Sum of the monthly contribution limits rule. This is the amount determined separately for each month based on eligibility and HDHP coverage on the first day of each month plus catch-up contributions. For this purpose, the monthly limit is 1/12 of the annual contribution limit.

A taxpayer whose coverage changed during the year and/or who does not use the last-month rule must use the sum of the monthly contribution worksheet to determine the maximum HSA contribution.

Refer to Publication 969 and the Instructions to Form 8889 for additional information and examples.

Arnold has a high-deductible health plan with an HSA with his company. His mother contributed to his HSA as a gift on his 40th birthday, which is an allowable contribution and a deduction for Arnold.

Code W in box 12 of Form W-2 is the HSA contribution made through the employer. Often, this is a salary-reduction contribution by the employee. No further deduction is available for such contributions.

If the testing period is not met or if the taxpayer is not an eligible individual for reasons other than death or disability, the taxpayer must recalculate their allowable contribution and will need to include the excess contribution in the following year when it is clear that the testing period has failed (subject to an additional 10% tax on Form 8889, Part III).

Excess HSA contributions

Taxpayers may not deduct an excess contribution, that is, a contribution over the limits. They must withdraw the excess to avoid an additional 6% tax by the April due date of the return. Any earnings on the excess must also be withdrawn and reported as other income on Form 1040, Sch 1. If the excess is not timely withdrawn, the return is out of scope.

Rules for married people

In the case of married individuals, each spouse who is an eligible individual and wants to have an HSA must open a separate HSA. Married couples cannot have a joint HSA, even if they are covered by the same HDHP; however, distributions can be used to cover the qualified expenses of the other spouse.

The rules for married people apply only if both spouses are eligible individuals. If either spouse has family HDHP coverage, the family contribution limit applies and both spouses are treated as having family HDHP coverage.

- The contribution limit is divided between the spouses by agreement. If there is no agreement, the contribution limit is split equally between the spouses.
- Each spouse who is age 55 or older is entitled to increase their contribution limit with an additional contribution that must be made by each spouse to their own HSA.

This year, Mr. Auburn and his wife are both eligible individuals. They each have family coverage under separate HDHPs. Mr. Auburn is 58 years old and Mrs. Auburn is 53. Mr. and Mrs. Auburn can split the family contribution limit equally, or they can agree on a different division. If they split it equally, each can contribute one-half the maximum contribution for family coverage. Mr. Auburn can contribute an additional $1,000 to his HSA because he is age 55 or over. Refer to HSA contribution limits in the Important Changes lesson or the NTTC 4012.

Form 8889, Health Savings Accounts

Form 8889 is required if the taxpayer (or spouse if filing a joint return) had any activity in an HSA. This is true even if the only activity was that the taxpayer's employer or the spouse's employer made contributions to the HSA. Taxpayers who are filing jointly and who each have separate HSAs will each complete a separate Form 8889. Married taxpayers cannot have a joint HSA.

Ask taxpayers during the interview process if their HDHP coverage is “self-only” or “family,” and check the corresponding box on Form 8889.

Form 8889, Part I, is used to report all HSA contributions and to compute the allowable HSA deduction. This includes contributions made by the filing deadline that are designated for the tax year. Contributions made by an employer are also shown in Part I, but are not included in the deductible amount.

How do I handle student loan interest?

The student loan interest deduction is generally the smaller of $2,500 or the interest payments paid that year on a qualified student loan. This amount is gradually reduced (phased out) or eliminated based on the taxpayer’s filing status and MAGI.

Robert has taken his first job after completing law school. His filing status is single. He paid $3,000 in interest on his student loans during the tax year. With all adjustments to income (except student loan interest adjustment), his MAGI is below the limits. He can deduct $2,500 of his student loan interest as an adjustment to income.

Veronica and her husband are filing jointly. She completed her doctoral degree last year and paid $2,400 in student loan interest during the tax year. Their MAGI is above the fully deductible income limits. Due to their high MAGI, the software will calculate their deduction; it will be less than the full amount of interest that she paid.

What type of interest qualifies?

Generally, student loan interest is paid during the year on a loan for qualified higher education expenses. The loan must meet all three of these conditions:

- It was for the taxpayer, the taxpayer’s spouse, or a person who was the taxpayer’s dependent when the loan was obtained
- The qualified higher education expenses were paid within a reasonable period of time before or after obtaining the loan
- It was for an eligible student

Interest does not qualify if the loan was from a related person, a qualified employer plan, or if the taxpayer is not legally liable for the loan.

What are the exceptions?

For purposes of the student loan interest deduction, the following are exceptions to the general rules for dependents:

- An individual can be your dependent even if you are the dependent of another taxpayer
- An individual can be your dependent even if the individual files a joint return with a spouse
- An individual can be your dependent even if the individual had gross income for the year that was equal to or more than the threshold amount for the year (see the NTTC 4012, Tab E, Adjustments, for the current year amount)

Exercises (continued)

Question 4: Todd and Janet have a MAGI below the limits. They are filing jointly. Two years ago, they took out a loan so Todd’s mother could earn her RN degree at night school. Todd could not claim her as a dependent on his return because he did not pay for more than one half of her support. This year, they paid $1,000 in interest on the loan. Does his mother meet the student qualifications?

a. Yes

b. No

Who is eligible for the deduction?

Generally, a taxpayer can claim the deduction if all the following are true:

- The taxpayer is not using the married filing separately filing status
- The taxpayer is not claimed as a dependent on someone else's return, even if they could be claimed as a dependent
- The taxpayer is legally obligated to pay interest on a qualified student loan
- The taxpayer paid interest on a qualified student loan

Conduct a probing interview to verify that the taxpayer meets all these tests for the deduction.

What are qualified higher education expenses?

Qualified expenses include: tuition and fees; food and housing (living expenses); books, supplies and equipment; and other necessary expenses (such as transportation).

Qualified expenses must be reduced by certain other educational benefits. Ask the taxpayer if the expenses were offset by any of the following:

- Employer provided educational assistance benefits if for interest (if for principal, do not reduce interest)
- Tax-free distributions from a Coverdell ESA or from a qualified tuition program
- U.S. savings bond interest excluded from income because it is used to pay qualified higher education expenses
- Certain scholarships and fellowships
- Veteran's educational assistance benefits
- Any other nontaxable payments (other than gifts, bequests, inheritances, or emergency financial grants) received for educational expenses

No double benefit allowed

Taxpayers cannot deduct as interest on a student loan any amount that is:

- An allowable deduction under any other provision of the tax law (e.g., as business interest).
- Paid from a distribution of earnings made from a qualified tuition program (QTP) after 2018 to the extent the earnings are treated as tax free because they were used to pay student loan interest.
- Paid by their employer after March 27, 2020, and before January 1, 2026, under an educational assistance program. That assistance is not taxable and a double benefit is not allowed.

What is an eligible educational institution?

An eligible educational institution is generally any accredited public, nonprofit, or private post-secondary 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 taxpayers do not know if an educational institution is an eligible institution, they should contact the school. A searchable database of all accredited schools is available on the U.S. Department of Education website.

Who is an eligible student?

An eligible student is someone 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.

This year, Jeremy paid interest on a loan that allowed his 21-year-old daughter, Kate, to complete a program in holistic medicine as a full-time student at the Southwestern College of Synergistic Therapy. Although she qualifies as his dependent, and the loan paid for books, supplies, and

equipment, the college is not accredited. Therefore, Jeremy cannot deduct the interest on the student loan.

Where can I get the information?

If the taxpayer paid $600 or more in interest to a single lender, the taxpayer should receive Form 1098-E, Student Loan Interest Statement, or another statement from the lender showing the amount of interest paid. This information will assist you in completing the student loan interest deduction.

The taxpayer should keep documentation of all qualified student loan interest paid during the tax year.

Taxpayer interview and tax law application

Here is how a volunteer helped Brenda determine if she can take the deduction for her student loan interest.

Sample interview

Volunteer Says…	Brenda Responds…
In reviewing your Tax-Aide Intake Booklet, I see indicated that you paid student loan interest this year?	Yes, I just graduated a year ago and I'll be paying those loans for a while.
Well, you might be able to take a deduction for that. You are filing as single, and your income before adjustments is not more than the limit for your filing status. Do you know how much interest you paid?	I have two loans; here are the statements.
The interest amounts add up to $2,600. Now, if your interest payments qualify for the deduction, the most we can claim is $2,500. Do you have any questions about that?	No, I understand.
I just need to ask a few questions to see if you qualify, okay? Earlier we decided that you can't be claimed as a dependent on someone else's return, so that's no problem. Can you tell me what you used the loan to pay for?	My tuition and fees, and my books.
Did you receive any educational assistance, like from your employer or the Veteran's Administration?	No.
How about tax-free withdrawals from a Coverdell educational savings account, another qualified tuition program, or from U.S. savings bonds?	No, none of those.
Did you get any other nontaxable payments, not counting gifts, bequests, or inheritances, which were specifically for educational expenses?	Heavens, no, I wish I had!
It looks like you can claim the maximum deduction of $2,500. [Indicate on the Tax-Aide Intake Booklet whether Brenda is eligible for this adjustment.]	

Is pay for jury duty an adjustment to income?

Jury duty pay received by taxpayers is included in other income on Form 1040, Sch 1. Some employees receive their regular wages from their employers while they are serving on a jury instead of working at their jobs. Often, employees must turn their jury duty pay over to their employers. If the taxpayer turned over any of their jury duty pay to their employer because the employer continued to pay the taxpayer while they served jury duty, include the amount the taxpayer gave their employer as an income adjustment on Sch 1.

Nontaxable Olympic and other prizes

As discussed in the Income – Other lesson 15, these prizes are not taxable if the taxpayer's AGI is less than $1 million ($500,000 if married filing separately). An adjustment to income is needed to remove the 1099-MISC income from AGI.

What is W-2 box 12 code H?

Code H reflects a contribution to a Sec. 501I(18)(D) pension plan that has not reduced taxable wages. The amount carries automatically to Sch 1 as an adjustment to income.

How do I determine adjusted gross income?

The taxpayer's total adjusted gross income (AGI) is the amount that is used to compute some limitations, such as the medical and dental deduction on Sch A and the credit for child and dependent care expenses. To find the taxpayer's AGI:

1. Add the Income section. This is the taxpayer's total income.
2. Add the Adjustments to Income section. These are the total Adjustments.
3. Subtract the Sch 1 adjustments from the total income. This is the AGI.

Taxpayer interview and tax law application

The volunteer assists Daniela with the adjustments to income covered in this lesson.

Sample interview

Volunteer Says…	Daniela Responds…
Daniela, we've discussed your income, so we can go on to Adjustments to Income. We might find ways to reduce the income that you're taxed on. Do you have any questions before we go on?	No, it all makes sense.
Now, let's review the expenses listed on your Tax-Aide Intake Booklet and the deductions listed in the Adjustments to Income section. Do you have a Health Savings Account?	No, I don't.
Okay. That brings us to self-employment tax. The tax software will calculate the deductible portion of your self-employment tax. The same thing happens with the penalty for an early withdrawal. I will put that in when I enter your interest income, and it will show up as an adjustment.	Cool
Did you pay any alimony?	No, I've never even been married.
Did you pay any health insurance premiums during the year?	No
Now, did you contribute to an IRA?	I put in $2,000 right after Christmas.
Good for you. Will you be contributing any more? You can put money in your IRA before the deadline for filing the return.	I don't think so, but that's good to know.
Was it a traditional, Roth IRA, or a SIMPLE IRA?	It was just a plain old IRA. Here's the statement.
There we go; it is what we call a traditional IRA. Were you covered by any kind of employer retirement plan at any time during the tax year?	No, none.
Because you weren't covered by a retirement plan, you will be able to deduct the full $2,000 you contributed. [The volunteer reviews all expenses listed on the Tax-Aide Intake Booklet and reviews all the adjustments on Sch 1, asks more questions and determines that Daniela does not qualify for the remaining adjustments.]	
We'll enter all the adjustments that apply to you. The software will calculate your total income, total adjustments, and will determine your Adjusted Gross Income that will be used to determine your deductions. [On the Tax-Aide Intake Booklet, note that you have addressed this adjustment.]	That's great! This program makes it really easy!

Summary

In this lesson, you learned how to identify and work with these adjustments to income:

- Educator expenses
- Deductible portion of self-employment tax
- Deduction for self-employed health insurance
- Penalty on early withdrawal of savings
- Alimony paid
- IRA deduction
- Health savings account deduction
- Student loan interest deduction
- Jury duty pay turned over to the taxpayer's employer

If you believe a taxpayer could benefit from an adjustment that is out of scope and was not covered in this lesson, discuss the situation with your Coordinator. It may be appropriate to decline the return.

Where to find more information

Pub 17, Your Federal Income Tax

Pub 969, Health Savings Accounts and Other Tax-Favored Health Plans

Pub 504, Divorced or Separated Individuals

Pub 590-A, Contributions to Individual Retirement Arrangements (IRAs)

Pub 970, Tax Benefits for Education

What situations are out of scope?

While this list may not be all inclusive, it is provided for your awareness. The following are out of scope for this lesson:

- Other adjustments to income, such as:
  - Self-employed health insurance deduction with premium tax credits unless coverage other than the Marketplace coverage is used for the deduction
  - Self-employed SEP, SIMPLE, and qualified plans other than IRAs
  - Certain business expenses of performing artists
  - Reservists' expenses, unless the preparer and reviewer are certified in Military
  - Other adjustments not covered in this training guide
- Excess contribution to an HSA not withdrawn timely
- Form 8889, Health Savings Accounts, Part III
- Participants in an FSA or HRA who also make a contribution to their HSA
- An HSA distribution due to the death of an HSA holder if the spouse is not the designated beneficiary
- Qualified HSA funding distribution from an IRA
- Form 1099-SA for Archer (Archer MSA) or Medicare Advantage (MA MSA) Medical Savings Accounts

See Form 1040, Sch 1, page 2 for a complete list of other adjustments to gross income.

To gain a better understanding of the tax law, complete the practice returns(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: c. She can deduct the full $23,400 because it is all required by the divorce instrument.

Answer 2: c. His IRA contributions are limited to $4,500, the amount of his compensation.

Answer 3: If married filing separately, Bob can contribute no more than $2,000, the amount of his compensation.

Answer 4: b, No. Todd's mother was not their dependent at the time they took out the loan and none of the exceptions applies.

Military Adjustments to Income

If you are pursuing Military certification, continue with this lesson. Otherwise proceed to the next lesson in your training plan.

Introduction

This lesson will help you determine which members of the U.S. Armed Forces are entitled to an adjustment to income for certain business expenses or moving expenses. To do this, you will need to determine certain business expenses, allowances and reimbursements, and deductible moving expenses.

To determine if the taxpayer has incurred any of these expenses, it is important to ask probing questions during the taxpayer interview.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012
- Form 2106 (employee business expenses)
- Form 3903 (moving expenses)

Optional:

- Form 1040 Instructions

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine if a taxpayer has military business expenses that can be deducted
- Determine if a move qualifies as a permanent change of station (PCS)
- Identify deductible moving expenses
- Determine when allowances and reimbursements must be included in income
- Determine eligibility for special IRA provisions for the Military

Employee business expenses

Military employee business expenses are necessary work-related expenses incurred by active and reserve members of the U.S. Armed Forces. The U.S. Armed Forces includes commissioned officers, warrant officers, and enlisted personnel in all regular and reserve units under the control of the Secretaries of the Defense, Army, Navy, Air Force, and Coast Guard. Ready Reserve Corps of the Public Health Service (part of HHS) is also included as a reserve component. It does not include members of the Merchant Marines or the American Red Cross.

Temporary active-duty reservists' expenses

Military reservists temporarily called to active duty who must remain away from home to perform their duties may claim unreimbursed travel expenses such as meals and lodging. This applies:

- As long as the duty occurred under competent orders and
- Whether or not the reservist was compensated

Reservists include those who are in the Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve; Army National Guard of the United States; Air National Guard of the United States; or Ready Reserve Corps of the Public Health Service.

To claim unreimbursed travel expenses, reservists must be stationed away from the general area of their job or business and return to their regular jobs once released. 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 Basic Allowance for Housing (BAH) and Basic Allowance for Subsistence (BAS). This includes any reimbursement reported under Code L in Box 12 of Form W-2.

What is the 100-mile rule for reservists?

Military reservists who must travel more than 100 miles away from home and stay overnight to attend a drill or reserve meeting may be able to deduct their travel expenses as an adjustment to income. The amount of expenses that can be deducted is limited to the:

- Federal per diem rate (for lodging, meals, and incidental expenses)
- Standard mileage rate (for car expenses) plus any parking fees, ferry fees, and/or tolls

Mary is in the Army Reserve. She lives in a town that is 120 miles from Base A, where she normally reports for reserve drills or meetings. During the current tax year, she occasionally traveled to Base B, which was only 40 miles from her home. Mary can claim the travel expenses she incurred going to Base A as an adjustment to income. She cannot claim the expenses for Base B as an adjustment.

How are reservists' expenses reported?

Armed forces reservists use Form 2106 to claim unreimbursed expenses as an adjustment to gross income.

Employee business expense deductions subject to the 2% of AGI hurdle are suspended through 2025. For years prior to 2018 and after 2025, if the reservist is prohibited from wearing certain uniforms when off duty (a rule that usually applies to reservists), they are generally able to deduct the cost to buy and maintain those uniforms while performing their away-from-home reservist duties. Actual expenses paid are reduced by the amount of any uniform allowance or reimbursement received. State laws may differ.

Moving expense deduction

Members of the Armed Forces on active duty who move due to a Military order and as a result of a permanent change of station (PCS) may deduct unreimbursed moving expenses as an adjustment to income.

What is a permanent change of station?

Moving expenses incurred as a result of a PCS are deductible only. A permanent change of station includes a move from:

- Home to the area of the first post of duty.
- One permanent post of duty to another.
- The last post of duty to home or to a nearer point in the U.S. The Armed Forces member must move within one year of ending active duty or within the period allowed under the Joint Travel Regulations.

What does a permanent change of station include for spouses and dependents?

If the Armed Forces moves service members and their spouses or dependents to or from separate locations, the moves are treated as a single move and the qualified expenses of both moves are combined and deducted on the same tax return.

Exercises

Answers are at the end of the lesson summary.

Question 1: Which of the following is a permanent change of station?

a. A move by an Air Force pilot to an airbase for a six-month detail
b. A move by an Army sergeant to his home two years after he ended active duty
c. A move by a new enlistee from her home to her first post of duty
d. A temporary move by a U.S. Marine to attend a six-month training program

What expenses are included in the moving expense adjustment?

Qualifying military moving expenses fall into the following two categories, the cost of:

- Moving household goods and personal effects
- Reasonable travel and lodging expenses

To qualify as “reasonable,” the route taken must be the shortest, most direct route available, from the former home to the new home. Additional expenses for stopovers, side trips, or pre-move house hunting expenses are

not deductible as moving expenses. Only miles traveled from the old home to the new home is included in the calculations.

Qualifying expenses that exceed government allowances and reimbursements are deductible.

Military reimbursements

Determine whether any moving allowances or reimbursements provided by the government should be included in a service member's income, and how to accurately report the deduction on Form 1040. The travel voucher will contain much of the information needed to compute the deduction.

What is a personally procured move?

Typically, Armed Forces members move their own household items in a personal or rented vehicle; this is called a personally procured move (PPM), formerly known as a do-it-yourself (DITY) move. The Armed Forces provides an incentive payment equal to 95% of the estimated cost to the government for a PPM. When the move is completed, the Armed Forces member provides receipts and paperwork to substantiate authorized expenses. The net financial profit is taxable and is reported on a separate Form W-2.

How do I report a PPM?

Taxable PPM payments are reported on Form W-2 and are entered as wages on Form 1040.

Armed Forces members may not take a moving expense deduction based on the expenses approved by the finance office when settling the PPM, as they have already been used to reduce taxable income.

Captain Cook receives orders for a PCS. He chooses to pack and drive his household goods to the new duty station in his own vehicle. The Air Force estimates that the move would have cost the government $2,500. Captain Cook's actual expenses for the move were $1,750. He receives a payment for $2,375 (95% of the government's estimate), but Form W-2, Box 1, will show only $625 ($2,375 minus $1,750) for the PPM. Captain Cook cannot deduct any of his expenses, since he's already been reimbursed.

What forms of reimbursement are *not* included as income?

Certain forms of reimbursement provided by the government are not to be included as income on the Armed Forces member's tax return.

- Moving or storage services furnished to the Armed Forces member
- Nontaxable allowances such as:
  - Dislocation allowance
  - Temporary lodging allowance
  - Mileage allowance in lieu of transportation
  - Per diem allowance
  - Move-in housing allowance (MIHA)

Exercises (continued)

Question 2: Sgt. Bishop received Form W-2 for $1,000 as a result of a PPM to a new Permanent Duty Station (PDS). In addition, the government paid her a mileage allowance of $300, a lodging allowance of $200, and a dislocation allowance of $1,200. How much should Sgt. Bishop include in her wages on Form 1040?

a. $1,500
b. $1,000
c. $300
d. $200

How do I calculate the adjustment?

Deductions can only be claimed for expenses not covered by a nontaxable reimbursement or moving allowance. If the taxpayers have allowable expenses that exceed the amount they were reimbursed, Form 3903 should be completed. Form 3903 is not needed if all the taxpayers' reimbursements were nontaxable allowances that were greater than their expenses.

The tax software addresses the Armed Forces PCS move and calculates the standard mileage amount based on miles traveled for the move. See the Important Changes lesson or the NTTC 4012 for the standard mileage rate.

Taxpayer interview and tax law application

Here's how a volunteer could help Mrs. Fannin determine if she had any deductible moving expenses:

Sample interview

Volunteer Says…	Mrs. Fannin Responds…
You said you just moved here during June of this year. Was this a PCS move?	Yes, my husband was transferred here in March, shortly before he deployed. I have family close by, so I'd rather stay here while he's overseas.
If your expenses were more than the Armed Forces reimbursement, you may be able to use the difference to reduce your gross income. We'll complete Form 3903 to see how it comes out. Did you bring your travel voucher with you?	It's right here. We drove our own car 1,000 miles to get here, and paid $120 for gas. We paid $300 for motels and $135 for meals on the way. The military moved our household goods, and we didn't have any overweight.
Did you drive directly here, or did you take any side trips?	We came right here so we could settle in before he deployed.
The IRS will let you use the standard mileage rate for a military move. To determine the moving mileage rate, let's look at NTTC 4012 and multiply the rate times the number of miles.	Okay
The IRS allows lodging costs, but not food. So your total allowable expenses includes $300 for the motels and your mileage expenses. The travel voucher shows a total of $400 in reimbursements – did you receive any other reimbursements or allowances?	No, that's it.
Then you'll get to deduct the amount you spent that was more than your reimbursement. [On the Tax-Aide Intake Booklet, be sure to note that you've addressed this adjustment.]	

When to claim the moving deduction

Armed Forces members who use the cash method of accounting (the most common) and have qualified expenses exceeding their reimbursement can deduct the expenses either in the year they paid them or in the year reimbursement was received. If taxpayers choose to deduct their moving expenses in the year of reimbursement, they can deduct:

- Expenses paid in a year before the year of reimbursement, or
- Expenses paid in the year immediately after the year of reimbursement but by the due date, including extensions, for filing the return for the reimbursement year.

If expenses are deducted and reimbursement is received in a later year, the reimbursement must be included in income.

Exercises (continued)

Question 3: In November of the current year, Petty Officer Wharton moved from California to Washington. The move qualified as a PCS. He incurred $800 in mileage expenses and $1,600 in lodging. He paid $1,400 to ship household goods over the allowed weight limit, and $500 to ship his dog. The following year, he filed his travel voucher and received $2,400 mileage and travel allowance. He also received a $1,500 dislocation allowance.

For what tax year(s) can Petty Officer Wharton claim his moving expenses on Form 3903?

- **a.** Next year only
- **b.** Current year only
- **c.** Either current year or next year

Taxpayer interview and tax law application

Amanda was relocated to another Air Force base. Here's how a volunteer could help Amanda determine if she had any deductible moving expenses:

Sample Interview

Volunteer Says…	Amanda Responds…
So, you were transferred from Maxwell Air Force Base to Scott Air Force Base last year, right?	Yes, I was reimbursed $400 for travel expenses on the way to Scott Air Force Base.
Did you receive any other allowances?	Yes, I also received a $1,000 dislocation allowance.
Well the reimbursements were not reported on your W-2. You can only deduct expenses that are larger than your combined reimbursements and allowances. First, let's add all your qualified expenses. How much was your travel and lodging?	I spent $575 on travel and lodging and another $200 for meals along the way.
Any other expenses?	Yes, I gave a $350 security deposit to my new landlord.
Only the travel and lodging on route can be claimed on Form 3903. The security deposit and meals are not deductible expenses. Your reimbursement and dislocation allowances add up to $1,400. Since that's more than your expenses, you don't have anything to deduct. But, you don't have to include any of the excess reimbursement as income, either.	

Special qualified plan provisions

Excluded combat pay for IRA purposes

Current or former members of the Armed Forces may qualify for additional retirement benefits. Under the Heroes Earned Retirement Opportunities (HERO) Act, taxpayers can count tax-free combat pay as compensation when determining whether they qualify to contribute to either a Roth or traditional IRA. Before this change, members of the Armed Forces whose earnings came entirely from tax-free combat pay were generally barred from using IRAs to save for retirement.

Extension of time to make IRA contributions

Under a special rule, members of the military who serve in designated combat zone, or have qualifying service outside of a combat zone, are eligible for extension of the deadline for making contributions to an existing or new IRA. The extension to the IRA contribution deadline is 180 days after the last day the person is in a combat zone plus any days that were left to make the contribution when the person entered a combat zone (or began performing qualifying service outside the combat zone).

If a return has already been filed for a particular year, contributions should be reported on an amended return, Form 1040X.

Qualified reservist repayments

Refer to the Income – Military Members for qualified plan repayments. The repayment of qualified reservists' distributions doesn't affect the current year's contribution amount that can be deducted to a traditional IRA.

Summary

This lesson focused on two types of deductions that members of the Armed Forces can claim as an adjustment to income on Form 1040, Sch 1. Two special qualified plan provisions for the Military were also discussed.

Where to find more information

Pub 3, Armed Forces' Tax Guide

What situations are out of scope?

While this list may not be all inclusive, it is provided for your awareness. The following is out of scope for this lesson:

- Form 2106 for other than reservists' travel expenses

To gain a better understanding of the tax law, complete the practice returns(s) for your course of study using the Practice Lab on L&LT.

You may not be able to complete the entire exercise if some of the technical issues in the exercise are not covered until later lessons. In these instances, complete as much of the exercise as you can. Come back later to finish the exercise after you cover all the technical topics.

Exercise answers

Answer 1: c. A move by a new enlistee from her home to her first post of duty is considered a PCS.

Answer 2: b. The $1,000 PPM payment should be included as wages. However, nontaxable allowances such as dislocation allowances, temporary lodging allowances and mileage allowances provided by the Armed Forces should not be included as gross income on the service member's tax return, even if they exceed allowable expenses.

Answer 3: c. Because Petty Officer Wharton paid for moving expenses in the year prior to the year of reimbursement, he can claim all of his moving expenses on Form 3903 in either the year he paid or the year he was reimbursed.

Deductions

Introduction

This lesson discusses deductions that a taxpayer may claim to arrive at taxable income. Through 2025, many, if not most, taxpayers will not itemize their deductions. Instead they will claim the standard deduction. The software uses the most advantageous method assuming you have entered all the information.

Also through 2025, self-employed taxpayers and those with investments in REITs (real estate investment trusts) may be able to claim the qualified business income deduction.

What do I need?

- Tax-Aide Intake Booklet
- Qualifying Child or Relative Resource Tool
- NTTC 4012
- Form 1040 Sch A & Instructions (itemized deductions)

Optional:

- Form 8995 (qualified business income deduction)

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine the standard deduction amount for most taxpayers
- Determine the standard deduction amount for taxpayers claimed as dependents
- Determine allowable itemized deductions
- Explain the recordkeeping requirements for claiming charitable contributions
- Determine the amount of qualified business income deduction, if any

Standard deduction or itemized deductions

In addition to the deductions covered in the Adjustments to Income lesson 17, there are deductions that are subtractions from a taxpayer's AGI. They reduce the amount of income that is taxed. Most taxpayers have a choice of taking a standard deduction or itemizing their deductions. When taxpayers have a choice, they should use the type of deduction that results in the lower tax. Use the interview techniques and tools discussed in earlier lessons to assist you in determining whether itemized deductions or the standard deduction will result in the largest possible deduction for the taxpayer. Be sure to keep state taxes in mind since often they are not the same as federal tax law.

What is a standard deduction?

A standard deduction for most taxpayers is a set dollar amount based on the taxpayer's filing status. An increased standard deduction is available to taxpayers who are 65 or older or blind. There are limitations on the standard deduction for taxpayers who can be claimed as a dependent on someone else's return.

The current year's standard deduction amounts are included in the Important Changes lesson and in the NTTC 4012, Tab F, Deductions. The software will use the applicable standard deduction based on your entries in the software, including whether the taxpayer or spouse is blind.

James, 44, and Sara, 39, are filing a joint return. Neither is blind, and neither can be claimed as a dependent. They decided not to itemize their deductions. They will use the married filing jointly standard deduction amount.

What are itemized deductions?

Itemized deductions allow taxpayers to reduce their taxable income based on specific personal expenses. If the total itemized deductions are greater than the standard deduction, it will result in a lower taxable income and lower tax. In general, taxpayers benefit from itemizing deductions if they have mortgage interest, very large unreimbursed medical or dental expenses when compared to their income, state taxes, or other large expenses such as charitable contributions.

If an expense item is reimbursed, or can be reimbursed, by insurance or otherwise, the taxpayer cannot claim it as a deduction. If the item is paid pre-tax, it also cannot be claimed as a deduction. A salary reduction plan is the most commonly seen pre-tax situation.

Standard deduction

Who cannot take the standard deduction?

Some taxpayers cannot take the standard deduction and must itemize their deductions on Sch A. During the interview, find out if the taxpayer is:

- Filing as married filing separately and the spouse itemizes regardless of who files first.
- A nonresident or dual-status alien during the year (and not married to a U.S. citizen or resident at the end of the year) – both are out of scope except some foreign students or scholars when the preparer and reviewer have certified in Foreign Students or Scholars.
- Filing a return for a short tax year due to a change in the annual accounting period – out of scope.

A married taxpayer who qualifies to file as head of household may claim the standard deduction even though their spouse files as married filing separately and itemizes.

Chase files as married filing separately. Her spouse, Grant, will be itemizing his deductions. Chase cannot use the standard deduction; she will have to itemize her deductions.

How does age or blindness affect the standard deduction?

The standard deduction is higher if the taxpayer or spouse is 65 or older, and if one or both are blind. Be sure to verify the taxpayer's and spouse's age and level of blindness as described below.

Sherman is 73 years old and blind. He files as single using Form 1040. After you check the box that he is blind on the input screen, the software will use the appropriate standard deduction based on your entry and the birth date entered for Sherman.

Who qualifies as 65 or older?

Taxpayers are entitled to a higher standard deduction if they are 65 or older at the end of the year. They are considered to be 65 on the day before their 65th birthday. In other words, a person born on January 1 is considered to be 65 on December 31 of the previous year.

The standard deduction for decedents is the same as if they had lived the entire year; however, if taxpayers die before their 65th birthday, the higher standard deduction does not apply.

Armando died on November 24. He would have been 65 if he had reached his birthday on December 12 of that same year. He does not qualify for a higher standard deduction for being 65 because he died before reaching his 65th birthday.

Who qualifies as blind?

Taxpayers are entitled to a higher standard deduction if they are considered blind on the last day of the year and they do not itemize their deductions. A taxpayer who is not totally blind must have a certified statement from an eye doctor (ophthalmologist or optometrist) that:

- The taxpayer cannot see better than 20/200 in the better eye with glasses or contact lenses or
- The field of vision is not more than 20 degrees

If the eye condition is not likely to improve beyond these limits, the statement should include that fact. Taxpayers should keep the statement for their records.

If vision can be corrected beyond those limits only by contact lenses and the taxpayer can only wear the lenses briefly because of pain, infection, or ulcers, the taxpayer can take the higher standard deduction for blindness.

What if only one spouse is over 65 or blind?

A married taxpayer can take the higher standard deduction if one spouse is 65 or older, or blind, and if:

- The taxpayer files a joint return, or
- The taxpayer files a separate return and their spouse had no income, isn't filing a return, and can't be claimed as a dependent on another person's return.

Tim is 67 and is filing as single. He is not blind and he cannot be claimed as a dependent on someone else's return. Based on your entries, the software will compute standard deduction.

Kevin and Jane are both 60, and Jane is blind. They are filing as married filing jointly. Neither can be claimed as a dependent on someone else's return. They are entitled to the regular standard deduction for married filing jointly plus an additional amount for Jane being blind.

Exercises

Use the Standard Deduction Chart in the NTTC 4012, Tab F, Deductions to complete the following exercises. Answers are after the lesson summary.

Question 1: Roderick is 64 and blind. Can he claim an additional deduction?

a. Yes
b. No

Question 2: Leticia died in May just before reaching her 65th birthday. Does she qualify as age 65?

a. Yes
b. No

What about individuals who can be claimed as dependents?

The standard deduction is generally lower for an individual who can be claimed as a dependent by another taxpayer. Remember that if the person that could claim the taxpayer is not required to file a return or files simply to get a refund of taxes paid in or withheld, the taxpayer is not a dependent. Do not check the "can be claimed" box in the software for that not-a-dependent taxpayer.

Taxpayers who can be claimed as a dependent by another taxpayer must use the Standard Deduction Worksheet for Dependents to determine their standard deduction. The worksheet can be found in the NTTC 4012, Tab F, Deductions and the dependent's standard deduction can be summarized as:

- $450 plus earned income
- Minimum: $1,300
- Maximum: the regular standard deduction amount
- Plus the additional amount for age 65 or older or blind, if applicable

Taxable scholarship income is treated as earned income for the standard deduction calculation of a student.

A dependent's standard deduction will be automatically calculated, as long as the box indicating they can be claimed as a dependent by another taxpayer has or has not been checked.

Janet is single, 22, a full-time student, and not blind. Her parents claimed her as a dependent on their current year tax return. She has no itemized deductions, so she will compute her standard deduction using the Standard Deduction Worksheets for Dependents.

Itemized deductions

How do I decide if a taxpayer should itemize deductions?

In general, taxpayers who have deductible mortgage interest, state or local taxes, charitable contributions, or a very large amount of unreimbursed medical/dental expenses compared to their income may benefit from itemizing their deductions.

Use the Interview Tips – Itemized Deductions in the NTTC 4012, Tab F, Deductions, to determine if itemizing deductions would be more beneficial for the taxpayer. If you think the taxpayer's itemized deduction **may** be greater than their standard deduction, enter the qualified expenses on Sch A. The tax software will automatically select the larger of itemized deductions versus standard deduction.

Itemized deductions include amounts paid for **qualified**:

- Medical and dental expenses
- Taxes paid
- Home mortgage interest
- Gifts to charity
- Casualty and theft losses — out of scope
- Miscellaneous deductions

Even though the standard deduction will be better for a taxpayer on their federal return, that may not be true for state tax purposes. You can enter all the itemized deductions into the software so that it has the information needed to determine the best option for both purposes.

What medical and dental expenses are deductible?

Taxpayers can deduct only the amount of unreimbursed medical and dental expenses that exceeds 7.5% of their Adjusted Gross Income (AGI).

Whose expenses are included?

Qualified medical and dental expenses paid by the taxpayer during the tax year can be included for:

- The taxpayer
- The taxpayer's spouse
- Dependents claimed at the time the medical services were provided or at the time the expenses were paid
- Individuals who could be the taxpayer's dependent except:
  - They do not meet the gross income test, or
  - They do not meet the joint return test, or
  - The taxpayers, or their spouse if filing jointly, could be claimed as a dependent on someone else's 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 they individually paid for the child.

Stewart and Carmen are divorced. Their son, Raymond, lives with Carmen, who claims him as a dependent. Carmen paid for and deducted Raymond's standard medical and dental bills. Stewart deducted the emergency bill he paid when Raymond broke his arm.

Use your Qualifying Child or Relative Resource Tool to help you confirm whose medical expenses can be claimed by the taxpayer.

What types of expenses are covered?

Generally, medical expenses must be paid during the tax year and may include payments for:

- Diagnosis, cure, mitigation, treatment, or prevention of disease
- Treatments affecting any part or function of body
- Equipment, supplies, and diagnostic devices
- Premiums for insurance that covers medical care
- Long-term care insurance premiums (limited by age - see the Important Changes lesson)
- Transportation/travel to get medical care
- Home improvements needed for mobility or medical care
- Medical expenses for a taxpayer that are paid within one year after the date of death are generally treated as paid when incurred.
- Medical expenses paid by credit card are deemed to have been paid when charged to the card, not when paid to the credit card company.
- Lodging expenses for out-of-town medical care is limited to $50 per person per night.
- The standard mileage rate allowed for out-of-pocket expenses for a car when used for medical reasons can be found in the Important Changes lesson or the NTTC 4012, Tab F, Deductions. Taxpayers can also deduct medical-related transportation (taxi, bus, etc.), parking, and tolls expenses.

Special education for mentally or physically disabled persons can be claimed as a medical expense. Preschool and after-school charges may be eligible for the child and dependent care credit (lesson 21). The taxpayer may allocate the expenses paid between the two benefits but without double counting any payments.

Refer to the NTTC 4012, Tab F, Sch A – Medical expenses.

What types of expenses are not medical expenses?

Examples of non-qualified expenses include:

- Cosmetic surgery
- Funeral or burial expenses
- Nonprescribed drugs, except insulin
  - A prescribed drug that is filled with over-the-counter medicine qualifies as medical expense
- Weight loss program that is not prescribed
- Diet food
- Health or long-term care premiums used by a retired public safety officer used to exclude part of their retirement plan distribution from income (no double dipping)
- Health or long-term care premiums use by self-employed taxpayers for the self-employed health insurance deduction (no double dipping)
- Medical insurance premiums or expenses paid with pre-tax dollars, reimbursed by an insurance company, reimbursed by a current or prior employer, or reimbursed through a tax-advantaged account, such as an flexible spending account (FSA) or health savings account (HSA).

If you and a taxpayer disagree as to whether a particular expense is deductible, discuss the issue with the Coordinator. The taxpayer may be correct, but you should not deduct an expense if you believe it would lead to a false return.

Exercises (continued)

Question 3: Bill and Kathy Ferris file a joint return. They paid the medical and dental bills listed below. The total of Bill and Kathy's qualified medical expenses is $_____.

Medical Expenses	Amount	Deductible?
Unreimbursed doctors' bills	$500	
Unreimbursed orthodontist bill for braces	$1,200	
Hospital insurance premiums	$300	
Life insurance premiums	$500	
Unreimbursed prescription medicines	$100	
Vitamins	$70	
Hospital bill (before insurance company's reimbursement of $1,000)	$2,000	
Smoking-cessation program	$150	
Total	$4,820	

Coordination with premium tax credits

For taxpayers who receive the premium tax credit (PTC) (lesson 26), only the premiums paid out of pocket by the taxpayer and not covered by the PTC, may be used as a medical expense when itemizing deductions. For example, if the taxpayer's insurance policy premium was $12,000 and they received a PTC of $10,000, they would only be able to include the $2,000 premiums paid out of pocket by the taxpayer as a deductible medical expense deduction.

Taxpayers may also deduct on the current year's return the excess advanced premium tax credit (APTC) they have to repay on the return and must reduce their deduction for any additional PTC they claim on the return.

What taxes may be deductible?

Taxpayers can deduct certain taxes if they itemize. To be deductible, the tax must have been imposed on the taxpayer and paid by the taxpayer during the current tax year. Taxes that are deductible include:

- State and local income taxes – This includes withheld taxes, estimated tax payments, or other tax payments (such as a prior year state or local income tax and includes a refund that the taxpayer chose to credit to their estimated tax for the following year). Check with your Coordinator about any other taxes that qualify for deduction in your state, such as state disability insurance. Do not include penalties or interest.
- Sales taxes – It may be possible to deduct sales taxes in lieu of state and local income taxes (from the optional sales tax tables or actual sales tax paid). Taxpayers who use the tables may be able to add the state and local general sales taxes paid on any motor vehicle, boat, aircraft, or home construction or improvement to the tax table amounts.

The sales tax tables are based on the location, family size, and AGI of the taxpayer. Be sure to add any tax-exempt income that is not already entered in the software in the Sales Tax Worksheet. Examples include life insurance proceeds, cash inheritances or gifts, or VA benefits.

Taxpayers may deduct either sales tax or state and local income tax, but not both. Enter both the state and local income taxes and the state and local sales taxes. The software will use the greater amount.

- Real estate taxes
  - State and local real estate taxes based on the assessed value of the taxpayer's real property, such as the taxpayer's house or land, are deductible.

- Taxes based on other than the assessed value of the property may be deductible in certain circumstances if they are levied:
  - For the general public welfare
  - By a proper taxing authority
  - At a similar rate on owners of all properties in the taxing authority's jurisdiction
- Real estate taxes, which may be reported on Form 1098, Mortgage Interest Statement, or a similar statement from the mortgage holder, are deductible. If the taxes are not paid through the mortgage company, the taxpayer should have a record of what was paid during the year.
- Some real estate taxes or charges that may be included on the real estate tax bill are not deductible. These include taxes for local benefits and improvements that tend to increase the value of the property, itemized charges for services, transfer taxes, rent increases due to higher real estate taxes, and homeowners' association fees.

Real estate taxes reported on Form 1098 may include nondeductible amounts. Use the interview techniques with taxpayers to determine if nondeductible amounts such as sanitation pickup and water fees are included in their Form 1098. These items should not be included on Sch A.

- State and local personal property taxes if the taxes were based on value alone and were imposed on a yearly basis.
- Foreign income taxes as discussed below.

Which taxes are not deductible?

Not all taxes are deductible and some items aren't actually classified as taxes. Some examples include foreign real estate taxes, employment taxes, federal income taxes, and license fees.

How do I handle taxes that are deductible?

Deductible taxes are reported on Form 1040, Sch A in the Taxes You Paid section. The aggregate deduction for state or local income (or sales taxes in lieu of income taxes) and state or local property taxes is limited to $10,000 ($5,000 if married filing separately) per return through 2025.

Any state and local taxes paid above the $10,000 ($5,000) cap cannot be deducted as an itemized deduction. Taxes claimed on Sch C, on Sch E, or for the production of income on Sch A, line 6, are not subject to the limitation.

No deduction is allowed for foreign property taxes unless it relates to a trade or business (report on Sch C) or for the production of income (report on Sch E income or on Line 6 of Sch A).

Foreign income taxes

Generally, income taxes that were paid to a foreign country can be taken as an itemized deduction on Sch A, line 6, or as a credit against U.S. income tax on Form 1040. You should compare claiming the foreign taxes paid as a nonrefundable credit to taking it as an itemized deduction and use whichever results in the lowest tax. Only the simplified limitation election for the foreign tax credit is in scope. To be eligible for this election, qualified foreign taxes must be $300 ($600 if MFJ) or less. More information will be provided in the Foreign Tax Credit lesson 23.

When claimed as an itemized deduction, foreign income taxes can be deducted in full and are not subject to the $10,000 cap noted above.

See the Taxes chapter in Pub 17 for more information.

Exercises (continued)

Question 4: Which of the following taxes are deductible on Sch A?

- **a.** Federal income tax
- **b.** State, local, and foreign income tax and real estate tax
- **c.** Tax on alcohol and tobacco
- **d.** Foreign sales tax

Question 5: For a tax to be deductible, a tax must be ____. (Select all that apply.)

- **a.** Imposed during the tax year
- **b.** Imposed on the taxpayer
- **c.** Paid during the tax year
- **d.** Paid by the taxpayer

How do I handle interest paid?

Certain types of interest payments qualify as itemized deductions. Qualified home mortgage interest, points (paid as a form of interest), and investment interest can be deducted on Sch A. Investment interest is out of scope if the taxpayer is itemizing deductions.

A taxpayer may be able to deduct interest on a main home and a second home. A home can be a house, cooperative apartment, condominium, mobile home, house trailer, or houseboat that has sleeping, cooking, and toilet facilities.

Qualified home mortgage interest

Generally, home mortgage interest is any interest paid on a loan, line of credit, or home equity loan on the taxpayer's main home or second home that is secured by the taxpayer's main home or second home, respectively. The deduction for any home mortgage interest is not allowed unless the loan proceeds were used to build, buy, or substantially improve the taxpayer's qualified residence – with an exception for grandfathered debt discussed below. For this purpose:

- A main home is the home where the taxpayer lives most of the time.
- A second home is a home that was not held out for rent. If the home is rented out for 14 days or less, see Pub 936.
  - If there is more than one second home, the taxpayer can choose the qualified second home for home mortgage deduction purposes.
- If a home is rented out more than 14 days during the year, the tax return is out of scope. For active Military taxpayers, refer to the Income – Military Members lesson 16.
- The main home or second home designation can change during the year, either by a change of facts or at the taxpayer's choice. For example, the taxpayer moves from one main home to a new main home or selects a different second home.

For this purpose, a family member includes brothers, sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants.

The mortgage must be secured by the respective property owned by the taxpayer. If the taxpayer borrows against their main home to buy a second home, that borrowing is not qualified and the interest paid on it is not deductible.

Interest paid on a mortgage on a personal residence that is not the main home or the designated second home is not deductible.

A home used by the taxpayer as a residence and rented out for less than 15 days during the year is not treated as a rental property and the rents collected are not taxable.

Limits on mortgage amount

The mortgage interest paid that may be deducted may be limited by the amount of the qualified home mortgage (as defined above) based on when the mortgage was taken out and applies to the total of the main home mortgage and second home mortgage:

- Mortgages taken out on or before October 13, 1987 (called grandfathered debt): interest is fully deductible. Use of the proceeds is not limited to buy/ build/ improve the home.
- Mortgages taken out after October 13, 1987, and prior to December 16, 2017 to buy, build, or substantially improve the home (called home acquisition debt), but only if these mortgages plus any grandfathered debt totaled $1 million or less ($500,000 or less if married filing separately) throughout the tax year.
    - Exception: A taxpayer who enters into a written binding contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, is considered to have incurred the home acquisition debt prior to December 16, 2017.
- Mortgages taken out after December 15, 2017, to buy, build, or substantially improve the home (called home acquisition debt), but only if all mortgages including any grandfathered debt totaled $750,000 or less ($375,000 or less if married filing separately) throughout the tax year.

The Interview Tips – Itemized Deductions in the NTTC 4012 will help you determine if interest paid by the taxpayer should be included on Sch A.

Members of the clergy and military can deduct qualified mortgage interest even if they receive a nontaxable housing allowance. Returns for members of the clergy with parsonage or housing allowances are out of scope.

Tax returns for taxpayers who received a Mortgage Credit Certificate are out of scope.

If a taxpayer refinances their qualified home mortgage increasing the loan to take out cash used for nonqualified purposes, the interest on the old qualified home mortgage amount is deductible; interest on the loan amount used for personal purposes is not deductible.

In 2022, Berti refinanced his qualified home mortgage of $325,000 for a new loan of $375,000 at 3% using the additional $50,000 for personal purposes. He will use his new interest rate on $325,000 to compute his deduction until such time as the loan balance is less than $325,000. The interest on $325,000 (3% x $325,000 = $9,750 for a full year) remains deductible. The rest of the interest paid is for the nonqualified debt and is not deductible. The nondeductible interest on the personal portion will be less each year as principal payments are made.

An alternate way to compute the deductible portion is to use the average debt approach. In Berti's case, assume the total mortgage at the beginning of the year was $370,000 and at the end of the year it was $360,000. The average debt is $365,000 (($370,000 + $360,000) ÷2). The total interest paid was $10,950. The deductible portion is the qualified mortgage amount of $325,000 ÷ $365,000 (average debt) x $10,950 (total interest paid) or $9,750.

Where do I find the mortgage interest paid?

Generally, the total amount of home mortgage interest paid by a taxpayer is shown on Form 1098. Only taxpayers who are legally liable for the debt can deduct the interest in the year it is paid. Remember that taxpayers may have more than one mortgage or may have refinanced during the year and may have multiple mortgage interest statements.

When the taxpayer does not receive a Form 1098, such as a seller-financed mortgage, additional information is needed to complete Sch A. See Form 1040 Sch A instructions.

From 2013 through 2015, Alfredo and Cindy Kendall obtained home equity loans totaling $91,000. Alfredo and Cindy used the loans to pay off gambling debts, overdue credit payments, and some medical expenses. The current balance of Alfredo and Cindy's home equity loan is $72,000. They also carry $30,000 of outstanding acquisition debt (the amount used to buy, build, or improve their home).

Alfredo and Cindy cannot deduct the interest on their home equity loans because none of the loan proceeds was used to build, buy, or improve the taxpayer's qualified residence. The interest on the acquisition debt of $30,000 is deductible.

Taxpayers who refinance qualified home mortgage debt with the same lender cannot deduct accrued interest "paid" with the new loan. The interest must be paid with new funds from the taxpayer or from a new lender.

Reverse mortgages

A reverse mortgage is a loan where the lender pays the homeowner (in a lump sum, a monthly advance, a line of credit, or a combination of all three) while the owner continues to live in the home and retains title to the home. Depending on the plan, the reverse mortgage becomes due, with interest, when the owner moves, sells the home, reaches the end of a preselected loan period, or dies. Because reverse mortgages are considered loan advances and not income, the amount received isn't taxable.

Any interest (including original issue discount) accrued on a reverse mortgage is not deductible until the interest is paid. When the interest accrues, interest on a reverse mortgage must satisfy the qualified home mortgage interest criteria to be eventually deductible when paid. See Pub 936 for information on reverse mortgages.

What are points and when are they deductible?

Points are the charges paid by a borrower and/or seller to a lender to secure a loan. They are also called:

- Loan origination fees (including VA and FHA fees)
- Maximum loan charges
- Premium charges
- Loan discount points
- Prepaid interest

Only points paid as a form of interest (for the use of money) can be deducted on Sch A. Generally, points must be spread over the life of the mortgage. However, if the loan is used to buy or build a taxpayer's main home, the taxpayer may be able to deduct the entire amount in the year paid if certain other conditions are met.

Points paid to refinance a mortgage are generally not deductible in full the year they were paid, unless the points were paid in connection with the improvement of a main home and certain other conditions are met. Beware of certain charges that some lenders call points. Points paid for specific services, such as appraisal fees, preparation fees, VA funding fees, or notary fees, are not interest and are not deductible.

Use the flow chart in Pub 936 to help determine if points are fully deductible.

What types of interest are not deductible?

Interest that cannot be deducted includes:

- Interest on car loans except if the car is used in a business (see the Income – Business lesson 9)
- Other personal loans
- Credit investigation fees
- Loan fees for services needed to get a loan

- Interest on a debt the taxpayer is not legally obligated to pay
- Finance charges for nonbusiness credit card purchases

Exercises (continued)

Question 6: Joe and Angela file a joint return. During the year, they made the interest payments listed below. The total of Joe and Angela's fully deductible interest for the tax year is $ _____.

Interest Payments	Amount	Deductible?
Interest on their qualified home mortgage, reported on Form 1098	$2,180	
Credit card interest used for personal purchases	$400	
Points paid to refinance their mortgage for a better interest rate (none of the points qualify as interest)	$1,500	
Interest on a car loan used for personal purposes	$2,000	
Total	$6,080	

How do I handle gifts to charity?

A charitable contribution is a donation or gift to a **qualified organization** (also called a 501(c)(3) organization), which may be deductible if the taxpayer itemizes. Cash, check, and noncash contributions should be reported on Sch A on either the *Gifts by cash or check* line or the *Other than by cash or check* line, respectively. Deductions may be taken for contributions to:

- Organizations that operate exclusively for religious, charitable, educational, scientific, or literary purposes
- Organizations that work to prevent cruelty to children or animals
- Organizations that foster national or international amateur sports competition if they do not provide athletic facilities or equipment
- War veterans' organizations
- Certain nonprofit cemetery companies or corporations
- The United States, or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions

To be deductible, contributions must be made to a qualifying organization, not an individual. The IRS has a search tool to confirm the tax-exempt status of an organization.

Deductible items include:

- Monetary donations
- Dues, fees, and assessments paid to qualified organizations above the value of benefits received
- Fair market value of used clothing, furniture, and other items in good condition
- Cost and upkeep of uniforms that have no general use but must be worn while performing services donated to a charitable organization
- Unreimbursed transportation expenses that relate directly to the services the taxpayer provided for the organization
- Part of a contribution above the fair market value for items received such as merchandise and tickets to charity balls or sporting events
- Up to $50 per month for housing a foreign exchange student

- Unreimbursed expenses for fostering a child if placed by an agency eligible to accept charitable contributions

Transportation expenses, including bus fare, parking fees, tolls, and either the cost of gas and oil or the standard mileage deduction may be taken. Refer to the Important Changes lesson for the standard mileage deduction for charitable contributions.

Form 1098-C, Contributions of Motor Vehicles, Boats and Airplanes, is out of scope if the value shown is more than $500. No additional reporting is required for vehicle donations whose value is $500 or less.

Which gifts are not deductible?

Contributions to the following types of organizations are not deductible as charitable contributions:

- Business organizations, such as the Chamber of Commerce
- Civic leagues and associations
- Political organizations and candidates
- Social clubs
- Foreign organizations
- Homeowners' associations
- Communist organizations

Amounts that may *not* be deducted as charitable contributions include:

- Cost of raffle, bingo, or lottery tickets
- Tuition
- Value of a person's time or service
- Blood donated to a blood bank or Red Cross
- Car depreciation, insurance, general repairs, or maintenance
- Direct contributions to an individual
- Sickness or burial expenses for members of a fraternal society
- Part of a contribution that benefits the taxpayer, such as the fair market value of a meal eaten at a charity dinner

Susan ran a 10K organized by the Chamber of Commerce to benefit a qualified charitable organization. She paid the race organizers a $30 entry fee and received a "free" T-shirt and pancake breakfast after the race.

Susan did not make a contribution to the qualifying organization. She paid the Chamber of Commerce, which allotted funds to the benefiting organization. Therefore, none of Susan's entry fee is tax deductible. If the race had been organized by the qualifying organization itself, part of her entry fee may have been deductible.

What limits apply to charitable deductions?

For in-scope returns, the deduction for charitable contributions is limited to 60% of AGI for cash donations and 50% for noncash donations. There are reduced limits of 20% and 30% of AGI for donations of specific types of property made to specific types of charities but those are out of scope. Amounts over the deduction limit are carried over to the next 5 years. Tax returns with charitable deductions that are limited by the applicable percentage either in the current year or in a prior year with a carryover to the current year are out of scope.

What records must the taxpayer keep for charitable contributions?

Taxpayers must keep records to verify the cash and noncash contributions they make during the year. Advise taxpayers that they cannot deduct a cash contribution, regardless of the amount, unless one of the following records of the contribution is kept:

- A credit card statement or a bank record, such as a canceled check, a bank copy of a canceled check, or a bank statement containing the name of the charity, the date, and the amount
- A written communication or receipt from the charity, which must include the name of the charity, date of the contribution, and amount of the contribution

Single monetary contributions of $250 or more. Taxpayers can claim a deduction of $250 or more only if they have a contemporaneous written acknowledgment from the charitable organization showing the amount of any money contributed and whether the organization did or did not provide any goods or services in return for the contribution. During the interview, be sure to review the documentation requirements with the taxpayer and confirm that they have the appropriate documentation. You can rely in good faith on their representation and do not need to see their documentation.

Out-of-pocket expenses related to donated services. For unreimbursed expenses related to donated services, the taxpayer must have:

- Adequate records of the expenses
- Organization's written acknowledgment and description of the taxpayer's services for unreimbursed expenses of more than $250

Only out-of-pocket expenses that are directly related to the donated services can be deducted. The value of time or services donated cannot be deducted. See Pub 526 for the rules applicable to out-of-pocket expenses incurred when rendering services to a qualifying organization.

Noncash contributions less than $250. For any single contribution of less than $250, the taxpayer must keep a receipt or other written communication from the organization or the taxpayer's own reliable written records for each donation, showing:

- Name and address of the organization
- Date and location of the contribution
- Reasonably detailed description of the donated property
- Fair market value of the donated property

If the taxpayer is itemizing their deductions that would include donated capital gain property or property that was previously depreciated, their return is out of scope.

Noncash contributions of at least $250 but not more than $500. For any single contribution of at least $250 and not more than $500, the taxpayer must have all the documentation described for noncash contributions less than $250. In addition, the organization's written acknowledgment must state whether the taxpayer received any goods or services in return and a description and good faith estimate of any such items.

Deductions are not allowed for the charitable contribution of clothing and household items if the items are not in good used condition or better.

The taxpayer needs to provide the fair market value of noncash donations, usually thrift store value.

Exercises (continued)

Question 7: Julia made the following contributions last year:

- $600 to St. Martin's Church (the church gave her a letter verifying the amount.)

- $32 to Girl Scouts (not for cookies!)
- $40 to a family whose house burned
- $50 for lottery tickets at a fundraiser
- $100 for playing bingo at her church

The amount that Julia can claim as deductible monetary contributions is $ _____

Noncash contributions of more than $500 up to $5,000. Noncash charitable contributions of more than $500 but not over $5,000 in total are in scope for Tax-Aide taxpayers. In figuring whether the deduction is $500 or more, combine claimed deductions for all similar items of property donated to any qualified organization during the year.

If taxpayers claim a deduction over $500 but not over $5,000 for a noncash charitable contribution, Form 8283, Section A must be completed and taxpayers must have a contemporaneous written acknowledgment (defined earlier).

Donations of appreciated property are out of scope. These might include securities, art, or real estate.

What are miscellaneous expense deductions?

Some miscellaneous deductions are allowed in full. For others, only the amount is excess of 2% of AGI are included. Those so-called 2% deductions are suspended through 2025. Examples of miscellaneous itemized deductions that are still allowed include:

Gambling losses and expenses

Through 2025 expenses to gamble can be added to gambling losses and deducted to the extent of gambling winnings (taxpayers must have a record of their losses). The full amount of winnings, reduced for the cost of the winning wager, must be reported as income. Gambling losses and expenses (up to the amount of winnings) can be claimed as an itemized miscellaneous deduction **not** subject to the 2% of AGI floor.

Unrecovered cost in an annuity

Upon the death of the last annuitant, the unrecovered cost can be claimed as a miscellaneous itemized, not subject to the 2% of AGI limitation

Work-related expenses for an individual with physical or mental disabilities

These are expenses that enable the taxpayer to work, such as attendant care services at their workplace. These are also **not** subject to the 2% of AGI floor.

Other miscellaneous deductions not subject to the 2% rule**,** other than the two listed above, are out of scope and include:

- Casualty and theft losses
  - Only casualty losses derived from federally declared disaster areas are deductible. All other losses are not allowed except to the extent of casualty gains. Tax returns for taxpayers with deductible casualty and theft losses are out of scope. Refer to the NTTC Casualty Loss Screening Tool to determine whether the taxpayer has a potential disaster loss deduction that would make the return out of scope.
- Federal estate tax on income in respect of a decedent
- Repayment of income over $3,000 – see the Payments and Miscellaneous Refundable Credits lesson 28
- Certain unrecovered cost in a pension
- Certain bond premium amortization on bonds acquired prior to 1987
- Contingent-payment or inflation-indexed debt instrument losses

Itemized deductions subject to the 2% of AGI limitation

These miscellaneous 2% deductions are not allowed through the end of 2025. The following was federal law prior to 2018 and is provided in case your state tax laws still follow the old federal rules. The 2% miscellaneous deductions include expenses a taxpayer incurs to:

- Produce or collect income
- Manage, conserve, or maintain property held for producing income
- Determine, contest, pay, or claim a refund of any tax

Examples of miscellaneous deductions that were subject to the 2% rule included:

- Credit or debit card convenience fees incurred when paying income tax, charged by the card processor
- Union dues and fees
- Professional society dues
- Uniforms not adaptable to general use
- Small tools and supplies used for business
- Professional books, magazines, and journals
- Employment-related educational expenses
- Expenses of looking for a new job in your present occupation
- Investment counseling fees
- Investment expenses
- Safe deposit box rental if used for investment documents or assets
- Tax counsel and assistance
- Trustee's administrative fees for IRA if paid from funds outside the IRA

Nondeductible expenses include, among other personal expenses:

• Commuting expenses (mileage to and from a taxpayer's regular place of work)

• Political contributions

• The cost of entertaining friends

• Lost or misplaced cash or property

• Travel as a form of education

Exercises (continued)

Question 8: Philip had the expenses shown below. What is the total of Philip's qualified miscellaneous itemized expenses? $_____ .

Expense	Amount	Deductible?
Income tax preparation fee	$100	
Safe deposit box rental (to store bonds)	$75	
Life insurance premiums	$300	
Credit card convenience fee for income tax payment	$70	
Loss on sale of personal home	$1,800	
Investment journals and newsletters	$250	

Investment expenses	$200	
Attorney fees for preparation of a will	$100	
Total	$2,895	

Which deduction is best for the taxpayer

If taxpayers are not required to itemize, they should take the higher of the standard deduction or the itemized expenses deduction. The taxpayer's standard deduction is automatically calculated and the software automatically selects the deduction method that gives the taxpayer the best result, but only if Sch A information is entered.

Because state standard deductions are often less than federal standard deductions, it may be advisable to enter the taxpayer's itemized deductions for state income tax purposes even though they will not itemize for federal tax purposes.

Qualified business income (QBI) deduction

Through 2025, there is a deduction for "pass through" businesses. Sole proprietors are categorized as "pass through" businesses. These are the key points of the QBI deduction:

- A sole proprietor will be able to take up to 20% of QBI as a deduction on the tax return.
- REIT dividends (Sec. 199A dividends) are also eligible for the 20% QBI deduction.
- The calculations on Sch C and Sch SE are not affected by the deduction.
- Taxable income is not reduced below zero by the 20% deduction.
- The 20% deduction is limited for higher incomes.
- The deduction will also be limited for specified service trades or businesses when the applicable threshold is exceeded.

The QBI threshold amounts can be found in the Important Changes lesson and the NTTC 4012, Tab F. If the threshold is exceeded, the return is out of scope.

For taxable income that does not exceed the applicable threshold amount, the QBI deduction is the **lesser** of:

- 20% of qualified business income (for example, it is the net profit reported on a Sch C) plus 20% of qualified REIT (Sec. 199A) dividends
    - Qualified self-employment business income is reduced by the deductible part of the self-employment tax, the self-employment health insurance deduction, and by contributions to certain qualified retirement plans (not traditional IRA deductions).
- 20% of taxable income (equals adjusted gross income minus the applicable standard or itemized deduction) minus net capital gains and qualified dividends.

Based on the taxpayer's entries, the tax software computes the QBI deduction and completes Form 8995, Qualified Business Income Deduction Simplified Computation. Tax returns for taxpayers with pass-through business income from an entity on a Sch K-1, income over the threshold amount, or who require Form 8995-A, Qualified Business Income Deduction, are out of scope.

Review the Form 8995 in the previous year's return for a carryover loss on Lines 3 or 7. If there is a carryover loss, the return is out of scope.

Summary

You should be able to identify taxpayers who can take the standard deduction, and how the deduction is affected by their filing status, age, blindness, and status as a dependent. All of this will make it easier for you to help taxpayers understand how their deduction is computed and how it affects their tax.

You should also understand itemized deductions that a taxpayer may claim, including:

- Medical and Dental Expenses
- Taxes
- Interest
- Gifts to charities
- Miscellaneous deductions

Taxpayers who are considered sole proprietors may take up to 20% of their qualified business income as a deduction on the return. Taxpayers with qualifying REIT dividends may also be eligible for the QBI deduction.

Where to find more information

Pub 17, Your Federal Income Tax

Pub 502, Medical and Dental Expenses

Pub 526, Charitable Contributions

IRS exempt organization search tool

Pub 936, Home Mortgage Interest Deduction

Pub 529, Miscellaneous Deductions

Pub 530, Tax Information for Homeowners

Pub 561, Determining the Value of Donated Property

What situations are out of scope?

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Casualty and theft losses
- Taxpayers with a mortgage credit certificate
- Investment interest if itemizing deductions
- Form 1098-C, Contributions of Motor Vehicles, Boats and Airplanes with a value over $500
- Taxpayers affected by limits on charitable deductions
- Taxpayers that file Form 8283 to report noncash contributions of more than $5,000
- If the taxpayer is donating property that was previously depreciated
- If the taxpayer is donating capital gain property such as appreciated stock or artwork
- Repayment of income over $3,000. Note there is also a credit that may be better – see Pub 525, Taxable and Nontaxable Income
- Pass-through business income shown on any Sch K-1 (Sec. 199A dividends are in scope)
- Taxable income before the QBI deduction that is greater than the threshold amount
- Form 8995-A or its schedules
- Taxpayers with carryover losses from the prior year for QBI deduction purposes

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: a, Yes. Roderick is entitled to an additional standard deduction amount for blindness.

Answer 2: b, No.

Answer 3: The total of qualified medical and dental expenses is $3,250, which does not include life insurance premiums, vitamins, or reimbursed hospital expenses.

Answer 4: b. State, local, foreign income tax, and real estate taxes are all deductible on Sch A.

Answer 5: b, c, and d. Taxpayers cannot deduct a tax they did not owe, did not pay, or that they paid during another year. However, the tax may have been imposed in a prior year.

Answer 6: $2,180. The only interest that is fully deductible for the tax year is Joe and Angela's home mortgage interest. The points they paid to refinance are not deductible because they don't qualify as interest, and the other interest paid was personal interest and is not deductible.

Answer 7: The amount that Julia can claim as deductible cash contributions is $632 (donations to her church and to the Girl Scouts). Bingo, lottery tickets, and donations to individuals in need are not deductible.

Answer 8: Zero. None of these expenses are qualified miscellaneous itemized deductions because the deduction for miscellaneous expenses subject to the 2% floor are suspended through 2025.

Taxable Income and Tax Calculation

Introduction

In this lesson, you will learn about the several ways that a taxpayer's income tax liability may be calculated. Computing the income tax is not the final step. In the next nine lessons you will learn about other taxes that may apply and credits that may reduce the amount of tax owed.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1040 & instructions

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify how taxable income is computed
- Identify how the tax has been computed on a return

How is taxable income determined?

Tax is based on the amount of taxable income, which is determined by subtracting from the AGI:

- Standard or itemized deductions
- Deduction for qualified business income (QBI)

How is tax determined?

Most taxpayers will compute their tax using the tax tables. Taxpayers with higher incomes will use the appropriate tax rate schedule.

A taxpayer who has qualified dividend income or net long-term capital gains will use the Qualified Dividends and Capital Gain Tax Worksheet found in the instructions to Form 1040. This income can be taxed at rates more favorable than for ordinary income. For example, many taxpayers may pay zero tax on their qualified dividend income. The rate goes to 15% and then 20% for higher-income taxpayers.

A taxpayer with foreign earned income will use the Foreign Earned Income Tax Worksheet to compute their income tax. This worksheet is also found in the Form 1040 Instructions. International certification is required to prepare a return with foreign earned income.

The software will compute the appropriate tax and print the respective worksheet if it is used.

There are other tax computations listed in the instructions to Form 1040, which are out of scope.

The software automatically calculates tax based on your entries. It is important to enter all income, deduction, and credit information correctly for the tax to be computed accurately.

The kiddie tax

For children under age 18 and certain older children, unearned income over a certain amount is taxed using the tax rates applicable to their parent(s). For this purpose, “unearned income” includes all taxable income other than earned income, such as taxable interest, ordinary dividends, capital gains, rents, royalties, etc. It also includes taxable Social Security benefits, pension and annuity income, taxable scholarship and fellowship grants not reported on Form W-2, unemployment compensation, alimony, and income received as the beneficiary of a trust.

Form 8615, Tax for Certain Children who have Unearned Income, is in scope for Native Americans receiving per capita payments and Alaska residents receiving permanent fund dividends. Form 8814, Parent’s Election to Report Child’s Interest and Dividends, is in scope for Alaska residents receiving permanent fund dividends. In all other circumstances, tax returns for children subject to the kiddie tax or a parent's election to include their child's income are out of scope. The following information is presented for awareness.

The kiddie tax might apply if all the following are true:

1. The child's unearned income was more than the ceiling amount. Refer to the Important Changes lesson for this year's ceiling amount.
2. The child is required to file a return for the tax year.
3. The child either:
   - Was under age 18 at the end of the year,
   - Was age 18 at the end of the year and did not have earned income that was more than half of their support, or
   - Was a full-time student at least age 19 and under age 24 at the end of the tax year and did not have earned income that was more than half of the child's support.
   - At least one of the child's parents was alive at the end of the tax year.
   - The child does not file a joint return for the tax year.

Refer to the NTTC 4012, Tab A, Chart B for the filing requirements for dependents. Refer to "Do you have to use Form 8615 to figure your child's tax?" in the NTTC 4012, Tab H: Other Taxes, Payments, and Refundable Credits.

Summary

You should understand how taxable income is calculated. The tax computation is based on taxable income and may be computed using a worksheet if the taxpayer has qualifying dividends or capital gains, foreign earned income, or is subject to the kiddie tax. The tax may be further reduced by tax credits to be covered in upcoming lessons.

Students who opt to include scholarships in income that exceed the unearned income ceiling amount may be subject to the kiddie tax, in which case the return is out of scope.

Where to find more information

Pub 17, Your Federal Income Tax

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness:

- Kiddie tax Forms 8615 or 8814, except for Native Americans or Alaska residents as noted above
- Tax computation worksheets other than as discussed above

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Child and Dependent Care Credit

Introduction

This lesson covers the credit for child and dependent care expenses. Some taxpayers may not be aware of this credit. Your time and effort may result in a lower tax for the taxpayers.

Don't confuse this credit with the child tax credit!

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012
- Form 2441 & Instructions (child/dependent care credit)

Optional:

- Form 1040 Instructions

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine if a taxpayer is eligible for the credit
- Calculate the amount of the credit

What is the difference between a refundable and a nonrefundable tax credit?

A tax credit is a dollar-for-dollar reduction of the tax liability. A nonrefundable credit can only reduce the tax liability to zero. A refundable credit can reduce the tax liability and result in a refund to the taxpayer. The credit discussed in this lesson is a nonrefundable credit.

Omar has a tax liability of $100 before credits. A nonrefundable credit of $150 can reduce the liability to zero, but not produce a refund. A refundable credit of $150 can zero out Omar's tax liability and produce a refund of $50.

The software will calculate these credits, but the correct information must be input. You don't need to remember all the details; you can use Tax-Aide Intake Booklet and NTTC 4012.

What is the child and dependent care credit?

This credit is available to eligible taxpayers as a percentage of their child and dependent care expenses. The credit may be claimed by taxpayers who, in order to work or look for work, pay someone to take care of their qualifying person. A qualifying person is a:

- Qualifying child under age 13
- Spouse who is incapable of self-care
- Dependent who is incapable of self-care

The meaning of "incapable of self-care" is not the same as "permanently and totally disabled." Persons who can't dress, clean, or feed themselves because of physical or mental problems are considered not able to care for themselves. Also, persons who must have constant attention to prevent them from injuring themselves or others are considered not able to care for themselves.

The software may use the term disabled when it really means incapable of self-care

The credit ranges from 20% to 35% of the taxpayer's expenses. The percentage is based on the taxpayer's earned income and adjusted gross income. The amount of the credit cannot be more than the amount of income tax on the return. It can reduce an individual's tax to $0, but it will not give the taxpayer a refund.

What are dependent care benefits?

Some taxpayers receive dependent care benefits from their employers, which may also be called "flexible spending accounts" or "reimbursement accounts." Taxpayers may be able to exclude these benefits from their income. Employer-provided dependent care benefits appear in the taxpayer's Form W-2, Box 10.

All taxpayers who receive employer-provided dependent care benefits are required to complete Form 2441, Part III to determine if they can exclude all or part of these benefits from their taxable income. If they have no qualifying care expenses, the employer-provided benefit is taxable.

The taxpayer may still be able to claim a child and dependent care credit; but, the amount of excluded benefits reduces work-related expenses and the dollar limit for the credit.

Paula has one dependent child, Jenny, who is 6 years old. She paid $3,900 in qualified expenses. Paula's Form W-2, Box 10, shows she received $1,400 during the year from her employer's dependent care assistance program. The dependent care benefits reduce her qualified expenses and the dollar limit. Paula's return will show $1,600 as qualified expenses for the credit — the maximum of $3,000 reduced by the $1,400 benefits from her employer.

How do I determine if a taxpayer is eligible?

As part of a good interview with taxpayers who have young children or a spouse who cannot take care of themselves, be sure to ask whether the taxpayer has paid for any type of dependent care.

Use the NTTC 4012 screening sheet. It covers the five eligibility tests the taxpayer must meet to qualify for the credit:

- Qualifying person test
- Earned income test
- Work-related expense test
- Joint return test
- Provider identification test

Keep in mind that the taxpayer must pass all five of the tests to qualify for the credit.

Tax-Aide Counselors can use the Qualifying Child or Relative Resource Tool to help determine if the taxpayer has a qualifying person and if the taxpayer is eligible for the credit.

What is the qualifying person test?

The taxpayer's child and dependent care expenses must be for the care of one or more qualifying people. Any of the following are qualifying persons:

- A qualifying child who is the taxpayer's dependent and under age 13 when the care was provided.
  - **Exception**: If the noncustodial parent is claiming the child as a dependent, the custodial parent is the only one entitled to claim the child as a qualifying person for this credit, even though they are not claiming the child as a dependent.
- Someone who was physically or mentally incapable of self-care and who the taxpayer claims as a dependent, or the taxpayer could claim except that:
  - The person had income greater than the current year threshold amount (gross income test for a qualifying relative) or
  - The person filed a joint return or
  - The taxpayer or spouse, if married filing jointly, could be claimed as a dependent on someone else's current year tax return

- A spouse who was physically or mentally unable to care for themselves and lived with the taxpayer more than half the year.

Jim paid someone to care for his wife, Janet, so he could work. Janet is physically unable to care for herself. Jim also paid to have someone prepare meals for their 12-year-old daughter, Jill. Both Janet and Jill are qualifying persons for the credit.

See the rules for qualifying child and the special rules for children of divorced or separated parents or parents who live apart in the Dependents lesson 6 of this publication.

What questions should I ask?

Ask the questions from the screening sheet in the NTTC 4012, Tab G, Nonrefundable Credits, and the Tax-Aide Intake Booklet. The sample interview shown uses these questions.

Sample Interview

Volunteer Says…	Dorothy Responds…
I see you indicated on your Tax-Aide Intake Booklet that you had child and dependent care expenses.	Yes, I did.
You may qualify for the child and dependent care credit. Let me ask you a few questions about that. Which of your dependents received the care?	My daughter.
Now, she is 16 years old, correct?	Yes, but she was diagnosed with a severe mental condition. She just can't take care of herself.
Even though Dorothy's daughter is over age 13, she meets the qualifying person test because she cannot care for herself. *Once you've determined if the taxpayer had eligible expenses for the child and dependent care credit, confirm that the appropriate box on the Tax-Aide Intake Booklet is checked.*	

What is the earned income test?

The taxpayer (and spouse, if married filing jointly) must have earned income during the year. Earned income includes:

- Wages, salaries, and tips
- Other taxable employee compensation
- Medicaid waiver payment income, even if excluded from taxable income
- Net earnings from self-employment (reduced for the S-E tax adjustment to income)
  - Statutory employees use gross receipts instead of net earnings (line 1 of Sch C)
- Strike benefits
- Disability pension reported as wages
- **Combat pay.** Members of the Military who choose to exclude combat pay from taxable income can choose to include it as earned income for purposes of the child / dependent care credit. They may make this election even if they have elected to not include combat pay as earned income for EIC purposes or for the exclusion of child and dependent care benefits. The taxpayer and spouse can each make their own election.

Earned income does not include:

- Wages that are excluded as foreign earned income on Form 2555, Foreign Earned Income (International certification required)

- Income earned while incarcerated or in a work release program.

Refer to the NTTC 4012, Tab I, Earned Income Credit, Earned Income Table for the list of earned income.

What if spouses are full-time students or are unable to care for themselves?

A taxpayer's spouse is treated as having earned income for any month the spouse is physically or mentally incapable of self-care or is a full-time student. The spouse's income is considered to be $250 for each month if there is one qualifying person in the home or $500 each month if there are two or more qualifying people. A fulltime student is defined as enrolled and attending a school for the number of hours or classes the school considers full time. The spouse must be a full-time student for some part of five calendar months during the year. This rule also applies to taxpayers who are filing jointly with their spouse; that is, the taxpayer is a full-time student or incapable of self-care.

If, in the same month, both the taxpayer and the taxpayer's spouse are full-time students or are not able to care for themselves, only one spouse can be considered to have earned income of either $250 for one qualifying person or $500 for two qualifying persons for that month.

What questions should I ask?

Ask the questions from the screening sheet in the NTTC 4012, Tab G, Nonrefundable Credits and the Tax-Aide Intake Booklet. Here is how a volunteer might interview a taxpayer about the earned income test.

Sample interview

Volunteer Says…	Dorothy Responds…
I believe you mentioned earlier that you and your husband both work. Is that correct?	Yes.
Did you both work while your daughter was in day care?	Yes and no. My husband just changed careers. He went to school the first half of the year, but he began working full time within a month of finishing his program in July.
So, he was a full-time student for the first six months of the tax year?	Yes. Does that disqualify us?
No. That does not disqualify you.	
Dorothy and her husband meet the earned income test because her husband was a full-time student for at least five months and is considered to have earned income for those months.	

What is the work-related expense test?

Expenses are considered work-related only if both of the following are true:

- The expenses allow the taxpayer (and spouse, if married filing jointly) to work or look for work and
- The expenses are for a qualifying person's care and to provide for that person's well-being and protection

For married taxpayers, generally both must work or be looking for work. A taxpayer's spouse is treated as working during any month the spouse was a full-time student or was incapable of self-care.

There is a limit on the amount of work-related expenses that can be used to figure the credit. The limit is $3,000 for one qualifying person and $6,000 for two or more qualifying persons. This $6,000 limit does not need to be divided equally among them and it is possible that all the expense is for one qualifying person and none for the other.

If qualified expenses for the previous year were paid in the current tax year, the total credit may be increased. The software will ask for details including provider information and information from the previous year tax return.

What are examples of work-related expenses?

The following expenses count as work-related:

- Cost of care outside the home for dependents under age 13, such as preschool or home day care, or before-school or after-school care for a child in kindergarten or higher grade
- Cost of care for any other qualifying person, such as adult day care or other dependent care
- Household expenses that are paid at least partly for the well-being and protection of a qualifying person, for example, the services of a housekeeper or cook

If a taxpayer's qualifying child turned 13 during the tax year, their qualifying expenses include amounts incurred for the child while the child was under age 13. For example, if the taxpayer's qualifying child turns 13 on September 16, count only those expenses through September 15.

Special education for mentally or physically disabled persons can be claimed as a medical expense (lesson 19). Preschool and after-school charges may be eligible for the child and dependent care credit. The taxpayer may allocate the expenses paid between the two benefits but without double counting any payments.

Leon has $6,500 of employment-related expenses for the care of his child who is physically incapable of self-care. The expenses are for services performed that also qualify as expenses for medical care. Of the total expenses, Leon may use $3,000 for the dependent care credit. Leon may deduct the balance of the expenses, or $3,500, as expenses for medical care if he itemizes on Sch A.

What expenses do not qualify as work-related?

Expenses that do not qualify as work-related include amounts paid for food, clothing, education, or entertainment. However, small amounts paid for these items can be included if they are incidental to and cannot be separated from the cost of care. Examples of childcare expenses that do **not** qualify as work related include:

- Education expenses to attend kindergarten or a higher grade
- The cost of sending a child to an overnight camp
- The cost of transportation not provided by a care provider

Roger takes his 10-year-old child to a private school. In addition to paying for the cost of the education, Roger also pays an extra fee so that his child can attend a before- and after-school program while he is at work. Roger can count the cost of the before- and after-school program when figuring the credit, but not the cost of the education.

Krista takes her 3-year-old child to a nursery school that provides lunch and educational activities as part of its preschool childcare service. She can count the total cost when she figures the credit.

What about taxes paid for household employees?

Taxpayers who paid someone to come into their home to provide care for their dependent or spouse may be required to pay household employment taxes. These taxes may be considered a work-related expense.

Generally, if the household employee earned less than a certain amount for the tax year, and the taxpayer did not withhold any income tax, the taxpayer is not required to pay employment taxes or provide the employee with Form W-2. This year's threshold amount is in the Important Changes lesson.

Tax returns for a taxpayer that is, or may be, liable for employment taxes for their household employees, are out of scope.

What if the taxpayer makes payments to a relative?

Payments to relatives may qualify as work-related expenses if the taxpayer does not claim the relative as a dependent. Do not count amounts paid to:

- A dependent that the taxpayer (or spouse, if married) can claim on the tax return

- The taxpayer's child who is under age 19 at the end of the year, even if the child is not the taxpayer's dependent
- A person who was the taxpayer's spouse at any time during the year
- The other parent of the taxpayer's qualifying child who is under age 13

What questions should I ask?

Continue asking questions from the screening sheet in the NTTC 4012, Tab G, Nonrefundable Credits, and the Tax-Aide Intake Booklet. Here is how a volunteer might interview a taxpayer about the work-related test.

Sample interview

Volunteer Says…	Dorothy Responds…
Did the caregivers assist your daughter only when you and your husband were at work?	That's right. We couldn't afford any more help than that. All last year, they arrived just before we left for work and they left when my mother came at 2 p.m.
Do you pay your mother to care for your daughter?	No, we don't. She just does it because she loves her granddaughter.
That's wonderful. You're all very fortunate. All your expenses were only to allow you to work – or in your husband's case to go to school or look for work prior to becoming employed.	Yes, exactly.
Dorothy passes the work-related expense test because the expenses are paid so that she and her husband can work and are not paid to a dependent relative.	

What is the joint return test?

Generally, married couples who wish to take the child and dependent care credit must file a joint return. However, taxpayers can be considered unmarried if they file a separate return and:

- Are legally separated under a divorce or separate maintenance decree on the last day of the tax year or
- Lived apart from their spouse for the last 6 months of the year and paid more than half of the cost of providing a home that was also the main home of the qualifying person for more than half the year.

There is a checkbox required on Form 2441 for married filing separately taxpayers that meet the requirements to claim the credit.

Generally, but not always, married persons who are considered unmarried will use the filing status, head of household because their qualifying person for the credit is likely the same as for head of household status.

A taxpayer whose spouse died during the tax year, and who has not remarried, must generally file a joint return to claim the credit. The surviving spouse may, but is not required to, take into account the earned income of the spouse who died during the year. That is, the surviving spouse can use just their own earned income and ignore the decedent's earned income. In this case, you'll need to refer to NTTC 4012 for the software entries.

There is another special rule if the care was for a deceased taxpayer. It applies when the surviving spouse has remarried and can file jointly with the new spouse. In this case, the deceased taxpayer will use the married filing separately status and can claim the credit for their own care.

At this point, you will have already determined the filing status and can rely on that to determine if the taxpayer passes the joint return test.

What is the provider identification test?

The provider identification test requires that taxpayers provide the name, address, and Taxpayer Identification Number (TIN) of the person or organization who provided the care for their child or dependent.

If the care provider is an individual, the TIN is usually the same as the provider's Social Security number. If the provider is an organization, then it is the Employer Identification Number (EIN). Certain tax-exempt organizations are not required to have an EIN.

Taxpayers who cannot provide all of the provider's information or who have incorrect information may still be able to take the credit if they can show that they used due diligence in trying to obtain the correct information. Refer to the sections titled Due Diligence and Provider Refusal in Pub 503 for more information. Returns that do not include the provider information cannot be filed electronically.

Exercises

Use the screening sheet in the NTTC 4012, Tab G, Nonrefundable Credits, to answer the following questions. The answers appear at the end of the lesson.

Question 1: Audrey is a stay-at-home mom. Her husband works and had earned income for the tax year. They have a young son with autism who must be supervised at all times. Audrey volunteers at a local autism information hotline 12 hours a week. She and her husband pay a caregiver to stay with their son during those hours. Do they qualify for the child and dependent care credit?

a. Yes
b. No

Question 2: Why don't Audrey and her husband qualify for the credit? (Select all answers that apply.)

a. The caregiver expense is not work-related
b. Their son is not a qualifying person
c. The caregiver's duties qualify as work-related
d. They do not pass the earned income test

Taxpayer Interview and Tax Law Application

Bill, 61, and Helen, 62, are married and have lived together for 20 years. Earlier in the interview with Bill, you learned that Helen is too sick to work and needs 24-hour care. Bill is claiming his granddaughter Lucy as a dependent, as noted in his Tax-Aide Intake Booklet. She is 18 and takes care of Helen. You wonder whether Bill can take the child and dependent care credit.

Apply the questions from the credit for child and dependent care expenses screening sheet in the NTTC 4012, Tab G, Nonrefundable Credits, to find out whether Bill can take the credit, as shown in the sample interview to follow.

Sample interview

Volunteer Says…	Bill Responds…
For the credit for child and dependent care, I'd like to ask you some questions about the care provided for your wife, Helen. You may qualify for the credit.	Oh, okay.
Why don't you tell me about your wife's illness and care?	Well, she has chronic lung disease; she can't take care of herself at all. We need to have someone in the home 24 hours a day.
I'm sorry that she is so ill. That must be difficult for both of you. [You have already determined earlier in the tax return preparation process that Bill has earned income from his full-time teaching job. So you skip these questions in the decision tree and move ahead to the next relevant question.]	Yes, it is … well, sometimes she has good days, and I'm thankful for that.

Volunteer Says…	Bill Responds…
Did you pay someone to take care of your wife so that you could go to work?	Yes, I pay my granddaughter Lucy, who just graduated from high school, to take care of Helen.
Oh, I see. Well unfortunately, you won't be able to take the credit for your wife because you are claiming Lucy as a dependent.	Oh, that's okay. Thanks for looking into it for me.
You're welcome. Just trying to help!	
Bill does not pass the work-related expenses test because his expenses were paid to a dependent relative. On the Tax-Aide Intake Booklet, indicate that the taxpayer doesn't qualify for this credit, and why.	

What limits apply to this credit?

The taxpayer's expenses are subject to an earned income limit. The amount of work-related expenses used to figure the credit cannot be more than:

- The taxpayer's earned income for the year (or deemed earned income if a student or incapable of self-care) or
- If married filing jointly, the smaller of the taxpayer or spouse's earned income for the year

If the taxpayer files a joint return after the death of a spouse during the tax year see NTTC 4012, Tab G, Miscellaneous Credits, for the entries that may be needed. The decedent's earned income, which might be little or none, does not need to reduce the credit.

As previously discussed, the amount of work-related expenses that can be used to figure the credit is limited to $3,000 for one qualifying person or $6,000 for two or more qualifying persons. If the taxpayer received dependent care benefits from an employer, the amount of the benefits excluded from income must be subtracted from the dollar limit.

Care expenses paid in the current tax year that were incurred in the prior tax year are subject to different rules as detailed on Form 2441 and its instructions. The taxpayer will need to provide a breakdown of the prior year care expenses paid during the current tax year.

Lastly, as a nonrefundable credit, the amount of credit allowed is limited to the amount of tax reduced by any other nonrefundable credits with greater priority. There is no carryover if the allowed credit is limited.

Mary has three qualifying children. She received $4,800 in dependent care benefits through her employer. When Mary figures her credit, her work-related expenses for the credit will be limited to $1,200 ($6,000 – $4,800).

Summary

The credit for child and dependent care expenses is a nonrefundable credit that allows taxpayers to reduce their tax liability by a portion of the expenses.

The maximum expense amounts are $3,000 for one qualifying person and $6,000 for two or more qualifying persons. This $6,000 limit does not need to be divided equally among them.

The maximum credit rate is 35% of the taxpayer's expenses.

A taxpayer must satisfy the five eligibility tests to qualify for the credit. The tests are the:

- Qualifying person test
- Earned income test
- Work-related expense test
- Joint return test
- Provider identification test

The credit is calculated on Form 2441.

Where to find more information

Pub 503, Child and Dependent Care Expenses

Pub 926, Household Employer's Tax Guide

What situations are out of scope?

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Taxpayers who owe or may owe employment taxes for household employees

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: b, No. They do not qualify.

Answer 2: a and d. Audrey is not using the caregiver's services to look for work or to perform work. In addition, both spouses must have earned income during the year to qualify. Only the husband had earned income for the tax year.

Education Credits

Introduction

This lesson covers tax credits available to help the taxpayer offset the costs of higher education by reducing the amount of income tax and possibly increasing a refund. This lesson suggests probing questions you can ask based on the Tax-Aide Intake Booklet, the NTTC 4012, Tab J, Education Benefits, and on the rules for claiming education credits.

During the interview, look for dependent children of college age and ask taxpayers if they are aware of the education credits. Next, gather information to determine if any credits can be claimed.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012
- Form 1098-T (tuition statement)
- Form 8863 & Instructions (education credits)

Optional:

- Form 1040 Instructions

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine who qualifies for an education credit
- Determine which credit the taxpayer can claim

What are education credits?

Education credits are amounts that will reduce the amount of tax due and may result in a refund. The amount is based on qualified education expenses that the taxpayer paid during the tax year.

There are two different education credits: the American opportunity credit and the lifetime learning credit. The American opportunity credit allows 40% of the credit to be refundable. There are general rules that apply to both credits, as well as specific rules for each credit.

For an overview of the various education tax benefits, review the NTTC 4012, Tab J, Education Benefits, Highlights of Education Tax Benefits.

Who can take an education credit?

Taxpayers can take education credits for themselves, their spouse, and/or dependents (claimed on the tax return) who were enrolled at or attended an eligible postsecondary educational institution during the tax year. The law requires that the student must generally receive a Form 1098-T, Tuition Statement, in order for the taxpayers to claim the education credit.

An educational institution is not required to furnish a Form 1098-T when the tuition and fees were fully paid by scholarships and grants. In this case, the taxpayer may claim an education credit – the student just has to provide the information that would otherwise be included on the Form 1098-T.

Review the dependent section of the Tax-Aide Intake Booklet for children who are of college age. Ask the taxpayer if there are education expenses.

What basic requirements must the taxpayer meet?

To claim an education credit, verify that the following are true for the taxpayer:

- They cannot be claimed as a dependent on someone else's tax return
- They are not filing as married filing separately
- Their adjusted gross income (AGI) is below the limitations for their filing status ($180,000 if married filing jointly; $90,000 if single, head of household, or qualifying surviving spouse)
- They were not nonresident aliens for any part of the tax year, or if they were, they elected to be treated as resident aliens

- Taxpayers claiming the American opportunity credit must have a valid identification number (SSN or ITIN) by the due date of the tax return (including extensions)
- The student claimed for the credit must also have a valid identification number (SSN, ITIN, or ATIN) by the due date (including extensions)

Taxpayers cannot file an amended return to claim the credit for a year that the taxpayer and/or student did not originally have a required identification number by the return due date.

How do I handle dependents?

The taxpayer must claim the student as a dependent to receive the credit for the student's qualified expenses. If the taxpayer claims the student as a dependent, all qualified education expenses of the student are treated as being paid by the taxpayer.

Carol Marshall has a grandson named Gary. He is claimed as a dependent on his parent's joint return. Carol paid Gary's tuition directly to the university. For purposes of claiming an education credit, Gary is treated as receiving the money as a gift and paying for the qualified tuition and related expenses. Since his parents are claiming him on their return, they may be able to use the expenses to claim an education credit. Alternatively, if he is claiming himself on his return, he might be able to claim the expenses as if he paid them to the school.

What is an eligible institution?

An eligible institution is generally any accredited public, nonprofit, or private college, university, vocational school, or other postsecondary institution eligible to participate in a student aid program administered by the U.S. Department of Education. The school should be able to tell the student if it is an eligible education institution. A searchable database of all accredited postsecondary institutions and programs are available at: https://ope.ed.gov/accreditation/.

Taxpayers claiming the American opportunity credit are required to report the EIN of the educational institution the student attended on Form 8863, Education Credits (American Opportunity and Lifetime Learning Credits). The student can get the EIN from the school if they did not receive Form 1098-T.

What are qualifying expenses?

Qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an eligible educational institution. Qualified education expenses include nonacademic fees, such as student activity fees, athletic fees, or other expenses unrelated to the academic course of institution that must be paid to the institution as a condition of enrollment or attendance. However, for the American opportunity credit, the definition for "certain related expenses" is different from the lifetime learning credit. This will be discussed later in the lesson.

Most students should receive Form 1098-T from the educational institution. The form should show the amounts the student paid for tuition and related expenses, the amounts of scholarships and grants received are shown in Box 5, and whether the student was at least a half-time student or a graduate student. Verify that the amount in Form 1098-T, Box 1, is actually the amount paid in the current tax year for qualified expenses by reviewing the student's school financial transcript issued by the school.

Also ask about qualified education expenses paid outside the school, such as from a bookstore. The taxpayer can include education expenses paid during the tax year only.

Form 1098-T may have incomplete information. Question the taxpayer to determine the amount of qualified expenses actually paid and adjust this amount by any non-taxable items, such as tax-free scholarships and tuition program distributions.

When Janice enrolled for her freshman year of college, she had to pay a separate student activity fee in addition to her tuition. This activity fee is required of all students and is used solely to fund on campus organizations and activities run by students, such as the student newspaper and the student government. No portion of the fee covers personal expenses. Although labeled as a student activity

fee, the fee is required for Janice's college enrollment and attendance; therefore, it is a qualified expense.

Which expenses do not qualify for the credits?

Do **not** include expenses such as:

- Food, housing, insurance, medical expenses (including student health fees), transportation costs, or other similar personal, living, or family expenses
- Any course of instruction or other education involving sports, games, or hobbies, unless:
  - the course is part of the student's degree program
  - for the lifetime learning credit, the course helps the student to acquire or improve job skills

Jackie paid $3,000 for tuition and $5,000 for food and housing at an eligible university. The $5,000 paid for her living expenses is not a qualified expense for either education credit.

If expenses or scholarships are adjusted in a later year, the school will report the amount in box 4 or box 6 of Form 1098-T. Prior credits claimed may need to be recaptured. Tax returns for taxpayers with adjustments on Form 1098-T are out of scope.

Are any amounts excluded from qualified expenses?

Tuition or other education expenses that have been used to make educational assistance received tax-free cannot be used to figure the credit. Similarly, expenses that have been refunded do not qualify. Once you have identified each person claiming a credit and their qualified expenses, ask if the student received any of these untaxed educational benefits during the year:

- Tax-free part of Pell grants
- Tax-free employer-provided educational assistance* (maximum $5,250)
- Veterans' educational assistance
- Tax-free parts of scholarships and fellowships
- Any other nontaxable payments received as educational assistance (other than gifts or inheritances). For example, distributions from a 529 plan reported on Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530)
- Refunds of the year's qualified expenses paid on behalf of a student (e.g., the student dropped a class and received a refund of tuition)

* Instead of applying employer benefits to education expenses, tax-free employer benefits can be applied toward a student loan through 2025 so that qualified education expenses are still available for one of the credits.

If you find taxpayers claimed an education credit in a prior year and they were refunded part or all of the expenses they used to claim the AOC or lifetime learning credit, they may have to repay (recapture) all or part of the credit. Information can be found in Pub 970, Tax Benefits for Education, but this topic is out of scope.

Scholarships or grants can be either restricted or unrestricted. Restricted scholarships or grants must be used for the stated purpose, usually tuition and fees. Unrestricted scholarships or grants can be used for any purpose, include living expenses. The most frequently seen unrestricted grants are Pell grants. If the student could withdraw the funds from their account, the scholarship or grant was unrestricted.

Generally, a scholarship or fellowship grant is treated as tax-free educational assistance. However, a scholarship or fellowship grant is not treated as tax-free educational assistance to the extent the student

includes it in gross income for the year the scholarship or fellowship grant is received. This is true even if the scholarship/grant was paid directly to the school.

If the student includes the educational assistance in income, has a filing requirement, and unearned income (including the taxable scholarship) over the ceiling amount, the student may be subject to the kiddie tax. In this case, the student's return is out of scope. The kiddie tax was discussed in the Taxable Income and Tax Calculation lesson 20.

Joan Smith received Form 1098-T from the college she attends. It shows her paid tuition was $9,500 (Box 1) and that she received a $1,500 (Box 5) scholarship that had to be used for tuition. She had no other scholarships or nontaxable payments. Her maximum qualifying expenses for the education credit would be $8,000 ($9,500 - $1,500).

Juan, a student, earned $11,000 from a summer job which is less than the cost of half of his support, had $4,000 in education expenses, and a $4,000 Pell grant. He otherwise has no filing requirement. Juan's parents file a return claiming Juan as a dependent and reported income that is within the allowable range for the American opportunity credit (AOC).

Scenario 1: Juan uses the grant to pay the education expenses. Juan has no filing requirement and files only to get his withholding (from his summer job) back. Juan's gross income = $11,000, no filing requirement, tax = 0. His parents' qualified education expenses would be zero.

Scenario 2: Juan chooses to declare $2,000 of the grant as income on his return and his parents use the education expenses toward the AOC. Juan's gross income is $11,000 + $2,000 = $13,000. As a dependent, Juan has no filing requirement and he has no tax. His parents claim $2,000 as qualified education expenses and an AOC of $2,000.

Scenario 3: Juan chooses to include the entire grant as income on his return. Juan's gross income is $11,000 + $4,000 = $15,000. Juan's income is over the dependent's filing requirement threshold. The taxable grant is unearned income so the kiddie tax applies. Juan's tax return is out of scope. Juan's parents can claim the entire $4,000 education expenses toward the AOC for the maximum AOC of $2,500.

It may be better to forgo some portion of the AOC when other issues, such as the kiddie tax or premium tax credits, could be adversely affected by Juan having a filing requirement. Use the Education Benefits Calculator from the Tax-Aide Colorado Resource Toolbox to determine the optimal situation.

What about payments for the next academic year?

The taxpayers can claim payments during the tax year for the academic period that begins in the first three months of the next calendar year (box 7 of Form 1098-T will be checked). Such amounts cannot be claimed again in the next year.

Thomas pays $1,500 in December for qualified tuition for the winter semester that begins in January. He can use the $1,500 paid in December to compute his credit for the current tax year. He cannot count it again next tax year.

What rules apply to each credit?

American opportunity credit

The American opportunity credit can be taken if the taxpayer and the expenses meet the requirements described under "What basic requirements must the taxpayer meet?", above and if the taxpayer can answer all of these questions as indicated below for a student:

- As of the **beginning** of the tax year, was the student still in the first four years of postsecondary education (generally, the freshman, sophomore, junior, and senior years)? *Yes*
  - Whether the first four years have been completed is determined by the school, not the student.

- The student may satisfy this requirement for the last year of undergraduate study. If so and all the other requirements are met, all qualified education expenses count toward the AOC, even those for graduate study later in the year.

- As of the **beginning** of the tax year, has the AOC (or its predecessor the Hope credit) been claimed for this student for four years? *No*
  - If the parents claimed the credit using the student's expenses for 2 years and the student claimed the credit for 2 years, the answer would be *yes*.
- Was the student enrolled in a program that leads to a degree, certificate, or other credential? *Yes*
- Was the student taking at least one-half the normal full-time workload for the course of study, for at least one academic period beginning in the current tax year? *Yes*
  - The school determines half-time or full-time status and will check the box on Form 1098-T if at least half-time.
- Has the student been convicted of a felony for possessing or distributing a controlled substance as of yearend? *No*
  - This determination is made as of **December 31** of the tax year.
- Did the taxpayer and student have the required TIN by the **due date of the return** (including extensions)? *Yes*

If the student does not meet all of the requirements for the AOC, the taxpayer may be able to take other education benefits for part or all of the student's qualified expenses.

Mindy's brother, Jim, started college in 2020. He was eligible for the AOC for 2020, 2021, 2022, and 2023. His parents claimed the AOC on their 2020, 2021, and 2022 returns. Jim claimed the credit on his 2023 tax return. Since the AOC has been claimed for four years, the credit can't be claimed on any additional returns based on Jim's expenses.

Qualified expenses include tuition, required enrollment fees, equipment (including a computer), supplies and course materials that the student needs for a course of study whether or not the materials are bought at the educational institution as a condition of enrollment or attendance.

The AOC can be up to $2,500 per eligible student, depending on the amount of eligible expenses and the amount of tax on the return.

- The credit is 100% of the first $2,000 in eligible expenses and 25% of the second $2,000 in eligible expenses per student, up to the amount of tax
- 40% of the credit is a refundable credit, which means the taxpayer can receive up to $1,000 even if no taxes are owed
- Taxpayers under age 24 cannot claim the refundable portion of the credit if certain conditions are met (these are the same conditions that would make the kiddie tax apply other than having unearned income in excess of the kiddie tax ceiling amount)

Refer to NTTC 4012, Tab J, Education Benefits, Student Under Age 24 Claiming American Opportunity Credit, for details.

Toby has receipts for books and supplies for his first year at college. He spent $1,291 for required books, lab supplies, and rock-hunting equipment he needed for his introductory chemistry and geology courses. The school has no policy requiring that these books and equipment be purchased from the college in order to enroll. These are qualified expenses for the AOC.

Lifetime learning credit (LLC)

The lifetime learning credit can be taken if the taxpayer and the expenses meet the requirements described under "What basic requirements must the taxpayer meet?", above. Points of distinction of the LLC from the AOC include:

- Student doesn't need to be pursuing a program leading to a degree or other recognized education credential
- A felony drug conviction doesn't make the student ineligible
- Up to a $2,000 non-refundable credit per return (20% of up to $10,000 in eligible expenses)
- Available for an unlimited number of tax years
- Available for all years of postsecondary education and for courses to acquire or improve job skills (no minimum amount of course workload)
- Course-related books, supplies, fees, and equipment (including a computer) are included in qualified education expenses only if they **must** be paid to the institution as a condition of enrollment or attendance

Jill attends Wanda's School of Beauty, an eligible institution. She pays $4,400 for the course of study, which includes tuition, equipment, and books required for the course. The school requires that students pay for the books and equipment when registering for the course. The entire $4,400 would be an eligible educational expense.

Jack attends a culinary school on Saturdays. He pays $4,400 for the course of study and qualifies for the lifetime learning credit. The school provides a list of equipment that he needs to bring to class. The $4,400 is an eligible educational expense, but the cost of the equipment and supplies is not.

Exercises

Use the NTTC 4012, Tab J, Education Benefits, and Pub 17, Comparison of Education Credits, to answer the following questions. Answers are at the end of the lesson summary.

Question 1: Bob was a full-time student and a fifth-year senior. He has only claimed the AOC for three earlier years. Does he qualify for the AOC?

a. Yes
b. No

Question 2: Janice works full time and takes one course a month at night school. Some of the courses are not for credit, but they are meant to advance her career. Which credit is appropriate for her?

a. American opportunity
b. Lifetime Learning

Question 3: Clark is an older student who has gone back to college half time after serving 18 months in prison for felony drug possession. Which credit is appropriate for him?

a. American opportunity
b. Lifetime Learning

What education benefits are possible?

Education expenses can be taken in any of several areas on the tax return. They can be used toward one of these credits, as a business expense on Sch C, or to reduce the taxable portion of scholarships, fellowships, grants, and distributions from education savings accounts. The definition of a qualifying expense varies among these different benefits, but in general, each expense can be used only once. For example, do **not**:

- Figure the education credits based on expenses that have already been taken on Sch C

- Take both an American opportunity credit and a lifetime learning credit for the same student in the same year

The taxpayer may claim a different benefit with respect to different costs or students:

- The AOC can be claimed for one student and the lifetime learning credit can be claimed for a different student in the same year.
- Business-related education can be claimed on a Sch C while an unrelated college course can be claimed for the lifetime learning credit (assuming all the criteria are met).

A taxpayer who has taken an early distribution from an IRA may take an exception to the 10% additional tax for an amount equal to the adjusted qualified education expenses, including food and housing costs if enrolled at least half-time. Using that exception does not reduce the amount of education expenses eligible to be claimed as a deduction or for a credit.

To determine the most beneficial way to claim education expenses, do not compare them until both federal and state tax returns have been otherwise completed.

How do I approach an education credit?

Here are the general steps:

1. Review the list of qualifying students and expenses and decide if the AOC or lifetime learning credit is more suitable (see the requirements discussed earlier).
2. Enter each student's qualified expenses. Be sure that these:
   - Include only qualified expenses paid during the tax year
   - Are reduced by untaxed benefits
   - Do not exceed the expense limit for the credit
3. After all the income and other tax information has been entered, the software will make the correct calculations. Review the return to see if the credit is the best answer for the taxpayer or whether claiming the education expenses elsewhere might be better, e.g. Sch C if business-related.

Taxpayer interview and tax law application

Here is how our volunteer helped a taxpayer, Barbara Smith, determine which education credits applied to her family.

Sample interview

Volunteer Says…	Barbara Responds…
Barbara, are you familiar with education credits?	They have something to do with tuition.
Yes, they apply to certain expenses for postsecondary education. Did anyone in the family attend college or vocational school during the tax year?	My daughter, Carla, is a freshman, going to college full time, and I am taking classes at City College.
There are two kinds of credits – here's a chart comparing the two education credits. [Explains the differences.]	Looks like American opportunity for Carla and lifetime learning for me!
I think you're right. You both meet the basic requirements, since you are both on the return and meet the income limits. Do you have your student account information showing the expenses paid?	Yes, these are for Carla's tuition, fees, and books for the tax year. These are for extracurricular field hockey.
The books will qualify but her field hockey costs will not. Did she receive any money from an employer, a scholarship, Pell grant, anything like that?	Only $5,000 from her grandfather.

Volunteer Says…	Barbara Responds…
We don't need to count the gift. The American opportunity credit is available for a student's first four years of college, so that might be the best for you to claim. Now let's look at your expenses.	All I have are tuition and fees for two classes in accounting for the spring and fall semesters.
Are these to improve your job skills?	Yes, but my boss doesn't reimburse me.
Are all of these fees required for your courses?	Yes.
You'll be eligible for the lifetime learning credit.	I'm so glad you were here to help me!
On the Tax-Aide Intake Booklet, indicate that you've addressed education benefits.	

Which education benefit is better?

Taxpayers have several options for using education expenses to reduce taxes. They are:

- American opportunity credit or lifetime learning credit
- Business expenses on Sch C if the expenses qualify
- Make an unrestricted scholarship or grant tax free
- Make a 529 plan or other education program distribution tax free

Generally, taxpayers will benefit the most from claiming the education credits. The American opportunity credit will always be greater than the lifetime learning credit. However, you should compare any of the other benefits for which taxpayers are eligible to determine which gives them the lowest tax. Do not claim multiple credits for the same education expense.

How can I avoid common errors?

Make sure that you have entered the names, SSNs, and education expense amounts correctly. Check that you have not claimed more than one tax benefit for the same expenses or taken a credit or deduction for expenses paid with a tax-free benefit like a scholarship.

On the Tax-Aide Intake Booklet, make sure that the appropriate box is checked to indicate that the taxpayer had education expenses. Note anything unusual that the quality reviewer may need to know when reviewing this part of the tax return. For example, you could note if some expenses were paid with a nontaxable scholarship.

AOC disallowed in a prior year

The Tax-Aide Intake Booklet asks if the taxpayer was previously disallowed an EIC, child tax credit, or American opportunity credit in a prior year. The taxpayer would have received a letter from the IRS specifying whether the disallowance is for 2 years or for 10 years and saying when they would have to complete and attach Form 8862 to claim the credit again.

If the taxpayer is denied AOC for the current tax year because of IRS disallowance, the taxpayer cannot claim AOC and is limited to another education benefit, such as the lifetime learning credit.

Summary

You are now ready to help taxpayers determine which education tax benefits are best for them. When you get to this section of the return, always check the Tax-Aide Intake Booklet and ask probing questions based on the taxpayer's information and on the rules for claiming education credits.

There are two education credits that may reduce a taxpayer's tax:

- American opportunity credit
- Lifetime learning credit

These are some requirements for the credits:

- Taxpayers and students must have a TIN by the due date of the return, including extensions, to claim the AOC
- 40% of the AOC refundable (up to $1,000)
- Taxpayers can claim the AOC for up to four years
- Lifetime learning credit can be claimed for an unlimited number of years
- Lifetime learning credit is a non-refundable credit of up to $2,000 per return (20% of up to $10,000 in expenses)
- Education expenses can be applied to one of the credits or deducted as business expenses on Sch C if they qualify
- Students that include tax-free scholarships or grants in income and may be subject to the kiddie tax, which is out of scope
- A taxpayer who claims the AOC and is not eligible can be banned up to 10 years from claiming the credit

Other education benefits are listed in the NTTC 4012, Tab J.

One of your roles as a volunteer is to help taxpayers maximize the benefits that they are entitled to under the tax law. Stay alert to ways they can use their education expenses to lower their tax.

Where to find more information

Pub 970, Tax Benefits for Education

What situations are out of scope?

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Taxpayers who must repay (recapture) part or all of an education credit claimed in a prior year.
- Taxpayers who are subject to the kiddie tax on their taxable scholarships or grants.

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Question 1: a, Yes. Bob qualifies for the American opportunity credit because he claimed the credit in three previous tax years only.

Question 2: b, Lifetime learning

Question 3: b, Lifetime learning

Foreign Tax Credit

Introduction

This lesson will show you how to help taxpayers claim the foreign tax credit. This credit applies to those who have paid or accrued taxes to a foreign country on foreign-sourced income and who are subject to U.S. tax on the same income.

Part I of this lesson deals with foreign taxes reported on a 1099-INT, 1099-DIV, or Sch K-1 and the possibility that Form 1116 is not required. This is in scope. Tabulate foreign taxes reported on 1099s or K-1s during the interview to identify whether the return is in scope.

Part II of this lesson deals with situations that require Form 1116 to be completed. To help these taxpayers, you must determine which taxes and types of foreign income are eligible for the foreign tax credit and accurately compute the credit. Form 1116 is in scope only with International certification.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

For International candidates:

- Form 1116 & Instructions (foreign tax credit)

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine which taxes and types of foreign income are eligible for the foreign tax credit
- Determine if a taxpayer does not need to complete Form 1116 to claim a foreign tax credit
- Determine how to accurately complete Form 1116 when it is needed – International certification required
- Calculate and report the foreign tax credit as a nonrefundable credit

What is the foreign tax credit?

U.S. citizens and residents compute their U.S. taxes based on their worldwide income. This sometimes results in U.S. citizens having to pay tax twice on the same income — first to the government of the foreign country where the income was earned and again to the U.S. government. As a general rule, taxpayers must choose to take either a credit or a deduction for all qualified foreign taxes. For exceptions to this general rule, see Pub 514, Foreign Tax Credit for Individuals.

Taxpayers can choose whether to take the amount of any qualified foreign income taxes paid during the year as a foreign tax credit or as an itemized deduction. Taxpayers may change their choice each year.

The foreign tax credit was created to help taxpayers avoid this double taxation. Taxpayers who paid income, war profits, or excess profits taxes to a foreign country or U.S. possession may be entitled to a credit on their U.S. taxes. Like other nonrefundable credits, the foreign tax credit allows taxpayers to take a dollar-for-dollar reduction in the amount of U.S. tax owed. However, in some cases, not all taxes paid to a foreign government on foreign-sourced income can be used in the computation of the credit.

Four tests must be met to qualify for the credit:

1. The tax must be imposed on the taxpayer
2. The taxpayer must have paid or accrued the tax
3. The tax must be a legal and actual foreign tax liability, and
4. The tax must be an income tax

Some foreign taxes, such as foreign real property tax, are not income taxes.

Part I: Simplified foreign tax credit

Taxpayers who receive a 1099-INT, 1099-DIV, or K-1 showing that foreign taxes have been paid on their behalf can elect to claim a foreign tax credit on Form 1040, Sch 3 without filing Form 1116 as long as the following conditions are met:

- All of the gross foreign source income is from interest and dividends and all of that income and the foreign tax paid on it are reported on a 1099-INT, 1099-DIV, or K-1 (or substitute statement).
- If the tax relates to dividend income from shares of stock, those shares were held for at least 16 days.
- The total foreign taxes shown on all the forms is not more than $300 (not more than $600 if married filing jointly).
- All 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.
- 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.

Tax returns for taxpayers who must complete Form 1116 because they do not qualify to claim the foreign tax credit without filing Form 1116 are out of scope, unless a volunteer preparer and reviewer have International certification.

Ryan, who is single, received Form 1099-DIV showing $29 of foreign taxes paid. According to Ryan, he received no other foreign source income and paid no other foreign taxes. The dividends were paid on shares of a mutual fund that he owned all year. He is eligible to claim the foreign tax credit on Form 1040, Sch 3 and does not have to complete Form 1116.

How do I report foreign taxes without Form 1116?

The taxpayer's 1099 or K-1 will show the total foreign taxes paid or accrued. After you confirm that the total for all foreign taxes does not exceed the $300/$600 limit, enter them in the appropriate screen of the tax software and it will claim the allowable credit. Remember this credit is nonrefundable.

Exercises

Answers are at the end of the lesson.

Question 1: To claim the foreign tax credit without filing Form 1116, a taxpayer who is filing single must have paid foreign taxes as shown on Form 1099-DIV, Form 1099-INT, or Sch K-1 that are equal to or less than $300.

a. True
b. False

Question 2: Clyde comes to your site seeking help with his foreign tax credit. He is single and his Forms 1099-DIV show a total of $324 of foreign tax paid. Can Clyde claim the foreign tax credit without filing Form 1116?

a. Yes
b. No

Question 3: Judy and Mark are married and will file a joint return. Their Forms 1099-DIV show a foreign tax paid of $590. Can they claim the foreign tax credit without filing Form 1116?

a. Yes
b. No

If you are pursuing International Certification, continue with the rest of this lesson. Otherwise skip to the Summary below.

Part II: Foreign tax credit on Form 1116

If the foreign tax paid is more than $300 ($600 for married filing jointly) or they do not meet the other conditions to make the election to claim the foreign tax credit (FTC) without filing Form 1116, taxpayers must file Form 1116 to claim the foreign tax credit.

The foreign earned income exclusion differs from the foreign tax credit; try both methods for taxpayers and choose the approach that results in the lowest tax.

- *The exclusion allows a portion of the foreign earned income to be excluded from taxable income.*
- *The credit adds the foreign income to the taxable income and then reduces the U.S. tax due by some portion of taxes paid to the foreign government(s).*

There are several factors to consider when determining if taxes paid to a foreign government are eligible for the foreign tax credit. With the taxpayer, you'll need to confirm:

- Was the income foreign-sourced?
- What type of tax was paid to the foreign government?
- Will the taxpayer receive some kind of specific economic benefit from the payment of this tax?

What qualifies taxpayers for the credit?

To qualify for the credit, the following requirements must be met. A taxpayer must:

- Have income from a foreign country
- Have paid taxes on that income to the same foreign country
- Not have claimed the foreign earned income exclusion on the same income (see the foreign earned income exclusion section of the Income – Other lesson 15)

In addition, the foreign tax must:

- Be paid to a foreign country on income derived from that country
- Be similar to the U.S. income tax
- Provide no economic benefit to the taxpayer paying the tax

Foreign taxes that qualify for the foreign tax credit generally include taxes on:

- Wages
- Dividends
- Interest
- Royalties
- Annuities

Foreign taxes for which an individual may not take a credit include taxes:

- On excluded income
- On foreign mineral income
- On combined foreign oil and gas income for which the taxpayer can take only an itemized deduction
- From international boycott operations
- Of U.S. persons controlling foreign corporations and partnerships

- Taxes paid to a foreign country that a taxpayer does not legally owe, including amounts eligible for refund by the foreign country

Taxpayers cannot take the foreign tax credit for foreign income taxes paid on income excluded under the foreign earned income exclusion.

Some foreign taxes that cannot be claimed for the credit may be deductible as an itemized deduction, even if the foreign tax credit is claimed. See Pub 514.

Robb and his wife, Nina, are U.S. citizens who reside in France. Their Form 1040, Sch B, Interest and Ordinary Dividends, lists $2,000 interest from a U.S. bank and $600 interest from a French bank. They paid income taxes on both amounts to both countries. On their U.S. tax return, they can compute a foreign tax credit to offset the taxes they owe 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 to offset the taxes paid to the U.S. on the interest income earned in the U.S.

Eva is a U.S. citizen who lives in Hong Kong. Eva owns her home in Hong Kong and paid $2,000 in real estate taxes and $1,000 in personal property taxes. She also paid $2,500 in income taxes to the government of Hong Kong. She cannot claim a foreign tax credit for either the real estate taxes or the personal property taxes because they are not income taxes. Eva can compute a foreign tax credit on the $2,500 in income taxes paid to Hong Kong.

A U.S. person, including a citizen or resident, must file a Report of Foreign Bank and Financial Accounts (FBAR) if they have a financial interest in or signature or other authority over at least one financial account located outside the United States if the aggregate value of those foreign financial accounts exceeded $10,000 at any time during the calendar year reported. That form (FINCEN 114) is out of scope and the taxpayer's return is also out of scope.

Additionally, Form 8938 may be required for specified foreign financial assets, making the return out of scope.

Exercises (continued)

Question 4: Anne is a U.S. citizen living in Japan. She listed wages, interest income, and dividend income on her U.S. tax return. She paid taxes on each of these types of income to Japan. Anne can claim a foreign tax credit for taxes paid on which of the following sources of income?

a. Wages from her job in the U.S.
b. Interest income from a U.S. bank
c. Interest income from a Japanese bank
d. Dividend income from a U.S. corporation

Question 5: Jean, a U.S. citizen, received an inheritance upon the death of an uncle in Spain and paid an inheritance tax to the Spanish government. Can Jean claim a foreign tax credit to offset the inheritance tax she paid in Spain?

a. Yes
b. No

When is income from a foreign country?

The source of income can be a complicated determination. Generally, earned income is sourced to where the service was performed. Unearned income is a mixture:

- Interest is sourced to the residence of the payer
- Dividends are sourced to the payer: is it a U.S. corporation or a foreign corporation

- Sale of personal property is generally sourced to the residence of the seller
- Sale of real property is sourced to the location of the property

Refer to Table 2 in Pub 514 for a more complete list and additional information.

What is "economic benefit"?

As mentioned earlier, the foreign tax paid cannot provide a specific economic benefit for the taxpayer and be included in the foreign tax credit computation. This means that the tax cannot be a payment that results in an individual receiving:

- Goods
- Services
- Fees or other payments
- The right to use, acquire, or extract resources, patents, or other property that the foreign country owns or controls
- Discharges of contractual obligations

Taxpayers are considered to receive a specific economic benefit if they conduct a business transaction with a person who receives an economic benefit from a foreign country, and under the terms and conditions of the transaction, the taxpayer directly or indirectly receives some part of the benefit.

Lawrence is a business owner who lives in China, which has a two-tier income tax system:

- *Everyone is taxed according to their income*
- *Business owners pay additional tax on their profits*

The second tier entitles business owners to certain reduced fees and other benefits, such as ability to rent space in a government building. Because of the specific economic benefits Lawrence receives, he cannot use the second-tier tax payments to compute a foreign tax credit on his U.S. tax return. However, the first-tier income taxes are similar to U.S. income taxes and can be used to figure his foreign tax credit.

FTC restrictions

Taxes paid to or accrued by certain countries do not qualify for the foreign tax credit. These are countries:

- That have been designated by the Secretary of State as repeatedly providing support for acts of international terrorism,
- With which the U.S. has severed or does not conduct diplomatic relations, or
- Whose government the U.S. does not recognize, unless that government is eligible to purchase defense articles or services under the Arms Export Control Act

See Pub 514 for the current list of sanctioned countries.

Foreign income earned in sanctioned countries is subject to U.S. tax. A separate Form 1116 must be completed for foreign income from a sanctioned country, using the "Section 901(j) income" category. This is out of scope.

Exercises (continued)

Question 6: Adele lived and worked in a sanctioned country until August of this tax year, when she was transferred to Italy. She paid taxes to each country on the income earned in that country. Can Adele take a foreign tax credit on her U.S. tax return for the taxes paid on income she earned in the sanctioned country?

a. Yes
b. No

Question 7: Assume the taxpayer is a U.S. citizen or resident living in a nonsanctioned foreign country and that the tax is being paid to a foreign government on foreign-sourced income. For each listed item determine if the tax qualifies for the foreign tax credit (Q) or does not qualify for the foreign tax credit (NQ).

Q or NQ	Dividend taxes
Q or NQ	Foreign oil related income tax
Q or NQ	Interest income tax
Q or NQ	Real estate taxes
Q or NQ	Income tax on wages from a foreign country, assuming the taxpayer does not take the foreign earned income exclusion
Q or NQ	Taxes paid that are returned to the taxpayer in the form of a subsidy

In scope FTC categories of income

At the top of Form 1116, Part I, taxpayers are asked to indicate the type of foreign income they received. Two of these income categories fall within our scope:

- Passive category income
- General category income

A separate Form 1116 must be completed for each type of income; each Form 1116 can include income from as many as three foreign countries. If there are more than three foreign countries to list, a supplemental schedule can be used.

Passive category income

This category includes passive income and specified passive category income. Passive income generally includes the following:

- Dividends
- Interest
- Royalties
- Rents
- Annuities
- Net gain from the sale of property that produces such income, or non-income-producing investment property

For example, a taxpayer who lives in a foreign country and pays taxes on interest income could claim the foreign tax credit and check the Passive category income box on Form 1116.

Wages and salaries are considered to be general category income, which is discussed later in this topic. Passive category income may qualify as general category income if the foreign government taxes it at a rate higher than the highest U.S. tax rate; see High-Taxed Income later in this lesson.

For additional information on passive income and specified passive category income, see Pub 514.

If Sch K-1 shows foreign taxes were paid or accrued and Form 1116 is required, Sch K-3 is needed to properly complete Form 1116.

General category income

General category income consists of income earned in a foreign country that an individual does not exclude, or excludes only part of, under the foreign earned income exclusion. Additionally, foreign income that does not come under any of the other categories on Form 1116 can typically be included as general category income.

Robert paid taxes to Spain for earned income and did not claim the foreign earned income exclusion. He can claim a foreign tax credit for the taxes paid to Spain.

What is high-taxed income?

Some passive category income can be included in general category income if it is taxed by a foreign government at a rate higher than the highest U.S. income tax rate. Therefore, if taxpayers pay more than the highest U.S. income tax rate on the foreign-sourced passive income for which they claimed the credit, the credit is computed under general category income.

Brenda is a U.S. citizen who lives in a foreign country and pays 45% income tax on her interest income in that country. She lists this as "General Category Income" on Form 1116, since the tax rate paid on this passive income is higher than the highest U.S. income tax rate.

Exercises (continued)

Question 8: Regina lives in a foreign country and is a U.S. citizen. She has both dividend income and interest income from foreign countries. Her foreign bank withholds 15% of her interest income for income taxes. She also pays foreign income taxes on her dividend income, at a rate of 45%. For the purposes of Form 1116, how should the following types of income be classified?

Interest Income: _____ Dividend Income: _____

a. Passive category income

b. General category income

Question 9: Bernard is a U.S. citizen who lives in Barbados. This year, he paid 17% income tax on interest income from his bank account in Barbados. For the purposes of Form 1116, Bernard's foreign interest income should be classified as:

a. Passive category income

b. General category income

How do I complete Form 1116?

The amount of the foreign tax credit is the portion of U.S. income tax liability allocated to gross taxable foreign income reduced by certain expenses.

An amount denominated in a foreign currency will need to be converted to U.S. dollars. See the discussion in the Income – Other lesson 15, Part II, for instructions on converting foreign currency amounts.

Some of these expense items or situations are complicated and beyond our scope, such as:

- Expenses directly related to the foreign income
- Investment interest expense
- Foreign losses, such as those from selling foreign assets or a loss from a business or partnership

If taxpayers have any of these types of deductions or if they have excess foreign tax credits that can be carried back to a prior year or forward to a later year, their return is out of scope.

Summary

Part I covered taxpayers who paid taxes to a foreign country or U.S. possession and may be able to take a nonrefundable foreign tax credit without filing Form 1116 if they meet certain requirements. Claiming the foreign tax credit in this circumstance is in scope for Tax-Aide Counselors.

Part II dealt with taxpayers who are required to file Form 1116 to claim a foreign tax credit. The preparer and reviewer must have International certification to prepare Form 1116.

To qualify for the foreign tax credit, the taxpayer, income, and taxes must all meet specific requirements. The credit is computed and reported on Form 1116. A separate Form 1116 must be completed for each category of income.

The foreign tax credit is different from the foreign earned income exclusion. If the taxpayer uses the foreign earned income exclusion, foreign tax paid on the excluded income cannot be used to claim the foreign tax credit. Taxpayers can choose the approach that results in the lowest tax.

Taxpayers have the option of claiming foreign income taxes as a credit or as an itemized deduction (not subject to the $10,000 ($5,000 if MFS) cap on state taxes. This is an annual election that applies to all foreign income taxes paid during the year – see the Deductions lesson 19.

Where to find more information

Pub 514, Foreign Tax Credit for Individuals

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Taxpayers who must complete Form 1116 unless your site has a volunteer and a reviewer with International certification
- Taxpayers who may deduct a foreign income tax that is not allowed as a credit in certain circumstances
- Certain expenses deducted to reduce foreign gross income on Form 1116
- Taxpayers who must report a carryback or carryover of foreign tax credits on Form 1116
- Taxpayers who must file a separate Form 1116 required for foreign income from a sanctioned country, using the “Section 901(j) income” category
- The FATCA filing requirement box is checked on any 1099 form or the taxpayer is otherwise required to file Form 8938, Statement of Specified Foreign Financial Assets
- The taxpayer is required to file form FINCEN 114 or received a distribution from, or was the grantor of, or transferor to, a foreign trust.

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: a, True. Form 1116 is not required if the total foreign taxes paid are less than or equal to $300 ($600 if married filing jointly).

Answer 2: b, No. Clyde is not eligible for the election to not use Form 1116 once his creditable foreign taxes exceed $300. Clyde will need to be referred to volunteers (preparer and reviewer) with International certification or preparing his return will have to be declined. Alternatively, Clyde can elect to deduct his foreign taxes if he is itemizing his deductions.

Answer 3: a, Yes. Judy and Mark do not have to complete Form 1116 because they file jointly and their foreign taxes are less than $600.

Answer 4: c. On Anne's tax return, she can claim a foreign tax credit to offset taxes she paid to Japan on interest received from the Japanese bank.

Answer 5: b, No. An inheritance does not qualify as income from a foreign country. Under U.S. tax law, inheritances are not taxable to the beneficiaries. Jean is not eligible to claim a foreign tax credit for the inheritance taxes she pays to the Spanish government.

Answer 6: b, No. Adele cannot take a foreign tax credit for the taxes paid on income she earned in the sanctioned country. However, this income is taxable in the U.S. since she is a U.S. citizen.

Answer 7:

Q – Dividend taxes

NQ – Foreign oil–related income tax

Q – Interest income tax

NQ – Real estate taxes

Q – Income tax on wages from a foreign country, assuming the taxpayer does not take the foreign earned income exclusion

NQ – Taxes paid that are returned to the taxpayer in the form of a subsidy.

Answer 8:

Interest Income – a, passive category income

Dividend Income – b, general category income because it is high taxed income.

Answer 9: a. Since 17% (the tax rate Bernard paid) is not more than the highest U.S. income tax rate, Bernard's income falls under passive category income.

Child Tax Credit & Credit for Other Dependents

Introduction

The child tax credit is unique because if a taxpayer cannot benefit from the nonrefundable credit, the taxpayer may qualify for the refundable additional child tax credit. The credit for other dependents applies to dependents who are not eligible for the child tax credit. In this lesson, you will learn about both credits and their relationship to each other. The tax software will automatically compute these credits based on the information entered.

The Tax-Aide Intake Booklet along with the Qualifying Child or Relative Resource Tool (QC/R Tool) and NTTC 4012, Tab G, Nonrefundable Credits are critical tools needed to determine eligibility for the credit.

Don't confuse these credits with the child and dependent care credit!

What do I need?

- Tax-Aide Intake Booklet
- Qualifying Child or Relative Resource Tool
- NTTC 4012

Optional:

- Sch 8812 & Instructions (child tax credit; credit for other dependents)
- Form 1040 Instructions

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine the taxpayer's eligibility for the credit(s)
- Determine which taxpayer can claim the credits

Child tax credit and additional child tax credit

The child tax credit (CTC) is a **nonrefundable** credit that allows taxpayers to claim a tax credit of up to $2,000 per qualifying child, which reduces their tax liability.

Taxpayers who are not able to claim the full amount of the child tax credit may be able to take the **refundable** additional child tax credit (ACTC). Completing Sch 8812 may result in a refund even if the taxpayer doesn't owe any tax.

Who can claim the CTC or ACTC?

To be eligible to claim the CTC or ACTC, the taxpayer must have at least one qualifying child who is also the taxpayer's dependent.

If taxpayers claim the CTC or ACTC but are not eligible for the credit, they can be banned from claiming the credit for either two or ten years (discussed later).

Tax-Aide Counselors can use the QC/R Tool to help determine when an individual qualifies the taxpayer to claim the CTC or ACTC.

Are there special rules for children of divorced or separated parents or parents who live apart?

Refer to the Special Rule for Children of Divorced or Separated Parents or Parents Who Live Apart section in the Dependents lesson 6 to determine which parent can claim the child as a dependent.

The noncustodial parent may be entitled to claim the CTC and ACTC for the qualifying child if the custodial parent provides them with Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent, or a similar statement. All noncustodial parents must attach Form 8332 or a similar statement to their return each year the custodial parent provides the release. Review the Child Tax Credit charts in the NTTC 4012, Tab G, Nonrefundable Credits for additional information.

Taxpayers with divorce decrees or divorce agreements executed after 2008 must use Form 8332 or a similar statement whose only purpose is to release the custodial parent's claim to the child tax credit. They cannot simply substitute pages from the divorce decree.

Mary and Ralph got a divorce in 2015. They have one child together, Amy, who lives with Mary. All are U.S. citizens and have SSNs. Mary and Ralph provide more than half of Amy's support. Mary's AGI is $31,000, and Ralph's AGI is $39,000. Amy is 12. The divorce decree does not state who can claim the child.

Ralph, the noncustodial parent, can claim the child tax credit only if Mary signs Form 8332. Mary can still claim the earned income credit, head of household, and child and dependent care credit for Amy assuming she qualifies for them.

Remember, a custodial parent's release of the dependent child will also release the CTC and the ACTC, if either applies, to the noncustodial parent.

Eligibility for the CTC or ACTC

To determine whether a child meets the criteria of a qualifying child for the CTC or ACTC, use the interview techniques and tools discussed in earlier lessons. Begin by reviewing and completing the Marital Status and Household Information section of the taxpayer's Tax-Aide Intake Booklet. Verify that the child:

- Is under age 17 on December 31 of the tax year
- Lived with the taxpayer for more than six months of the year (remember the special rules for divorced or separated parents or parents who live apart)
- Did not provide over half of their own support
- Meets the relationship criteria
- Is a U.S. citizen, U.S. national, or resident of the United States
- Has a valid Social Security number

NTTC 4012, Tab G, Nonrefundable Credits, Table 1: Does Your Qualifying Child Qualify You for the Child Tax Credit or Credit for Other Dependents? provides helpful probing questions to ask the taxpayer.

Tax-Aide Counselors can use the QC/R Tool to determine whether the child and taxpayer qualify for CTC and ACTC.

Taxpayers claiming the child tax credit must have a valid identification number (SSN or ITIN) by the due date of the tax return, including extensions. In addition, the dependent claimed must have a valid SSN by the due date of the return, including extensions. Taxpayers cannot subsequently file amended returns to claim the credit for a year that they did not originally have a valid identification number by the return due date.

Ed's son, Jeff, turned 17 on December 30, and has a valid Social Security number (SSN). He is a citizen of the United States. According to the child tax credit rules, he is not a qualifying child for the child tax credit because he was not under the age of 17 at the end of the tax year.

Exercises

Answers are at the end of the lesson.

Question 1: Jose and Yolanda Alameda are married filing jointly and have five dependent children under the age of 17. Jose and Yolanda both have valid SSNs. Their children have Individual Taxpayer Identification Numbers (ITINs). Are their children qualifying children for the purpose of the child tax credit?

a. Yes

b. No

What is the amount of the credit?

The maximum amount taxpayers can claim for the child tax credit is $2,000 for each qualifying child. The amount claimed on Form 1040 depends on the taxpayer's filing status, modified adjusted gross income (MAGI) and tax liability. The amount of the credit may be reduced if the taxpayer's:

- MAGI is above the limit for the taxpayer's filing status as noted in the Important Changes lesson or
- Tax liability reduced by the majority of the nonrefundable credits is less than the maximum child tax credit

The credit is figured on Sch 8812. The tax software makes all these calculations based on your entries.

Stan files as head of household and has three children who qualify for purposes of the child tax credit. Stan's MAGI is $54,000 and his tax liability is $4,680. Stan is eligible to take a child tax credit of up to $4,680 to offset his tax liability. Stan cannot claim the full $6,000 child tax credit because it is limited to his tax liability of $4,680. Stan may also be eligible for the additional child tax credit.

May and Bob file as married filing jointly and have two children who qualify for the child tax credit. Their MAGI is $56,000 and their tax liability is $954. They can only claim $954, reducing their tax to zero. As they could not claim the maximum child tax credit, May and Bob may also be eligible for the additional child tax credit.

What is MAGI?

Typically, the taxpayers' MAGI is the same as their AGI from Form 1040 increased for excluded amounts of foreign, Puerto Rico or American Samoa income. If MAGI is more than $400,000 for married filing jointly taxpayers or $200,000 for all other filing statuses, no CTC or ACTC is allowed.

If the taxpayers' tax liability is zero, they cannot take the CTC because there is no tax to reduce. However, the taxpayers may be able to take the ACTC, as discussed below.

Exercises

Use your QC/R Tool or Table 1: Child Tax Credit from the NTTC 4012, Tab G, Nonrefundable Credits to complete the exercises.

Question 2: Laura's adopted son Jack is 12. He is a citizen of the United States and lived with Laura for the entire tax year, during which time Laura provided full financial support. Is Jack a qualifying child for the child tax credit?

a. Yes
b. No

Question 3: Which one of the following individuals (all of whom have two qualifying children for the purposes of the child tax credit) are eligible to claim the maximum $2,000 per child for the CTC on their tax return?

a. Fiona, who is married filing separately with a MAGI of $202,000
b. Ken, a qualified surviving spouse with a MAGI of $30,000 and tax liability of $490
c. Nick, who is single with a MAGI of $70,000 and a tax liability of $5,000
d. Julie, who is married filing jointly with a MAGI of $422,000

What is the ACTC?

The ACTC is for certain individuals who get less than the full amount of the CTC. The ACTC may give taxpayers a refund even if they do not owe any tax. The criteria for a child to be a qualifying child for the ACTC are the same as the criteria for the CTC listed above.

What is the amount of the credit?

The ACTC allows eligible taxpayers to claim up to a set amount for each qualifying child. See the Important Changes lesson for the maximum amount for this year. For taxpayers with earned income over $2,500, the credit is based on the lesser of:

- 15% of the taxpayer's taxable earned income that is over $2,500 or
- The amount of unused CTC (caused when tax liability is less than allowed credit)

Earned income for the ACTC is the same as for the earned income credit.

The refund for taxpayers claiming the ACTC will not be issued prior to February 15.

Remember May and Bob who have two qualifying children, a MAGI of $56,000, and a tax liability of $954? Because their tax liability is less than the full amount of the CTC (in their case $4,000), they may be able to take the ACTC.

What about household employee income?

Domestic employees such as housekeepers are only issued Form W-2 if their earnings are more than a certain amount. Refer to the Important Changes lesson for this year's amounts. Even if no W-2 is received, the income should be added to wages on Form 1040. The software will include this income to calculate the ACTC.

What about Medicaid waiver payments?

Certain Medicaid waiver payments (MWP) may be excluded from income under Notice 2014-7. Refer to the Wages, Interest, Etc. lesson 8 for details. Even though excluded, these payments may be included in earned income if there is benefit from the inclusion. If both spouses earn Medicaid waiver payment income, each can make the election to include their MWP income as earned income for ACTC and EIC purposes.

What about strike or lockout benefits payments?

Strike or lockout benefits payments (other than bona fide gifts) are earned income for EIC and ACTC purposes. Payers may report these amounts on a Form 1099. This was discussed in the Income – Other lesson 15.

What about election worker income?

Payers generally report election worker income on Form W-2 when Social Security or Medicare taxes are required to be withheld. Election worker income is earned income for ACTC and EIC purposes regardless of how it is reported. This was discussed in the Income – Other lesson 15.

What about combat pay?

Combat pay can be included in earned income for purposes of the ACTC if the taxpayer so elects. This election can be made even if combat pay was not included for purposes of the EIC.

Penal income (earned during incarceration or work-release) is not earned income for the ACTC or EIC.

How do I calculate the additional child tax credit?

Sch 8812 is used to calculate the credit, which is entered on the ACTC line of Form 1040.

There is another method to compute the additional child tax credit for taxpayers with three or more qualifying children. These taxpayers may benefit if they:

- Had Social Security or Medicare taxes withheld from their pay
- Were self-employed and paid self-employment tax
- Paid tax on tips not reported to their employer
- Did not receive the maximum available child tax credit

The tax software will automatically calculate the credit and place that entry on the appropriate line of the refundable credits.

Taxpayers electing to exclude foreign earned income from tax can only claim CTC; the ACTC is not refundable for them.

If you have a question about the amount that appears as the CTC, the taxpayer's completed Child Tax Credit Worksheet may help you understand the determination.

What is the credit for other dependents?

There is a $500 nonrefundable credit for dependents who do not qualify for the $2,000 child tax credit. The dependent must be a U.S citizen, U.S. national, or resident of the U.S. The dependent must have a valid identification number (SSN, ITIN, or ATIN).

Taxpayers cannot claim the credit for themselves (or a spouse if married filing jointly). Taxpayers that exceed the MAGI limits for the credit for other dependents will not get the full amount of the credit. These are the same MAGI limits as for the CTC and ACTC noted above.

Individuals who qualify as dependents because they are residents of Canada or Mexico do not qualify for either the CTC/ACTC or the credit for other dependents.

Robert and Susan file a joint return and they both have SSNs. Their tax liability is $2,000. They have three qualifying dependents. Tom is their 18-year-old son, has an SSN, and meets the qualifying child dependent test. Jill is their 16-year-old adopted child, has an ATIN, and meets the qualifying child dependent test. Robert's mother, Esther, is 65 years old, has an ITIN, and meets the qualifying relative test. They are all U.S. residents. Tom, Jill, and Esther are all qualifying dependents for the credit for other dependents.

How do I avoid common errors?

When considering the CTC/ACTC or credit for other dependents, it is critical to interview the taxpayer thoroughly and complete the dependent section of the Tax-Aide Intake Booklet to correctly identify eligible children or other dependents.

Credits were disallowed in a prior year

The Tax-Aide Intake Booklet asks if the taxpayer was previously disallowed a EIC, child tax credit, or American opportunity credit in a prior year. The taxpayer would have received a letter from the IRS specifying whether the disallowance is for 2 years or for 10 years and saying when they would have to complete and attach Form 8862 to claim the credit again.

If the taxpayer is denied CTC, ACTC or the credit for other dependents for the current tax year because of IRS disallowance, the taxpayer cannot claim until the ban has lapsed and Form 8862 has been filed.

Summary

The CTC is a nonrefundable credit that allows qualifying taxpayers to reduce their tax liability by the lesser of the amount of the credit or their adjusted tax liability.

If a taxpayer is not able to benefit from the maximum $2,000 CTC per qualifying child, the taxpayer may be eligible for the ACTC, which is a refundable tax credit up to a set amount.

When dependents are not eligible for the CTC/ACTC, they may be eligible for the nonrefundable $500 credit for other dependents.

Taxpayers claiming the CTC/ACTC or the credit for other dependents must have a valid identification number (SSN or ITIN) by the due date of the return, including extensions. For the CTC and the ACTC, the qualifying child must have a valid SSN by the due date of the return including extensions.

To claim the credit for other dependents, the dependent must have a valid identification number (SSN, ITIN, or ATIN) by the due date of the return including extensions.

For all three credits, the dependent must be a U.S. citizen, U.S. resident or U.S. national.

If taxpayers claim the CTC, ACTC, or credit for other dependents but are not eligible for the credit, they can be banned from claiming the credit for either two or ten years.

Where to find more information

Pub 17, Your Federal Income Tax

To gain a better understanding of the tax law, complete the practice return(s), or supplements for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: b, No. The children do not qualify for the child tax credit because they do not have valid SSNs.

Answer 2: a, Yes. Jack is a qualifying child for the child tax credit because he was under the age of 17 at the end of the current tax year; he meets the relationship requirement, lived with Laura for at least six months of the year, and he did not provide more than half of his support.

Answer 3: c. Nick may be able to take the full $2,000 credit for each of his qualifying children because his MAGI is not affected by the threshold limit for his single filing status. In addition, his tax liability of $5,000 is more than the amount of $2,000 per child for the credit.

Miscellaneous Credits

Introduction

In addition to the credits covered in earlier lessons, three other in-scope nonrefundable credits are covered in this lesson. Refer to Sch 3, Part I, for a list of nonrefundable credits other than the CTC/ACTC and credit for other dependents, which are reported on page 2 of Form 1040. Nonrefundable credits not covered in this or prior lessons are out of scope.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 8880 (savings credit)
- Form 5695 & Instructions (residential energy credits)
- Sch R (elderly or disable credit)
- Form W-2 (codes on back of form)

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine if a taxpayer qualifies for the retirement savings contributions credit
- Recognize if a taxpayer qualifies for the energy efficient home improvement credit
- Calculate the credit for the elderly or the disabled

Use the information from the Tax-Aide Intake Booklet, along with the documents provided by the taxpayer to determine eligibility for these credits.

What is a nonrefundable credit?

In an earlier lesson, you learned the difference between a nonrefundable credit and a refundable credit. A nonrefundable credit can only reduce the tax liability to zero. All the credits discussed in this lesson are nonrefundable credits.

Generally, nonrefundable credits are applied against federal tax in the order they are listed on Form 1040, Sch 3, Nonrefundable Credits.

Retirement savings contributions credit

The retirement savings contributions credit is a nonrefundable credit eligible taxpayers may claim if they made a qualifying contribution to a retirement plan. If the contribution is tax deductible (such as a traditional IRA), the taxpayer receives the benefit of the tax deduction and a tax credit. This is considered a double benefit and is rarely allowed. Contributions to nondeductible accounts (such as Roth IRAs) can qualify the taxpayer for the credit as well. The credit is calculated on Form 8880, Credit for Qualified Retirement Savings Contributions.

Who is eligible for the retirement savings contributions credit?

The retirement savings contribution credit is available to a taxpayer who:

- Made a voluntary contribution to a retirement account, after reductions as required and discussed below
- Is at least 18 years of age
- Is not a dependent
- Is not a full-time student
- Has AGI below the maximum – see the Important Changes lesson for this year's amounts

What are eligible contributions for the purpose of the retirement savings contributions credit?

To be eligible for the credit, taxpayers' contributions must be elective or voluntary. For purposes of this credit, an employee contribution will be voluntary as long as it is not required as a condition of employment, participation in the employer's retirement plan, or in order to get benefits under the plan. Eligible contributions include:

- Traditional IRA contributions whether deductible or nondeductible

- Roth IRA contributions
- Elective deferrals to a 401(k) or 403(b) plan (including designated Roth contributions), a governmental 457 plan, SEP, or SIMPLE plan
- Voluntary employee contributions to a qualified retirement plan as defined in section 4974(c) (generally all other types of retirement plans, including the federal Thrift Savings Plan)
- Contributions to a 501(c)(18)(D) plan
- Contributions by a designated beneficiary of an Achieving a Better Life Experience (ABLE) to their ABLE account (tax years 2018-2025)

Transfers, rollovers, or conversions are not contributions for purposes of the credit.

Marge's employer has a defined benefit plan to which she is required to contribute in order to participate in the plan. Her contributions are not voluntary and not eligible for the retirement savings credit.

Contributions designated under Internal Revenue Code Section 414(h)(2) (government pick-up plans) are treated as employer contributions and do not qualify for the credit.

How do I know if the taxpayer made an eligible contribution?

In most cases, eligible contributions will be listed on the taxpayer's Form W-2, Box 12 and includes one of the following codes: D, E, F, G, H, S, AA, BB, or EE. These are the codes most frequently seen. For a complete list of Box 12 codes, refer to the Form W-2 Instructions.

When reviewing the Tax-Aide Intake Booklet, be sure to ask if the taxpayer made a contribution to an IRA or other retirement account or if they intend to make an IRA contribution before the April due date of the return.

Contributions to Roth IRAs are limited based on the filing status and modified AGI of the taxpayer and spouse if filing jointly. Only allowable contributions are eligible for the credit. Refer to the income limitations in the Important Changes lesson.

What may reduce an eligible contribution for purposes of the credit?

Eligible contributions are reduced by the gross amount of the following distributions received during the testing period:

- Traditional or Roth IRAs
- ABLE accounts
- 401(k), 403(b), governmental 457, 501(c)(18)(D), SEP, or SIMPLE plans
- Qualified retirement plans as defined in section 4974(c) (including the federal Thrift Savings Plan) if the taxpayer could make voluntary contributions to the plan

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

Ask the taxpayer if they received any distributions in the testing period. Do not reduce eligible contributions by distributions received:

- From military retirement plans
- From any other plan if the taxpayer could not make voluntary contributions to the plan
- That were transferred, rolled over or converted to another qualified plan, whether taxable or not taxable
- That is a plan loan

- By a spouse who filed a separate return during the testing period and in the current year the taxpayer is filing jointly with their spouse and made an eligible contribution to a retirement plan
- From an inherited IRA by a non-spousal beneficiary

Refer to the NTTC 4012, Tab G, Nonrefundable Credits, for additional exceptions that do not need to be included in total distributions.

The software automatically reduces contributions by any distributions from current tax year Forms 1099-R. The total amount of other distributions that reduce the amount of contributions must be manually input on the appropriate line of the Retirement Savings Contributions Credits screen, such as distributions during the look-back or look-forward period that must reduce eligible contributions. Check the box on the Form 1099-R input screen if the distribution should not carry to Form 8880.

How is the amount of the credit determined?

Form 8880 is used to figure the credit. The credit can be as low as 10% or as high as 50% of a maximum annual contribution of $2,000 per person depending on filing status and adjusted gross income.

What is the maximum contribution amount for married taxpayers for the credit?

For married taxpayers filing a joint return, both spouses may be eligible for a credit based on a maximum annual contribution of $2,000 each. If either spouse has received a distribution during the testing period, both spouses must reduce their eligible contribution by that amount assuming they filed jointly throughout the testing period. See above for distributions during a year that the couple filed separately.

Jose and Lucy are married and will file a joint return. Their adjusted gross income was below the retirement savings contributions limit. They each contributed $3,000 to a 401(k) plan. They did not receive any distributions during the three-year-plus period. Jose and Lucy are eligible for a credit based on the maximum eligible annual contribution amount of $2,000 each.

Joe and Mary have been married for five years and always file a joint return. In the previous tax year, Mary changed jobs and cashed in a small 401(k) from her former employer. In the current tax year, both Joe and Mary made eligible contributions to their IRAs and otherwise qualify for the retirement savings credit. They both must reduce the amount of their eligible contributions by the amount of the distribution that Mary received last year. This calculation is completed on Form 8880.

Exercises

Answers are at the end of the lesson.

Question 1: All of these taxpayers contributed to their employers' 401(k) plan. Who qualifies for the retirement savings credit based on adjusted gross income? (Use the credit table found in the NTTC 4012, Tab G, Retirement Savings Contributions Credit)

a. Ed, who is single and has an AGI of $49,000
b. Sybil, who is married, files jointly, and has an AGI of $52,500
c. Megan, who is head of household and has an AGI of $65,400
d. Carl, who is a qualifying surviving spouse, and has a modified AGI of $59,250

Taxpayer interview and tax law application

Our Tax-Aide volunteer is working with Ryan and has already determined that Ryan's filing status is single, no one can claim him as a dependent, his AGI is $25,000, and he is 28 years old. Using the NTTC 4012, Retirement Savings Contributions Credit – Screening Sheet, follow along with our volunteer as she determines Ryan's eligibility for the credit.

Sample Interview

Volunteer Says…	Ryan Responds…
Ryan, I see from your Form W-2 that you contributed $1,500 to your employer's 401(k) plan. Did you make contributions to any other qualified plans, such as an IRA?	No, I put all my savings into the 401(k) because my employer matches it.
That's a great benefit. Were you a full-time student during the tax year?	No, I've been out of school for several years.
Well, it looks like you qualify for the credit. I will complete Form 8880 to see how much the credit will be.	Great!
Did you receive any distributions from your retirement plan at any time this tax year or the last two years, or do you plan to take any distributions before the tax filing deadline?	Well, last year I took out a loan against my 401(k) to use as a down payment on a car. I've already paid it back through payroll deductions. Does that count?
No, your loan isn't considered a distribution, so you'll get to use the full $1,500 contribution in the calculation of your credit. The credit will be a percentage of your contribution. It will reduce your amount of total tax, so you'll end up with a bigger refund.	I'll take every penny!

What are residential energy credits?

Taxpayers who purchase qualified energy efficient improvements for their main home may be allowed nonrefundable tax credits. There are two types of residential energy credits:

- Residential clean energy credit (previously named the residential energy efficient property credit) on Form 5695, Residential Energy Credits, Part I, which is out of scope
- Energy efficient home improvement credit (previously named the nonbusiness energy property credit) on Form 5695, Part II

What is the residential clean energy credit?

The residential clean energy credit is claimed on Form 5695, Part I, and is out of scope. For awareness only, taxpayers may be eligible to claim an energy credit for:

- Solar, wind and geothermal power generation equipment
- Solar water heaters
- Fuel cells
- Battery storage

If the taxpayer has purchased qualifying energy property, check with your Coordinator whether you should decline the taxpayer's return.

What is the energy efficient home improvement credit?

A taxpayer can claim the nonrefundable energy efficient home improvement credit only for qualifying expenditures incurred for an existing home or for an addition to or renovation of an existing home, and not for a newly constructed home. This credit can be up to $3,200 annually comprised of separate $1,200 and $2,000 limits as follow.

A $1,200 aggregate yearly credit limit applies across any combination of new building envelope components, home energy audits, and new residential energy property:

- Building envelope components installed on or in the taxpayer's main home that they owned located in the United States satisfying the energy efficiency requirements (see below), and having an expected lifespan of at least 5 years. Installation labor costs don't qualify for this part of the credit

- Exterior doors (the tentative credit is 30% of costs up to a maximum credit $250 per door, up to a total of $500)
- Exterior windows and skylights (the tentative credit is 30% of costs up to a maximum credit $600)
- Insulation materials or systems and air sealing materials or systems (the tentative credit is 30% of costs)

- Home energy audits, which must include an inspection of the taxpayer's main home located in the U.S. (includes renters) and written report by a Qualified Home Energy Auditor (30% of costs up to a maximum credit of $150).
- Residential energy property installed in a home located in the U.S. and used as a residence by the taxpayer, including renters and second homes (30% of costs, including labor, up to a maximum credit of $600 for each of these four line items) satisfying the energy efficiency requirements (see below):
  - Central air conditioners
  - Natural gas, propane, or oil water heaters
  - Natural gas, propane, or oil furnaces and hot water boilers
  - Improvements to or replacements of panelboards, sub-panelboards, branch circuits, or feeders that are installed along with building envelope components or other qualified energy property listed in this lesson and enable its installation and use

A separate $2,000 aggregate yearly credit limit applies across the items below (30% of costs, including labor). Property must be new and installed in a home located in the U.S. and used as a residence by the taxpayer, including renters and second homes:

- Electric or natural gas heat pump water heaters
- Electric or natural gas heat pumps
- Biomass stoves and biomass boilers

Labor costs for on-site preparation and installation depend on the type of qualified property. Review the Form 5695 Instructions or the FAQs on IRS.gov for more information.

In the current tax year, Jason purchased and installed two exterior doors for $1,000 each, windows and skylights at a total cost of $2,200, and one central air conditioner at a cost of $5,000. All property installed meets the applicable energy efficiency and other requirements for qualifying for the credit.

First, 30% of each door's cost is $300, but the per-door limit of $250 applies. Thus, Jason's expenditures for exterior doors tentatively qualify him to claim up to a $500 credit.

Next, 30% of the $2,200 of expenditures for windows and skylights is $660, but the $600 limit for all windows and skylights applies. Thus, Jason's expenditures for windows and skylights tentatively qualify him to claim up to $600.

Finally, 30% of the $5,000 cost paid for the central air conditioner is $1,500, but the $600 per item limit for energy property applies to limit Jason's credit for such expenditures to $600.

Adding these credit amounts yields a sum of $1,700 ($500 + $600 + $600), but the aggregate limit of $1,200 applies to limit Jason's total energy efficient home improvement credit to $1,200.

The credit is calculated based on the actual cost of the improvement to the taxpayer, so the cost must be reduced by the amount of any rebates from the vendor or the manufacturer. However, a "rebate" from a government entity or a public utility may not actually be a rebate, but may instead be income, resulting in the taxpayer receiving a 1099-MISC. See the Form 5695 instructions or the FAQs on IRS.gov to determine the tax effect. Also, check whether the government subsidy is exempt from state and local taxes.

The adjusted basis of the home is reduced by the residential credit received.

Who can claim the credit

All filing statuses are eligible for the credit, including married filing separately and each can get the maximum amount if all the criteria are met. Additionally, married taxpayers who file jointly with their spouse but are living apart, can each get the maximum on their respective home.

A member of a condominium management association for a condominium you own or a tenant-stockholder in a cooperative housing corporation is treated as having paid their proportionate share of any costs of such association or corporation. Co-owners of a home can each qualify for the credit based on the amount each paid. Similarly, the taxpayer and a neighbor shared the cost of qualifying property to benefit each of your main homes, they can each take the energy efficient home improvement credit based on the part of the cost each paid. The limit on the amount of the credit applies to each separately.

A taxpayer may not claim the credits until the year the property is installed.

What energy efficiency requirements must be met to qualify for the energy efficient home improvement credit?

Certain energy efficiency standards must be met to qualify for the credit. Standards vary based on the type of improvement made. Refer the taxpayer to the FAQs on IRS.gov or the Instructions for Form 5695 for details.

Taxpayers should retain appropriate documentation of improvements claimed for the energy efficient home improvement credit. If the taxpayer is unsure if their improvement qualifies, they should review their documentation in light of the IRS instructions. If a taxpayer who is still not sure the improvement qualifies and who wishes to claim the credit, check with your Coordinator. Most likely, the tax return in such a situation needs to be declined.

Credit for the elderly or the disabled

In addition to being a qualified individual, the taxpayer's total income must be within certain limits. The income limits can be found in the NTTC 4012, Tab G, Nonrefundable Credits. Few taxpayers qualify for this credit because the credit calculation includes the taxpayers' nontaxable Social Security, veterans' benefits, or other excludible pension, annuity, or disability benefits. Most taxpayers' Social Security benefits alone exceed the limit. If a taxpayer qualifies, it is calculated on Sch R.

Who qualifies for the credit for the elderly or the disabled?

Taxpayers who qualify for the elderly or the disabled credit are:

- Age 65 or older or
- Under age 65, retired on permanent and total disability, receiving taxable disability income, and under the mandatory retirement age their company has set

A taxpayer with a permanent and total disability is unable to engage in "substantial, gainful activity," or in other words, paid employment. Taxpayers who can do such work are not considered disabled. Working in a sheltered workshop setting, however, is not considered substantial, gainful activity.

Mandatory retirement age is the age set by a taxpayer's employer at which the taxpayer would have been required to retire, had the taxpayer not become disabled.

Generally, disability income comes from an employer's disability insurance, health plan, or pension plan. The payments replace wages for the time the taxpayer missed work because of the disability. The plan must provide for disability retirement for the payments to be considered disability income.

John is unmarried and filing a single return. He is 67 years old and received $12,000 in nontaxable Social Security benefits in the tax year. His AGI is $9,000. Even though John is a qualified individual, he is not eligible to claim the credit since his nontaxable Social Security benefits exceed $5,000.

How do I determine the amount of the credit?

If the taxpayer is 65 or over, or under 65 and retired on permanent and total disability, complete Sch R to determine the amount of the credit, if any.

All Social Security and Tier 1 railroad retirement benefits must be entered on the Social Security benefits screen, even if none of the Social Security is taxable, so the tax software can correctly calculate this credit.

Exercises (continued)

Question 2: Taxpayers may be able to take the credit for the elderly or disabled if they are:

- Under age 65 at the end of the tax year
- Retired on permanent and total disability
- Under the mandatory retirement age on January 1, of the tax year, and
- Receiving taxable disability income

a. True

b. False

Taxpayer interview and tax law application

Albert arrives at the tax center with his tax return nearly complete, but he wants to know if he can claim the credit for the elderly or the disabled. Follow along in the conversation.

Sample interview

Volunteer Says…	Albert Responds…
Are you either a U.S. citizen or a resident alien?	Yes, I'm a U.S. citizen.
Are you over 65?	No, I'm only 54, not even old enough for retirement. But I had to stop working last year because of my disability.
Are you retired on permanent and total disability?	Yes. In fact, I started receiving disability retirement benefits last August.
I see you received $4,430 in Social Security benefits and your adjusted gross income is $15,430. Did you receive any other pension benefits that might not be taxable?	No, I just get my Social Security and disability benefits.
And your filing status is single, so it looks like you might be able to claim the credit. I'll complete Sch R in the software to see if you qualify.	

What is the mortgage interest credit?

This topic is out of scope and is included for informational purposes only. Taxpayers who hold mortgage credit certificates (MCCs) under a qualified state or local government program may claim a nonrefundable credit for mortgage interest paid. The taxpayer must have a document titled "Mortgage Credit Certificate (MCC)."

Summary

Retirement savings contributions credit

Taxpayers who voluntarily contribute to certain retirement plans or IRAs may be eligible for a nonrefundable retirement savings contributions credit.

Be sure to ask the taxpayer if IRA contributions were made or if they intend to make an IRA contribution before the April due date of the return. Carefully review the taxpayer's Form(s) W-2 for pretax retirement plan contributions and accurately input the amounts into the tax software.

The amount of the credit is determined by the taxpayer's filing status, adjusted gross income, and the taxpayer's qualified retirement contributions, reduced for certain retirement plan distributions during the test period. Form 8880 is used to calculate the credit.

Taxpayers' IRA contributions are often overlooked. Ask taxpayers if they made traditional or Roth IRA contributions that may qualify for the retirement savings contributions credit. Taxpayers have until the April due date of the return to make contributions for the tax year.

Energy efficient home improvement credit

Taxpayers may be eligible to claim a credit for certain energy efficient improvements they make to a dwelling they use as a residence. The annual credit limit that may be claimed depends on the type or types of energy efficient improvements that the taxpayer makes during the year. form 5695, part ii, is used to claim this credit.

Credit for the elderly or the Disabled

Taxpayers age 65 or older, or under age 65 who retired on permanent and total disability, may be able to claim a special nonrefundable credit if they are U.S. citizens or resident aliens. Few qualify for this credit because most taxpayers' Social Security benefits exceed the income limits.

The NTTC 4012 provides a flowchart for determining basic eligibility and a quick reference table of income and Social Security limits. Sch R, Credit for the Elderly or the Disabled, is used to calculate the credit.

Where to find more information

IRS.gov for retirement savings credit

IRS.gov for residential energy credit FAQs

IRS.gov for energy efficiency requirements

What situations are out of scope?

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Residential clean energy credit (Form 5695, Part I)
- Qualified electric vehicle credits (Form 8834)
- Mortgage interest credit
- Other credits listed on Sch 3 not included in this or a prior lesson.

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: b. Sybil qualifies for the credit because her adjusted gross income is under the threshold limit for married filing jointly.

Answer 2: a, True. A taxpayer who is under age 65 at the end of the tax year, retired on permanent and total disability, had not reached mandatory retirement age by January 1 of the tax year, and who receives taxable disability income, may be able to take the credit for elderly or disabled. All these items must first be met before a taxpayer who is under age 65 can be considered for the credit for the elderly or disabled.

Premium Tax Credit

Introduction

As part of the Affordable Care Act, individuals may qualify for assistance in paying their health insurance premiums. In this lesson you will learn how to determine if taxpayers are eligible to receive this assistance, called a premium tax credit (PTC).

The PTC is a refundable tax credit and can reduce a taxpayer's tax or produce a refund. If there is excess advance PTC, the taxpayer may be required to repay some or all of the excess.

A list of terms you may need to know is included at the end of the lesson.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1095-A (health insurance Marketplace statement)
- Form 8962 & Instructions (premium tax credit)

Objectives

At the end of this course, using your resource materials, you will be able to:

- Determine eligibility for the PTC
- Calculate the PTC
- Report taxpayers' PTC on the tax return

What is the Affordable Care Act?

Under the Affordable Care Act (ACA), the federal government, state governments, insurers, employers, and individuals share responsibility for improving the quality and availability of health insurance coverage in the United States. The ACA also creates the Health Insurance Marketplace. For more information about the Marketplace, see healthcare.gov. Some states have established their own health insurance marketplaces. We will refer to them all simply as the Marketplace.

Using income and household information supplied by the taxpayer, the Marketplace estimates the amount of the PTC that eligible taxpayers may be able to claim on their federal income tax returns. PTC is available only to those individuals who must get their own coverage. That is, they do not have access to adequate other coverage, such as Medicaid, Medicare, from an employer, etc. Based on the Marketplace's estimate, eligible taxpayers can decide if they want to have all, some, or none of their estimated credit paid in advance to their insurance company to help pay for coverage — called advance premium tax credits (APTC).

As a Tax-Aide Counselor, you will help the taxpayer finalize the amount of assistance to which the taxpayer is entitled based on their actual income and tax family situation.

Did the taxpayer receive Form 1095-A?

While conducting an interview with taxpayers using the Tax-Aide Intake Booklet, as whether taxpayers received Form 1095-A, Health Insurance Marketplace Statement. The Marketplace sends this form to individuals who enrolled themselves or family members in qualified health coverage through the Marketplace. The form includes information about the coverage and the amount APTC paid.

The deadline for the Marketplaces to provide Form 1095-A to taxpayers is January 31 of the year after the year of coverage. Taxpayers expecting to receive a Form 1095-A should wait to file their income tax return until they receive that form. Receiving a Form 1095-A with APTC creates a filing requirement regardless of the taxpayer's income level.

Who is allowed PTC?

In general, taxpayers are allowed a PTC if they meet all of the following:

- The taxpayer, spouse (if filing a joint return), or claimed dependents are enrolled in a qualified health plan offered through the Marketplace for one or more months

- The enrolled individual is not eligible for minimum essential coverage (MEC) other than coverage in the individual market, such as:
  - An employer plan that was affordable
  - A governmental plan, including Medicaid, Medicare, TRICARE, CHIP, etc.
- The taxpayer paid their share of premiums for the plan or plans in which they were enrolled by the due date of the taxpayer's return (not including extensions).
- The taxpayer cannot be claimed as a dependent by another taxpayer.
- If married, the taxpayer files a joint return with their spouse. **Exceptions**:
  - The taxpayer is considered unmarried for head of household filing status.
  - The taxpayer is a victim of domestic abuse or spousal abandonment.
- The taxpayer is an applicable taxpayer. That is, their household income is at least 100 percent of the federal poverty line for the taxpayer's family size. **Exceptions:**
  - The individual who is enrolled in a qualified health plan is not a U.S. citizen but is lawfully present in the U.S. and not eligible for Medicaid because of immigration status. For example, many lawfully present immigrants are generally required to wait five years from the date they were granted their immigration status before they can qualify for full Medicaid or CHIP.
  - The taxpayer was determined eligible for APTC by the Marketplace and received the benefit of APTC for one or more months of coverage of a family member.

You can rely on the taxpayer's eligibility for PTC when the Marketplace has granted APTC, though be careful if the taxpayer's facts have changed and the Marketplace has not been kept up to date of changes such as employer plan coverage.

Coverage other than individual market coverage

Individual market coverage generally refers to a private policy, whether purchased through the Marketplace or directly from the insurance company. Coverage other than that would be either employer sponsored or government sponsored.

Coverage offered by an employer

Generally, a person enrolled in Marketplace coverage for months they are eligible for affordable employer-sponsored coverage is not eligible for a PTC for those months, even if the person turns down the employer's coverage.

In general, for individuals requesting APTC, the Marketplace determines whether the employer coverage is affordable. You can rely on the taxpayer's eligibility for PTC if the Marketplace determined that the taxpayer was eligible for and granted APTC.

If a household member actually enrolls in an employer plan, PTC is not allowed for this individual's coverage for the months the individual is enrolled in the employer coverage. If you believe that the taxpayer may currently be enrolled in both employer coverage and a qualified health plan with APTC payments, you should advise the taxpayer to contact the Marketplace immediately.

Cedric is single and has no dependents. When enrolling through the Marketplace during open enrollment, Cedric was not eligible for employer-sponsored coverage.

In August of the tax year, Cedric began a new job and became eligible for employer-sponsored coverage that is affordable and provides minimum value on September 1st. Since Cedric became eligible for employer-sponsored coverage on September 1st and the coverage was affordable and provides minimum value, he would usually be unable to claim a PTC for September and the other months he was eligible for the employer coverage. Cedric may be able to get a PTC for September if

APTC was being paid for his Marketplace coverage, Cedric informed the Marketplace about his new coverage, and the Marketplace did not discontinue the APTC for September.

Maria is single and has no dependents. Her employer offers health insurance, but she didn't enroll because she felt it was too expensive. The Marketplace determined that the employer offer was not affordable, and Maria enrolled in Marketplace coverage and received the benefit of APTC. At the end of the year, she received both a Form 1095-A from the Marketplace and a Form 1095-C from her employer indicating that the employer coverage was affordable. Maria provided the Marketplace information about her employer offer and the Marketplace determined that the coverage was unaffordable as evidenced by the APTC it granted. Maria can claim PTC for the year but should update her information with the Marketplace.

Two employer situations are out of scope:

Qualified small employer health reimbursement arrangement (QSEHRA): Under a QSEHRA, an eligible employer can reimburse eligible employees for health care costs, including premiums for Marketplace health insurance. If taxpayers were covered under a QSEHRA, their employer should have reported the annual permitted benefit in Box 12 of Form W-2 with code FF. If the QSEHRA is affordable for a month, no PTC is allowed for the month. If the QSEHRA is unaffordable for a month, taxpayers must reduce the monthly PTC (but not below $0) by the monthly permitted benefit amount.

If there is a code FF on Form W-2 Box, 12 and the employee has a marketplace policy and is otherwise eligible for PTC, the return is out of scope.

Individual coverage health reimbursement arrangement (ICHRA)**:** Employers may offer an ICHRA to reimburse their employees or retirees for individual market coverage, including premiums for Marketplace health insurance. An ICHRA is considered affordable if the employee's monthly premium for the lowest-cost silver plan offered to the employee by the employee's Marketplace, minus the employer's ICHRA contribution, does not exceed the employee's required contribution. If the ICHRA is affordable for a month, no PTC is allowed. If the ICHRA is unaffordable for a month, the employee is eligible for PTC for a Marketplace plan only if they opted out of the employer's ICHRA.

The taxpayer should have advised the Marketplace of their ICHRA coverage. If the taxpayer is otherwise eligible for PTC, their tax return is out of scope.

Coverage through a government-sponsored program

An individual is not allowed PTC for the months the individual is eligible for government-sponsored coverage. However, an individual is treated as not eligible for Medicaid, CHIP, or a similar program if the Marketplace determines or considers the individual to be not eligible for Medicaid or CHIP.

If the Marketplace made a determination that the taxpayer or a family member was ineligible for government-sponsored coverage and granted APTC when the individual enrolled, the individual can claim PTC. This applies even if the taxpayer's actual income for the tax year suggests that the individual may have been eligible for Medicaid or CHIP.

If you believe that the taxpayer may currently be enrolled in both Medicaid and a qualified health plan with APTC payments, you should advise the taxpayer to contact the Marketplace immediately.

Taxpayers can qualify for PTC even though they are covered by limited coverage Medicaid, AmeriCorps or AfterCorps (for returning Peace Corps), or other coverage that is not MEC. Volunteers can generally rely on the Marketplace's determination when it has granted APTC.

Taxpayers have a limited time to obtain Medicare, during which time they remain eligible for PTC. A person who is eligible for Medicare loses eligibility for PTC even if they fail to enroll in Medicare. The loss of eligibility occurs the first day of the fourth full month after the person became eligible for Medicare.

Alberto enrolled in Marketplace coverage with APTC. He became eligible for Medicare on his 65th birthday on May 17. He will lose eligibility for PTC on the earlier of September 1, the first day of the fourth full month after Medicare eligibility ***or*** *the month in which his Medicare coverage actually starts.*

If APTC is being paid for coverage of an individual enrolled in a qualified health plan and the individual becomes eligible for government-sponsored coverage that is effective retroactively (such as Medicaid or CHIP), the individual will not be considered eligible for the government-sponsored coverage until the month after the date of approval. Taxpayers can get PTC for Marketplace coverage until the first day of the calendar month after they are approved for the government-sponsored coverage.

A person is considered eligible for other coverage only if the person is eligible for that coverage for every day of that month. For example, if a person does not become eligible for employer- or government-sponsored coverage until the 5th day of a month, they may be allowed a PTC for the month. The person should alert the Marketplace to the change and discontinue any APTC being paid for the Marketplace coverage.

Adele is single with no dependents. She works part-time and has no offer of employer-sponsored health coverage. She projects her income to be roughly 150 percent of FPL based on her earnings at the same job in the prior year. She enrolls in a qualified health plan in the Marketplace and is determined eligible for and given APTC.

Adele's place of employment was closed for two weeks, unexpectedly lowering the number of hours she worked. Her employer also didn't pay an end-of-year bonus that she anticipated. Adele's actual household income for the year was such that she would have been eligible for Medicaid under her state's eligibility rules. However, based on Adele's projection of income when she enrolled in Marketplace coverage, the Marketplace determined that she was not eligible for Medicaid. Therefore, Adele is treated as not eligible for Medicaid for the year and is eligible for the PTC.

How is PTC calculated?

The taxpayer is responsible for a portion of their health coverage premiums based on a sliding scale. The more household income the taxpayer has (as defined below), the greater percentage of their income that they are expected to pay. This scale is measured as a percentage of the federal poverty line (FPL) for the tax family size reported on the return.

There are three FPLs: Alaska, Hawaii, and the contiguous 48 states. If the taxpayer or spouse lived in Alaska or Hawaii during the year, be sure to indicate that so the tax software will use the higher FPL for those states.

A tax family is only the individuals claimed on the return: the taxpayer, the spouse if filing jointly, and claimed dependents.

The PTC helps to cover the cost of qualified health coverage. Optional coverages, such as vision, are not qualified health coverage and that cost is not included in the PTC calculation. The PTC will never be more than the actual cost of qualified health coverage. Form 1095-A shows the cost of qualified health coverage in Column A. You may need to add up amounts if there is more than one Form 1095-A for the individuals on the return. This can happen, for example, if the taxpayer moves or a tax family member resides in a different locale.

The PTC is also limited by the second lowest cost silver plan (SLCSP) cost (also referred as the benchmark plan). When a taxpayer selects a high-cost plan (e.g., a gold-level plan), they will be responsible for more of the premiums. If the SLCSP premium amount does not appear on Form 1095-A or the SLCSP premium amount reported on Form 1095-A is incorrect, the taxpayer must find the correct applicable SLCSP premium on either healthcare.gov or the respective state-based Marketplace's site or by calling the Marketplace customer service.

Special PTC calculations

Tax returns in two special situations are out of scope:

- A **shared policy** is when Form 1095-A includes individuals who are not on the taxpayer's return. The three attributes on the form must be allocated between your taxpayer and the other taxpayer: column A policy cost, column B SLCSP, and column C APTC. Possible shared policy situations include:
  - Taxpayers who got divorced or legally separated during the tax year
  - A taxpayer who claims as a dependent an individual enrolled in a policy with a member of another tax family
  - A taxpayer who receives a Form 1095-A that includes an individual claimed as a dependent by another tax family
  - A taxpayer who files a separate return from their spouse
- There is an **alternate calculation** for individuals who married during the year, are filing jointly, one or both individuals received APTC, and the general PTC calculation shows there is excess APTC. The alternative calculation can be used to reduce excess APTC, but not to claim additional PTC. If the taxpayers do not have excess APTC, they cannot use the alternative calculation and the return remains in scope.

Computing PTC

The final amount of PTC is computed on a monthly basis. This is particularly important when the taxpayer's circumstances change during the year. If the circumstances are the same throughout the year, the form allows a simpler annual calculation. Changes in circumstances that can affect the amount of the actual PTC include:

- Increases or decreases in household income
- Marriage or divorce
- Birth or adoption of a child
- Other changes in household composition
- Gaining or losing eligibility for government-sponsored or employer-sponsored health care coverage
- Change of address

If taxpayers are currently enrolled in Marketplace coverage and have an excess APTC repayment, they should contact the Marketplace now to adjust their APTC to avoid another repayment.

What is household income and what are its limits?

A taxpayer's household income is the total of the modified adjusted gross income (MAGI) of the taxpayer (and spouse, if married filing jointly) and the MAGI of all dependents required to file a federal income tax return because the dependent's income meets the filing threshold.

*David and Melinda are married filing jointly taxpayers. Their oldest child, Philippa, is 17 and is claimed as a dependent. Philippa works part time and has a filing requirement. Their younger child George had a small amount of income and is not required to file a return. David and Melinda's household income calculation includes their MAGI and Philippa's MAGI; it does **not** include George's income.*

The taxpayer may decide to not claim a dependent depending on the PTC consequences. This may be helpful when the dependent has MAGI that must be added to household MAGI and that has a negative impact on PTC. The taxpayer would need to also consider the impact on the now-unclaimed dependent and whether there is a shared policy that makes the return out of scope.

In a shared policy situation, the taxpayer with the lowest AGI should generally claim all the attributes on Form 1095-A. They will be allowed the greatest amount of PTC.

MAGI for the purpose of the PTC is the adjusted gross income on the federal income tax return increased by:

- any excluded foreign income
- nontaxable Social Security benefits (including tier 1 railroad retirement benefits)

- tax-exempt interest

It does not include Supplemental Security Income (SSI) or other types of exempt or excluded income. The taxpayer's MAGI does not include the MAGI of a person who is not claimed as a dependent. Similarly, the spouse's MAGI is not included when the taxpayer is filing married filing separately or qualifies to file as head of household.

The software will compute MAGI for the taxpayer. You will need to add the MAGI for a claimed dependent if the dependent has gross income above the filing threshold.

A taxpayer can lower their MAGI and improve their PTC situation even after year end by making a deductible IRA contribution or an HSA contribution, if eligible for those deductions.

Exercises

Answers are at the end of the lesson.

Question 1: Jocelyn and Larry file jointly and claim their child, Hank. Hank has a part-time job and earns $5,000. Hank will file a return to get a refund of the tax that was withheld from his paychecks.

Will Jocelyn and Larry include Hank's $5,000 as part of their household income for ACA purposes?

a. Yes
b. No

Question 2: (Continuing from Question 1) If Hank earned $20,000, would Jocelyn and Larry include Hank's income as part of their household income for ACA purposes?

a. Yes
b. No

Question 3: Leana and Jake are married, but lived apart the entire year. Their son Elton lives with Jake, who qualifies to file as head of household. Leana will use the married filing separately status. Will Jake's return include Leana's MAGI as part of his MAGI for PTC purposes?

a. Yes
b. No

Question 4: (Continuing from Question 3.) Under what circumstances could Leana claim PTC?

a. Only if she qualifies under the exception for abused or abandoned spouses.
b. Only if she works part-time.
c. Only if she lived with Jake for at least part of the year.

What else do I need to know about PTC?

Cap on excess APTC repayment

When the taxpayer received more APTC than the final PTC amount based on the taxpayer's actual household income, the excess has to be repaid. The amount of repayment may be capped based upon the actual household income as a percentage of FPL – refer to the Important Changes lesson for the caps. Remember that the FPL is based on the tax family size and includes only those individuals claimed on the return.

Brandon is single with no dependents. When he enrolled through the Marketplace, Brandon was approved for APTC based on his projected household income. Brandon's Form 1095-A shows APTC of $1,486. Based on Brandon's actual modified AGI, he is eligible for a PTC of $500. Brandon's income is household income is at 310 percent of the FPL, so he is allowed a repayment limitation. Brandon must increase his tax liability by the lesser of the excess of his APTC over his PTC, $986, or the repayment limitation.

A taxpayer who files using the married filing separately filing status is generally not allowed any PTC (see the exceptions noted above); however, the repayment cap does apply to each spouse separately based on the household income reported on each return.

The repayment cap applies when a taxpayer's household income is below 400% of the applicable FPL and the applicable repayment cap amount is less than the taxpayer's excess APTC. If MAGI is more than 400% of FPL, all excess APTC must be repaid (no cap).

An individual for whom APTC is paid does not file a return and is not claimed as a dependent by anyone

If an individual for whom APTC was paid neither files a tax return nor is claimed as a dependent on a tax return, the taxpayer who indicated to the Marketplace at enrollment that the individual would be in the taxpayer's tax family for the year the APTC was paid must report the APTC paid for that individual's coverage. Since that taxpayer is not claiming the individual, all APTC will need to be repaid subject to the cap. This is done by reporting the amount of APTC for the unclaimed individual shown on Form 1095-A, but entering zeroes for the policy cost and the SLSCP.

What about individuals not lawfully present?

PTC is not allowed for the coverage of an individual who is not lawfully present in the United States. All APTC paid for an individual not lawfully present who was enrolled in a qualified health plan must be repaid. If a member of the family is not lawfully present and is enrolled in a qualified health plan with family members who are lawfully present for one or more months of the year, use the instructions in Pub 974 to find out how much APTC, if any, must be repaid. If all family members enrolled in a qualified health plan are not lawfully present, all APTC must be repaid by reporting the amount of APTC shown on Form 1095-A, but entering zeroes for the policy cost and the SLSCP.

Effect on deductible health coverage premiums

The itemized deduction for health insurance premiums is net of PTC meaning that only the portion of the premiums that exceeds the PTC is deductible. For taxpayers who itemize their deductions, the deduction for health premiums is increased for any APTC repayment and decreased for additional PTC as shown on Form 8962.

For taxpayers who are self-employed claiming the self-employed health insurance adjustment to gross income, the calculation becomes circular and their returns are out of scope unless other premiums can be used for the SEHI. Refer to the Schedule C Guidelines paper for more information.

Exercises (continued)

Question 5: Pedro is retired and covered by Medicare. His wife Camilla is too young for Medicare. Both are U.S. citizens. Even though Pedro is on Medicare, can Camilla get a PTC if she enrolls in coverage through the Marketplace (and is otherwise eligible for a PTC)?

a. Yes
b. No

Question 6: You are completing the return for Antonio, who purchased health coverage through the Marketplace and received the benefit of APTC. In completing Form 8962, you note that Antonio's MAGI is 401 percent of the FPL and the calculation shows that he has to repay most of his APTC. Assuming that Antonio would be entitled to an IRA deduction if he made an IRA contribution, can Antonio reduce his MAGI for the PTC calculation even though the tax year has ended?

a. Yes
b. No

Question 7: Piper's income is 300 percent of the FPL for her family size. She purchased health insurance through her employer. Is Piper eligible to take the PTC for her coverage?

a. Yes
b. No

Question 8: Harry purchased insurance through the Marketplace. What form will he receive from the Marketplace to prepare his tax return?

a. Form 8962
b. Form 1095-A
c. Form W-2

Question 9: Judy is single with no dependents. In December, Judy enrolled through the Marketplace in a qualified health plan for the following year. On July 14, Judy enlisted in the Army and was immediately eligible for government sponsored minimum essential coverage. For what period is Judy able to claim a PTC (if she meets all of the eligibility criteria)?

a. The entire tax year
b. January through June
c. January through July
d. Judy is not eligible for the PTC

This lesson does not cover all the situations you may encounter. Consult the PTC section of NTTC 4012, Tab H, Other Taxes, Payments, and Refundable Credits, instructions for Form 8962, and Pub 974.

Summary

The Affordable Care Act addresses health insurance coverage and financial assistance options for individuals and families, including the premium tax credit.

Only taxpayers who purchase qualified health care coverage through the Marketplace for themselves, their spouse with whom they are filing jointly, or their dependents are allowed a PTC. Eligible taxpayers may choose to get the benefit of advance credit payments, the amount of which is based on their estimated PTC, to reduce their share of the cost of monthly premiums. Taxpayers who chose to forgo advance credit payments get all of the benefit of the PTC when they claim it on the tax return. Taxpayers will receive Form 1095-A from the Marketplace, which will contain the information necessary to complete Form 8962.

Where to find more information

Pub 974, Premium Tax Credit (PTC)

Healthcare.gov

NTTC's Schedule C Guidelines

IRS FAQs on PTC basics

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Self-employed health coverage deductions for taxpayers who are also allowed a PTC (unless other premiums can be used for the SEHI)
- Shared policies (Form 8962 Part IV)
- Alternative calculation for year of marriage (Form 8962 Part V)
- There is a code FF on Form W-2, Box 12 and the employee has a Marketplace policy and is otherwise eligible for PTC

- The individual has an Individual Coverage Health Reimbursement Arrangement (ICHRA) with Marketplace coverage and is otherwise eligible for PTC

Exercise answers

Answer 1: b, No. Hank's income is below the filing threshold for a dependent with earned income so his parents will not include his MAGI in the Household Income for ACA purposes.

Answer 2: a, Yes. Hank's income is above the filing threshold for a dependent with earned income, so his parents will include his MAGI in the Household Income for ACA purposes.

Answer 3: b, No. Leana has her own household.

Answer 4: a. As married filing separately, she could only claim PTC if she qualifies under the exception for abused or abandoned spouses.

Answer 5: a, Yes. Camilla is eligible for a PTC if she enrolls in coverage through the Marketplace (and is otherwise eligible).

Answer 6: a, Yes. Antonio can make a deductible IRA contribution up until the April due date of the return.

Answer 7: b, No. the coverage must have been purchased through the Marketplace.

Answer 8: b. Form 1095-A.

Answer 9: c. Judy is eligible for the PTC from January through July.

Terms You May Need to Know

Applicable taxpayer (for purpose of premium tax credit) – A taxpayer must be an applicable taxpayer to claim the premium tax credit (PTC). Generally, an applicable taxpayer is one who has household income of at least 100% of the federal poverty line (FPL) for their family size, although there are exceptions when the Marketplace has granted APTC and for certain aliens lawfully present in the United States

An individual who can be claimed as a dependent by another taxpayer and a taxpayer who is married at the end of the year but doesn't file a joint return cannot claim a PTC, although there are exceptions for head of household filers and victims of spousal abuse or abandonment.

Coverage family – All members of the taxpayer's family who are enrolled in a qualified health plan and are not eligible for minimum essential coverage other than coverage in the individual market. The members of the coverage family may change from month to month. A taxpayer is allowed a PTC only for qualified health insurance purchased through the Marketplace for members of the coverage family.

Domestic abuse – Domestic abuse includes physical, psychological, sexual, or emotional abuse, including efforts to control, isolate, humiliate, and intimidate, or to undermine the victim's ability to reason independently. All the facts and circumstances are considered in determining whether an individual is abused, including the effects of alcohol or drug abuse by the victim's spouse. Abuse of the victim's child or any family member living in the household may constitute abuse of the victim. If the taxpayer is a victim of domestic abuse or abandonment and does not qualify to use head of household filing status, the taxpayer may be able to claim a premium tax credit if they file a return as married filing separately and meets the exceptions as listed in Exception 2 of the married taxpayer definition later in this section. See Pub 974 for a list of documentation that the taxpayer should retain.

Form 1095-A – Used to report certain information to the IRS about family members who enroll in a qualified health plan through the Marketplace. Form 1095-A is furnished to individuals to allow them to claim the premium tax credit, to reconcile the credit on their returns with advance payments of the premium tax credit (APTC), and to file an accurate tax return.

Form 1095-B – Used to report certain information to the IRS and to taxpayers about individuals who have minimum essential coverage.

Form 1095-C – Employers with 50 or more full-time employees, including full-time equivalent employees, use this form to report information about offers of health coverage and enrollment in health coverage for their employees.

Qualified health plan – A health plan certified by the Department of Health and Human Services to be offered through the Marketplace. Plans in the Marketplace are offered in different categories: Bronze, Silver, Gold, and Platinum ("catastrophic" plans are also available to some people, but do not qualify for PTC and no Form 1095-A will be issued). See **www.healthcare.gov** for additional information about plan levels.

Spousal abandonment – A taxpayer is a victim of spousal abandonment for a taxable year if, taking into account all facts and circumstances, the taxpayer is unable to locate their spouse after reasonable diligence. If taxpayer is a victim of domestic abuse or abandonment and does not qualify to use head of household filing status, the taxpayer may claim a premium tax credit if they file a return as married filing separately and meets the exceptions as listed in Exception 2 of the **Married taxpayer** definition above. See Pub 974 for documentation that the taxpayer should retain.

Tax family – For the purposes of Form 8962, a taxpayer's tax family consists of:

- The taxpayer (unless the taxpayer qualifies as a dependent of another taxpayer)
- The taxpayer's spouse if a joint return is filed (unless the spouse qualifies as a dependent of another taxpayer)
- The dependents of the taxpayer claimed on the return

The tax family does **not** include an individual a taxpayer can claim as a dependent but does not actually claim as a dependent on their taxpayer's tax return.

You should never change the tax family size in the software.

Other Taxes

Introduction

This lesson covers the Other Taxes reported on the return. You will determine if taxpayers owe additional taxes, which can decrease a refund or increase a balance due.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1040, Sch SE & Instructions
- Form 4137 (taxes on tips)
- Form 5329 & Instructions (qualified plan additional taxes)
- Form 5405 & Instructions (first time homebuyer credit)

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify the different types of other taxes on a return
- Determine if a taxpayer is liable for other taxes that are within our scope
- Determine how to report these additional taxes on the tax return and complete the applicable forms or schedules

What are other taxes?

"Other taxes" are different from the income tax from the tax tables or figured using one of the tax computation worksheets. They include, but are not limited to:

- Self-employment tax
- Social Security and Medicare taxes on tip income
- Additional taxes on IRAs and other qualified retirement plans
- Additional tax on taxable HSA distributions
- Repayment of the first-time homebuyer credit

These amounts are usually calculated on their own form or schedule and entered on Form 1040, Sch 2. The taxes are added after the nonrefundable credits are calculated; the nonrefundable credits do not reduce the other taxes.

Household employment taxes are also included in Other Taxes. However, this topic is beyond our scope.

Two additional taxes may apply to taxpayers with higher income. These are the additional Medicare tax on wages (Form 8959, Additional Medicare Tax) and the net investment income tax (Form 8960, Net Investment Income Tax Individuals, Estates, and Trusts). Both forms are out of scope.

Refer to the Premium Tax Credit lesson 26 contained in this publication for information on the repayment of the advanced premium tax credit that is added to the tax liability before nonrefundable credits.

What is self-employment tax?

Self-employment (S-E) tax is Social Security and Medicare taxes collected primarily from individuals who work for themselves. It is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners except a self-employed individual pays both the employee part and what would be the employer part. Payments of S-E tax contribute to the taxpayer's coverage under the Social Security system. Social Security coverage provides the taxpayer with retirement, disability, and survivor benefits.

Who must pay self-employment tax?

S-E tax must be paid if either of the following applies:

- The taxpayer had income as a church employee of $108.28 or more – in scope if the taxpayer is not a clergy.

- The taxpayer receives net earnings from self-employment income in the amount of $400 or more (excluding church employee income).

Generally, taxpayers who are independent contractors or sole proprietors must file Sch C and Sch SE. Since taxes are not withheld from independent contractors' pay, it is the taxpayer's responsibility to pay income and S-E taxes. Taxpayers should make quarterly estimated tax payments during the year to pay these taxes to avoid a possible penalty.

The Social Security Administration uses the information from Sch SE to figure a person's benefits under the Social Security program. Not reporting all of a taxpayer's self-employment income could cause their Social Security benefits to be lower when they retire.

This tax applies no matter how old the taxpayer is and even if they are already getting Social Security or Medicare benefits.

Self-employed taxpayers who receive tips should include the tips in gross receipts on Sch C.

How do I complete Sch SE?

Net profit from a business was covered in the earlier Income – Business lesson 9. When assisting a taxpayer with self-employment income, first complete Sch C. The software completes Sch SE and the deductible part of the S-E tax is reflected as an adjustment to income on Form 1040, Sch 1. The adjustment to income is similar to the benefit that employers receive when they deduct their share of the Social Security and Medicare taxes as payroll taxes.

Self-employment tax is Social Security and Medicare taxes collected primarily from individuals who work for themselves, similar to the Social Security and Medicare taxes withheld from the pay of most wage earners.

The self-employment tax rate on net earnings is 15.3% (12.4% Social Security tax plus 2.9% Medicare tax).

Who does not pay self-employment tax?

Some professions do not have a requirement to pay the self-employment tax:

- Notaries public are not subject to the self-employment tax by law. Be sure to identify notaries on the input forms.
- Statutory employees have Social Security and Medicare tax withheld and do not have to pay the self-employment tax even though they report their income and expenses on Sch C.

What about taxes on unreported tip income?

All tip income is subject to federal income tax. However, tips of less than $20 per month that are not reported to the employer are not subject to Social Security and Medicare taxes.

Individuals who receive $20 or more per month in tips from any one job must report their tip income to their employer. The employer reports these tips as part of the wages on Form W-2, Box 1. The employer withholds Social Security and Medicare taxes and federal income tax on that income.

What about allocated tips?

An employer may "allocate" tips to an employee if the employee worked in a restaurant, cocktail lounge, or similar business and reported tips that were less than the employee's share of 8% of food and drink sales. If the employer allocates tips to employees, the amount is reported on Form W-2, Box 8, and included in income on Form 1040. Social Security and Medicare taxes are not withheld on allocated tips. The employee pays the Social Security and Medicare taxes by completing Form 4137, Social Security and Medicare Tax on Unreported Tip Income.

If the employee can show, using a daily tip record, that the actual tips received are different from the allocated amount, then the actual amount is reported on Form 1040. The actual tips received are also reported on Form 4137 to calculate Social Security and Medicare taxes.

What about tips that the employee did not report to the employer?

If the employee received $20 or more in unreported cash and charge tips in any month from any job, the employee must report that income on Form 1040 and pay the Social Security and Medicare taxes on that income. But, if the employee received less than $20 in tips in any month from any job, they are not required to report them to the employer. However, these amounts do need to be included on Form 1040. They will not be subject to Social Security or Medicare taxes and you will need to indicate that on Form 4137.

See NTTC 4012, Tab D, Income, for instructions on reporting tip income. The software calculates Social Security and Medicare taxes on the tips based on your entries on the W-2 input and Form 4137 input. The software will also add unreported tips to Form 1040 as wages.

Carla waits tables at a café. Her employer reports all tips that customers add to their credit card tabs, but she leaves it up to Carla to keep track of her cash tips. Carla receives more than $20 per month in cash tips. Carla keeps a record but, because she doesn't report her cash tips to her employer, they are not included on her Form W-2. Carla includes the unreported tips as income on Form 1040. Carla also uses Form 4137 to calculate and pay the Social Security and Medicare taxes on those tips.

How do I figure and report these taxes?

To figure the tax, determine if during any month the taxpayer received any tips that were not reported to the employer. Then, were there any months where the total tips were less than $20. Unreported tips are entered on the W-2 screen. Form 4137 will also be needed if there were tips less than $20 in a month.

As part of your interview, explain to taxpayers that sometimes people do not realize they owe taxes on tips they do not report to their employer. Also explain the taxes paid on those tips actually boost the taxpayer's future Social Security benefits.

Exercises

Answers are at the end of the lesson.

Question 1: Nancy had a summer job at a coffee hut. She made $18 in tips in May, $755 in June, $600 in July, and $45 in August. Until a co-worker told her, she didn't realize she had to report her tips to their employer. She then reported $1,000 in tips to her boss.

What amount of tips will Nancy have to add to her Form 1040 as wages?

a. $1,418
b. $1,000
c. $418
d. $18

Question 2: What amount of unreported tips does Nancy have to pay Social Security and Medicare taxes on when she files her tax return?

a. $1,418
b. $400
c. $45
d. $18

Taxes on IRAs and retirement plans

Traditional IRAs and other qualified plans allow individuals to defer paying taxes on contributions and earnings until the funds are distributed. If the rules for contributions and distributions are not followed, additional taxes may be due.

For example, the taxpayer must pay income tax **plus** an additional tax if any of the following apply:

- A distribution is taken before the individual reaches the age of 59½, is not rolled over into another qualified plan or IRA, and no exception applies or self-certification is not available
- Minimum distributions are not withdrawn when required (out of scope except to request a waiver of the additional tax)
- Excess contributions are not withdrawn by the due date of the return including extensions — out of scope if the 6% excess contribution additional tax applies

The additional tax for each situation is outlined on Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.

Only Part I, the exceptions to the additional tax on part or all of the early distributions from IRAs or qualified pension plans, and Part IX, requesting a waiver of the additional tax for failure to take an RMD, of Form 5329 are in scope. The other parts of Form 5329 are out of scope.

Some exceptions apply only to IRA distributions, some apply only to distributions from a qualified retirement plan, and some exceptions apply to both IRA and retirement plan distributions. Refer to the NTTC 4012, Tab H for the list of exceptions.

Refer to the Tax-Aide Intake Booklet for the question regarding retirement income or payments from pensions, annuities, and/or IRA. If checked, review any Form 1099-R that reports these payments to determine if the taxpayer is subject to the additional tax or qualifies for an exception.

Additional tax for early distributions

If Form 1099-R correctly shows code 1 in Box 7 indicating an early distribution, the additional tax applies unless the taxpayer qualifies for an exception. In some circumstances, Form 5329 is not required because no exception applies. The additional tax is 10% of the distribution before age 59 ½. However, distributions from a SIMPLE IRA (1099-R with code S in box 7) in the first two years are subject to a 25% early distribution penalty.

If an exception to the penalty applies, complete Form 5329 Additional Taxes on Qualified Plans (Including IRAs) and Other Tax Favored Accounts. Exceptions include the following.

Corrective distributions

Corrective distributions of the income on excess contributions distributed before the due date of the tax return (including extensions). See Withdrawal of Excess Contributions in the Income – Retirement lesson 11 for withdrawing such excess.

Victims of domestic abuse

New for 2024, a distribution to a domestic abuse victim is a distribution made from an applicable eligible retirement plan that is no greater than $10,000 (indexed for inflation) and is made during the 1-year period beginning on any date on which the taxpayer is the victim of domestic abuse by a spouse or domestic partner. The distribution may be repaid during the 3-year period beginning on the day after the date the distribution was received.

Emergency expenses

New for 2024, an emergency personal expense distribution is a distribution made from an applicable eligible retirement plan that is used for purposes of meeting unforeseeable or immediate financial needs relating to necessary personal or family emergency expenses. The qualifying distribution is limited to one per calendar

year, dollar limits of generally not more than $1,000, and limits on subsequent distributions. The distribution may be repaid during the 3-year period beginning on the day after the date the distribution was received.

Public safety employees

Qualified public safety employees who receive distributions from a governmental defined benefit pension plan aren't subject to the additional tax on early distributions. Qualified public safety employees include those who are or provide:

- police protection
- firefighting services
- emergency medical services for a state or municipality
- private sector firefighters
- corrections officers
- forensic security employees providing for the care, custody, and control of forensic patients
- federal law enforcement officers
- federal customs and border protection officers
- federal firefighters
- air traffic controllers
- nuclear materials couriers
- members of the United States Capitol Police or Supreme Court Police
- diplomatic security special agents of the Department of State

Further, they must have separated from service in or after the year they attained age 50 or reached 25 years of service, if earlier. Note that more employees qualify for this exception than are eligible for the public safety officer exclusion discussed in the Income – Retirement lesson 11.

Other early distribution exceptions

In addition to the exceptions discussed above, other exceptions include:

- Distributions incorrectly coded 1, J, or S
- Unreimbursed medical expenses that are more than 7.5% of AGI
- The cost of medical insurance during a period of unemployment
- Qualified higher education expenses
- Total and permanent disability
- Terminal illness – see NTTC 4012 for the physician's certification requirement
- Being a beneficiary of a deceased IRA owner
- Receiving distributions in the form of a series of substantially equal periodic payments
- Distributions to buy, build, or rebuild a first home
- Qualified birth or adoption
- The distribution is due to an IRS levy of the IRA or retirement plan
- Qualified natural disaster distributions (up to $22,000) - requires the taxpayer to incur a disaster loss and is out of scope
- Qualified reservist distributions (Military certification required)

Refer to NTTC 4012 or Pub 590-B for details on all the exceptions to the early distribution additional tax.

Do not reduce medical expenses or education expenses eligible for a deduction or credit for the amounts used to reduce the addition to tax on an early distribution. This is not a double dip situation and is allowable.

Laura is 41 years old and received an early distribution from her 401(k) account. The volunteer determines that Laura paid for unreimbursed qualified medical expenses in excess of 7.5% of her AGI, which is more than the amount of her distribution. In this case Form 5329, Part I, would be completed. Laura would not have to pay the additional tax on this distribution. If Laura is itemizing deductions, she can claim the whole amount of her medical expenses even though she used the expenses to reduce the additional tax.

What is the addition to tax for failing to take a minimum distribution on Form 5329 Part IX?

An owner of a traditional IRA must generally start receiving distributions from their IRA when they reach their required start year as discussed in the Income - Retirement lesson 11.

If the taxpayer fails to take the required minimum distribution (RMD), there is an additional tax of 25% of the distribution shortfall (was 50% in earlier years). The additional tax can be reduced to 10% if certain corrective distribution rules are satisfied. Tax-Aide Counselors can request a waiver of this penalty using Form 5329 Part IX. The taxpayer must take catch-up distributions to request this waiver.

IRS extended the penalty waiver through 2024 for a missed RMD from an inherited IRA by certain beneficiaries where the decedent died in 2020, 2021, 2022, or 2023.

What is the additional tax on excess IRA contributions (Form 5329 Parts III and IV)?

Generally, an excess contribution is the amount contributed to a traditional IRA and/or a Roth IRA for the year that is more than the general limitation amount or the taxable compensation for the year. The additional tax is 6% of the excess each year the excess remains in the IRA. If the additional tax applies, the return is out of scope.

See Withdrawal of excess contributions in the Income – Retirement lesson 11 for withdrawing such excess to avoid the additional tax.

Additional tax on taxable HSA distributions

If distributions are not repaid as a mistaken distribution, not rolled over, or not offset by qualified medical expenses, the amount withdrawn will be included in income and reported on Form 1040 as discussed in the Income – Other lesson 15. HSA distributions included in income are subject to an additional 20% tax unless the account beneficiary:

- Died
- Became permanently and totally disabled
- Turned age 65

If one of these exceptions applies, it is claimed on Form 8889, Part II.

An HSA distribution that is rolled over to another HSA is not taxable and not subject to the additional 20% tax. See the Income – Other lesson 15.

Repayment of the first-time homebuyer credit

Review the Tax-Aide Intake Booklet to determine if the taxpayer claimed the 2008 homebuyer credit and must pay back a portion of the credit each year.

If the taxpayer received the first-time homebuyer credit for a home purchased in 2008, generally they must repay the credit over a 15-year period in 15 equal installments. The repayment period began in 2010. However, if the home ceases to be the taxpayer's main home before the 15-year period is up, the taxpayer must repay all remaining annual installments.

The home ceases to be the main home if the taxpayer sells the home; converts the entire home to business or rental property; the home is destroyed, condemned, or disposed of under threat of condemnation; or the lender forecloses on the mortgage. There are certain exceptions to the repayment rule. See the Form 5405 instructions for details.

If the taxpayer dies, they do not have to repay the balance of the credit.

Special rules apply for taxpayers who filed a joint return for 2008 and claimed the first-time homebuyer credit. If the home is transferred to a spouse (or ex-spouse as part of a divorce), the spouse receiving the home is responsible for repaying the credit, unless an exception applies. Or if one of the spouses dies, their half of the remaining credit is forgiven and does not need to be paid back.

The credit is repaid by including it as additional tax on the return for the year the home ceases to be the taxpayer's main home.

Summary

This lesson explained how to report Other Taxes on the return. Other taxes are not calculated using the income tax tables or the tax computation worksheets. They include:

- Self-employment tax
- Social Security and Medicare taxes on unreported tip income
- Additional taxes on IRAs and other qualified retirement plans
- Additional tax on taxable HSA distributions
- Repayment of the first-time homebuyer credit

Where to find more information

Pub 531, Reporting Tip Income

Pub 575, Pension and Annuity Income

Pub 969, Health Savings Accounts and Other Tax-Favored Health Plans

IRS.gov for first-time homebuyer credit look-up tool

IRS on emergency expense and domestic abuse exceptions

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Employment taxes for household employees
- IRA minimum distributions not withdrawn when required and to which a waiver is not requested for the additional tax
- Excess contributions to an IRA that are not withdrawn by the due date of the return, including extensions, if the excess contribution addition to tax applies
- Distributions or excess contributions shown on parts II through VIII of Form 5329
- Individuals subject to the additional Medicare tax on Form 8959
- Individuals subject to the net investment income tax on Form 8960
- Other taxes listed on Sch 2, not discussed in this lesson or in the Premium Tax Credit lesson 26

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: c. Nancy's combined tips for May, June, July, and August were $1,418, and she reported only $1,000 to her employer. She needs to add $418 as wages on her tax return.

Answer 2: b. Nancy does not have to pay Social Security and Medicare taxes on the tips she received in May, because they amounted to less than $20 for the month.

Payments and Miscellaneous Refundable Credits

Introduction

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1040-ES
- Form 4868 (extension form)

The federal income tax system is a "pay as you go" system. That means tax is paid as income is earned or received during the year. Income tax is generally withheld from the following types of income:

- Salaries and wages
- Tips
- Taxable fringe benefits
- Sick pay
- Pensions and annuities
- Retirement plan and IRA distributions
- Gambling winnings
- Unemployment compensation
- Certain federal payments such as Social Security benefits

This lesson covers income tax withholding, estimated tax payments, certain refundable credits, and other payments made by the taxpayer. Some of the credits will be entered on the appropriate lines of the return while some payments and credits may be entered on Sch 3, Additional Credits and Payments.

Other refundable credits have already been covered: premium tax credit, additional child tax credit, and the refundable education credit. Earned income credit will be covered in the next lesson.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify the following types of payments and credits that are applicable for most low- and moderate-income taxpayers:
  - Federal income tax withheld from Forms W-2
  - Federal income tax withheld from Forms 1099
  - Estimated tax payments and amounts applied from the prior year's return
  - Amount paid with a request for an extension to file
  - Excess Social Security and tier 1 RRTA tax withheld
- Report these payments and credits correctly on the taxpayer's return

The information you obtain from the taxpayer's Tax-Aide Intake Booklet will help you determine the payments and credits that should be reported.

How do I report federal income tax withheld?

If taxpayers have income tax withheld during the tax year, they will receive one of the following forms showing the amount withheld:

- Form W-2, Wage and Tax Statement
- Form W-2G, Certain Gambling Winnings
- One or more of several different types of Forms 1099, including brokerage composite statements

The amounts withheld are entered in the software as part of the form data on the respective input screen. The unintentional omission of withheld income tax is a common error. To avoid this mistake, review your input on each form to ensure all income taxes withheld are included before proceeding to the next one.

The total amount withheld from income is included on the return. If a paper return must be filed, attach all Forms W-2 and any Forms W-2G and Forms 1099 if tax was withheld.

Freda worked as a clerk and received a Form W-2 that reported federal income tax withholding of $1,000. She also received Form 1099-INT from her bank, which reflected federal income tax withholding of $50. The correct total withholding reported on her return would be $1,050 ($1,000 + $50).

Exercises

Answers follow the lesson summary.

Question 1: Federal income tax is always withheld from all types of income a taxpayer receives.

a. True

b. False

Estimated tax payments

What are estimated tax payments?

Many taxpayers have income from self-employment, dividends, interest, capital gains, rent, and royalties from which taxes are not normally withheld. To comply with the "pay as you go" system, estimated tax must be paid if the total tax (after withholdings and credits) exceeds $1,000.

If insufficient tax has been withheld or paid in when required, a penalty could be imposed. See the Refund and Amount of Tax Owed lesson 30 for more information on estimated taxes.

Estimated tax payments are used to pay both income tax and self-employment tax, as well as other taxes and amounts reported on your tax return.

Where do I get this information?

Review the taxpayer's Tax-Aide Intake Booklet to determine if they had income from sources such as self-employment or investments for which taxes may not have been withheld. If so, ask, "Did you pay estimated taxes to the IRS?" Be sure to note the dates and amounts of the payments on the Tax-Aide Intake Booklet and enter them into the software.

If a taxpayer paid substantially more or less than required in estimated tax, encourage them to recalculate it. They can adjust their estimated tax payments by following the instructions and worksheet on Form 1040-ES. Taxpayers who are wage earners should use the IRS Tax Withholding Estimator to determine whether they need to update their withholding.

Exercises (continued)

Question 2: Generally, taxpayers should make estimated tax payments if their main source of income is from self-employment and they don't have enough refundable credits or taxes withheld from other sources of income.

a. True

b. False

What about tax payments applied from a previous year?

Taxpayers who overpay their income taxes in one year can apply all or part of their overpayment to the next year's estimated tax by indicating the amount they want to apply. This information should be included in the taxpayer's Tax-Aide Intake Booklet, but confirm by asking the taxpayer:

- Did last year's return show an overpayment?
- Did you apply any part of the overpayment to this tax year?

If the answer is “yes” to both questions, ask to see last year’s tax return to document the amount of tax applied to this year’s tax return.

Taxpayer interview and tax law application

Let’s see how our volunteer helped a taxpayer, Ernie, with his payments.

Sample interview

Volunteer Says…	Ernie Responds…
The tax software added up all the income tax withheld from your Forms W-2 we entered earlier. I know you had a little self-employment income and I see you responded “yes” to the question on estimated tax payments on the Tax-Aide Intake Booklet. Is that correct?	Yes, I did.
Do you have a record of your payments, perhaps on a Form 1040-ES?	Yeah, here it is.
Good, you paid each quarter. We’ll enter those payments. While we’re here, did last year’s return show an overpayment?	Yes, here it is: $150.
Did you apply any of that overpayment to this year’s tax return?	Yes, all of it.
Okay, we’ll enter that too. Now we show the total of the withholding from your Forms W-2, your estimated tax paid and the refund amount from last year’s return applied to this year.	Good!

Extension payments?

Taxpayers can get an automatic six-month extension of time to file by submitting Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return. This form extends the time to file until October 15. This is only an extension to file, not an extension to pay. If taxpayers do not pay their taxes by the April due date, they will owe interest and may be charged penalties.

Later, when taxpayers file their return, they report the payment made with Form 4868 on the applicable line on Form 1040, Sch 3.

One of Bernice’s Forms W-2 was lost in the mail. She requested a copy from her former employer, but it did not arrive by April 15. She filed for an extension, calculated the amount of taxes owed based on her final pay stub from that employer, and paid the $243 that was due. When she finally received her Form W-2, she filed her return and reported the $243 on the applicable line on Form 1040, Sch 3.

How can taxpayers file the extension?

Taxpayers may file the extension electronically or on paper. The extension must be transmitted or mailed by the due date of the return. You can help taxpayers file for an extension using the tax software.

Go to the NTTC 4012, Tab M, Other Returns, to review the step-by-step procedures for filing for an extension or review the Completing the Return lesson 31 for additional information.

Exercises (continued)

Question 3: When taxpayers file an extension to file a tax return, it also extends the time to pay any income tax balance due.

a. True
b. False

Excess Social Security and tier 1 RRTA tax withholding

A taxpayer may have more than one employer and a combined income over the Social Security wage base. This means the taxpayer may have paid more in Social Security tax than is required. This excess amount is

reported on the applicable line on Form 1040, Sch 3, and is a refundable credit. The software will calculate this automatically based on the amount entered for each Form W-2. Therefore, be sure the information from each Form W-2 is entered accurately.

Repayments of previously taxed income

Repayments of more than $3,000 are out of scope. If the taxpayer repaid income of $3,000 or less, there is no federal deduction or credit. State tax laws may differ. The following is provided for awareness.

When a taxpayer repays income that they included in a prior year's tax return of more than $3,000, the taxpayer may choose between a deduction in the year of repayment or a tax credit (IRC Sec. 1341 credit) on the return of the year of repayment. If choosing the deduction, it would be claimed in the same manner as the income was previously included:

- Sch C if it was business income
- Sch D/Form 8949 if it was a capital gain (same short or long term as originally reported)
- Sch E if it was originally reported on that form (e.g. rent income)
- All other as a miscellaneous itemized deduction not subject to the 2% rule

If choosing the tax credit, it is computed on a with-and-without basis to measure the incremental tax that was paid in the prior year when the income was included. The credit is reported on Sch 3, Line 13d (now supported in the tax software >Payments & Estimates > IRC 1341 Repayment Amount).

If taxes other than income taxes were paid on the previously included income, the taxpayer may be able to file a claim for refund using Form 843. Form 843 is beyond our scope.

Summary

Listing all the payments the taxpayer made during the year, and the taxpayer's refundable credits is critical to completing an accurate return. You must be able to identify the types of payments and credits that apply to each taxpayer when you are preparing their return.

Where to find more information

Pub 505, Tax Withholding and Estimated Tax

Pub 17, Your Federal Income Tax

What situations are out of scope?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Tax returns for taxpayers who choose to claim any of the following credits:
  - Form 4136, Credit for Federal Tax Paid on Fuels
  - Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains
  - Form 8839, Qualified Adoption Expenses
  - Form 843, Claim for Refund and Request for Abatement
  - Credit for repayment of amounts included in income in a previous year (IRC Sec. 1341)

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: b, False. Taxpayers often have income with no withholding, such as interest income.

Answer 2: a, True. In order to avoid penalties, taxpayers who have income but not enough tax withholding, such as self-employment income, should make quarterly estimated payments.

Answer 3: b, False. An extension of time to file a tax return does not extend the time to pay taxes due. Penalties may be asserted and interest will be charged.

Earned Income Credit

Introduction

This lesson covers the earned income credit (EIC). There are several common errors associated with claiming this credit on the return. The NTTC 4012 and the Tax-Aide Intake Booklet are critical tools in avoiding these mistakes.

What do I need?

- Tax-Aide Intake Booklet
- Qualifying Child or Relative Resource Tool
- NTTC 4012

Optional:

- Form 1040 and Instructions
- Sch EIC
- Form 8862 (claiming credits after disallowance)

Objectives

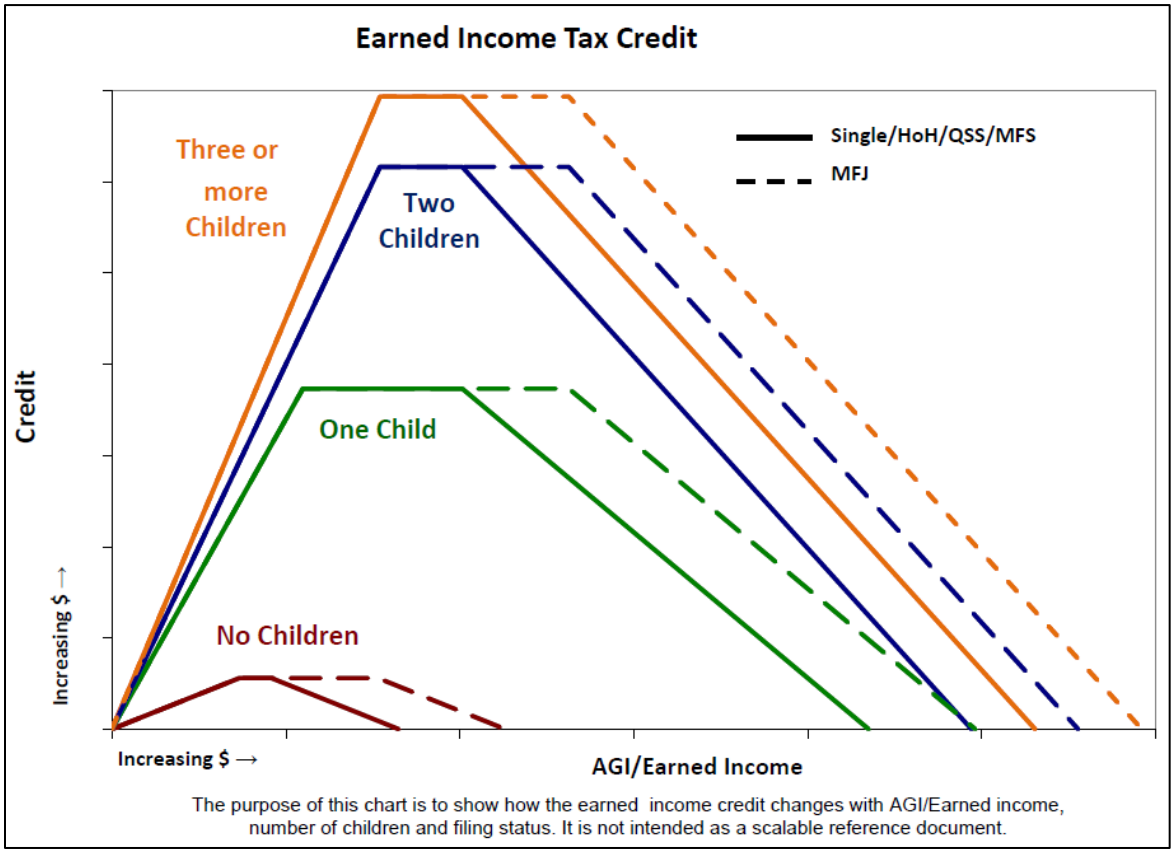
At the end of this lesson, using your resource materials, you will be able to:

- Determine if a taxpayer is eligible for the earned income credit
- Calculate the earned income credit

What is the EIC?

The earned income credit (EIC) is a refundable tax credit for people who work but do not earn high incomes. The purpose of the EIC is to reduce the tax burden and to supplement the wages of working families whose earnings are less than the maximums for their filing status. Eligible taxpayers can receive a refund with this credit, even if they have no filing requirement, owe no tax, and had no income tax withheld. As a fraud prevention measure, a refund for taxpayers claiming the EIC will not be issued prior to February 15.

The EIC can be a very valuable credit. The EIC amounts are adjusted for inflation every year as shown in the Important Changes lesson. This graph depicts how the EIC works. A taxpayer must have some earned income; but too much, and the EIC is reduced or eliminated.



How does a taxpayer qualify for the EIC?

There are general sets of rules for claiming the earned income credit:

- Rules for everyone
- Rules for taxpayers with a qualifying child
- Rules for taxpayers who do not have a qualifying child

What rules apply to everyone?

As detailed in the chart titled “Summary of EIC Eligibility Requirements” in the NTTC 4012, Tab I, Earned Income Credit, any taxpayer wishing to claim EIC must satisfy these requirements:

- Must have earned income and their AGI must be less than certain amounts (see the Important Changes lesson for this year's amount)
- Taxpayers and qualifying children must all have SSNs that are valid for employment by the due date of the return (including extensions)
- The filing status cannot be married filing separately unless the exception applies
- Must be a U.S. citizen or resident alien all year
- Cannot file Form 2555 (relating to the foreign earned income exclusion)
- Investment income must be less than the maximum shown in the Important Changes lesson
- Cannot be the qualifying child of another person.

A taxpayer who is married and is not filing a joint return can claim EIC if they:

- Have a qualifying child living with them for more than 1/2 the year **and**
- Either:
  - Lived apart from their spouse for the last 6 months of the year or
  - Have a decree, instrument or agreement and was not a member of the same household with the taxpayer’s spouse by the end of the year.

Investment income includes such items as taxable interest, tax-exempt interest, dividends, capital gain net income (but not net capital losses), and income from residential rental property. The software will handle this calculation based on your entries.

Taxpayers cannot file an amended return retroactively to claim EIC for any year in which they did not have a valid Social Security number by the due date of the return (including extensions).

James and Jill are filing a joint return and both have valid SSNs. They have two daughters; Susie has a valid SSN and Sally has an ITIN. Only the daughter with the valid SSN may qualify the tax return for EIC.

What is earned income for EIC purposes?

Earned income includes wages, salaries, tips, and other taxable employee pay and self-employment income. Turn to the Earned Income Table in the NTTC 4012, Tab I, Earned Income Credit, for examples of earned income.

One type of payment considered earned income is taxable long-term disability benefits received prior to minimum retirement age. Refer to the Income – Retirement lesson 11 earlier for additional information.

What about combat pay?

Combat pay is never taxable to most soldiers. Members of the U.S. Armed Forces who served in a combat zone may elect to include their nontaxable combat pay in their earned income for the purposes of computing their EIC. Doing this may increase or decrease the taxpayer's EIC. If the election is made, all of the nontaxable combat pay must be included. If both spouses filing a joint return have combat pay, they can individually choose to make the election on the tax return.

If a taxpayer has combat pay listed in Box 12 of Form W-2 marked with code Q, the software will determine if the combat pay should or should not be added to the taxpayer's income.

What about self-employment income?

Net earnings from self-employment are considered earned income. For most taxpayers within our scope, "net earnings" for EIC purposes will be the amount reported as business income minus the deductible portion of the self-employment tax that is reported on Form 1040, Sch 1.

A statutory employee's earned income is the gross receipts shown on line 1 of Sch C, not reduced by their expenses.

Jeff's self-employment income reported on Form 1040 is $2,000. The deductible portion of his self-employment tax, which is recorded on Sch 1 of Form 1040, is $142. His income for EIC purposes is $2,000 – $142 = $1,858.

As an IRS-certified volunteer, you must exercise due diligence when preparing or assisting in the preparation of, approving, and filing tax returns. Although you may rely in good faith on information provided by the taxpayer without requiring documentation as verification, you must ask questions if the information furnished appears to be incorrect, inconsistent, or incomplete.

What about household employee income?

Domestic employees such as housekeepers are only issued a Form W-2 if their earnings are more than a certain amount. Refer to the Important Changes lesson for this tax year's amounts. Even if no W-2 is received, the income should be added to wages on Form 1040. This income should also be included when calculating the EIC.

What about Medicaid waiver payments?

Certain Medicaid waiver payments (MWP) may be excluded from income under Notice 2014-7. Refer to the Wages, Interest, Etc. lesson 8 for details. Even though excluded, these payments may be included in earned income if there is benefit from the inclusion. If both spouses earn MWP income, each can make the election to include their MWP income as earned income for EIC purposes.

What about strike or lockout benefits payments?

Strike or lockout benefits payments (other than bona fide gifts) are earned income for EIC purposes. Payers may report these amounts on a Form 1099. See the Income – Other lesson 15.

What about election worker income?

Payers generally report election worker income on Form W-2 when Social Security or Medicare taxes are required to be withheld. Election worker income is earned income for EIC purposes regardless of how it is reported. See the Income – Other lesson 15.

Earned income not qualifying for the EIC

One income item that is reported on Form W-2 but does not qualify as earned income for EIC purposes is income received for work performed while an inmate in a penal institution. This includes income earned while on a work-release program.

A scholarship or fellowship grant that isn't reported to the taxpayer on a Form W-2 also isn't considered earned income for the EIC.

Generally, excluded income is not earned income for EIC purposes – exceptions are made for combat pay and Medicaid waiver payments as noted above. Refer to the NTTC 4012, Tab I, Earned Income Credit, for additional income that is not earned income.

Exercises

Use the Summary of EIC Eligibility Requirements Chart in the NTTC 4012, Tab I, Earned Income Credit, to answer the following questions. Answers follow the lesson summary.

Question 1: A taxpayer without a qualifying child is filing as married filing separately. Does this taxpayer qualify for the EIC?

a. Yes

b. No

Question 2: A taxpayer has interest income of $4,500. His earned income is only $7,000. He is single, has a valid Social Security number, and is not the qualifying child of anyone else. Does he qualify for the EIC?

a. Yes

b. No

Rules for taxpayers with qualifying children

The taxpayer can file Form 1040 to claim the EIC with a qualifying child if the child meets the relationship, age, residency, and joint return tests as detailed in the Dependents lesson 6, in addition to the rules above for all taxpayers. Follow along using your QC/R Tool or the NTTC 4012, Tab I, Earned Income Credit charts.

Note that there is no support test to be a qualifying child for EIC. That is, for EIC purposes, a qualifying child does not have to be the taxpayer's dependent (unless the child is married). Therefore, even if the child is not the taxpayer's dependent, the taxpayer may be able to claim the child for EIC if they meet the age, relationship, and residency tests.

Maria and her 19-year-old son, Marco, live together; both work and contributed to the house hold costs about evenly. Marco was a full-time for 6 months during the year. Because Marco provided for more than half of his own support, Maria cannot claim him as a dependent. She can, however, claim Marco as her qualifying child for EIC. Be sure to add Marco to Maria's return.

The child cannot be claimed as the qualifying child for EIC purposes by more than one taxpayer. In the case of divorced or separated parents, the custodial parent (with whom the child lived for more than half the year) can qualify for the EIC regardless of whether or not they claim the child as a dependent. The noncustodial parent cannot qualify for EIC because the child did not live with them for more than half the year.

Jane, 31, and Todd, 33, have an 8-year-old daughter, Amanda. All are U.S. citizens and have valid SSNs. Jane and Todd have never been married. Jane and Amanda lived together all year in an apartment. Todd lived alone. Jane earned $15,000 working as a clerk in a clothing store. Todd is an assistant manager of a hardware store and earned $48,000. He paid over half Jane's rent and utilities and also gave Jane extra money for groceries. Todd does not pay any expenses or support for any other family member.

Although Todd provided over half the cost of a home for Jane and Amanda, he cannot file head of household and he cannot claim Amanda for EIC since she did not live with him more than half the year. Jane cannot file as head of household either because she did not pay for more than half of her household costs. Jane is the only one who can claim Amanda as a qualifying child for EIC.

What are the rules for a qualifying child of more than one person?

There can be situations in which more than one taxpayer could claim the same person for the EIC, for example in a multi-generation household. In this situation, the IRS has established tie breaker rules. Use your QC/R Tool or refer to the Qualifying Child of More than One Person rules in the NTTC 4012, Tab I, Earned Income

Credit. Keep in mind that all the dependency benefits are a package and cannot be split between taxpayers except in the case of divorced or separated parents. A child who meets the conditions to be a qualifying child of more than one person can only be claimed by one taxpayer for the EIC.

If a taxpayer can't claim the EIC because the qualifying child is treated under the tiebreaker rules as the qualifying child of another person, the taxpayer may be able to take the EIC using a different qualifying child, or take the EIC using the rules for people who don't have a qualifying child if they qualify.

Robyn is 25 years old. She and her 2-year-old son, Aiden, lived with Robyn's mother all year. Aiden has a valid Social Security number.

Using the EIC With a Qualifying Child Chart from the NTTC 4012, Tab I, Earned Income Credit, based on what we have learned so far about Robyn and her family:

Step 1 is YES

Step 2 is YES

Step 3 is YES

Step 4 is NO

Step 5 is YES

For Step 6, check to see if Aiden can be anyone else's qualifying child for EIC purposes.

Who else lived in the house that is related to Aiden? Robyn's mother also lives with them. Go through the steps to see if Aiden can be a qualifying child for Robyn's mother.

Tax-Aide Counselors can use the QC/R Tool to navigate the rules for a qualifying child for EIC.

Rules for taxpayers without qualifying children

To claim the EIC without a qualifying child, a taxpayer must satisfy all the conditions and rules for all taxpayers and:

- Must be age 25 but under age 65 as of December 31 of the tax year.
  - Taxpayers turning age 25 on January 1 are considered to be 25 as of December 31.
  - Taxpayers reaching age 65 on January 1 remain age 64 on December 31.
  - If filing MFJ, this age test is met if one spouse is at least 25 but not 65 or older.
- Cannot be the dependent of another taxpayer nor can the taxpayer be the qualifying child of another taxpayer for EIC purposes.
- Must have lived in the United States more than half the year.

Tom and Martha are a married couple. Tom is 66 and Martha is 58 years old. If all other rules are met, they would qualify for the EIC.

Exercises (continued)

Using your QC/R Tool or the EIC charts in the NTTC 4012, determine if each of these taxpayers has a qualifying child or can claim the EIC. Each taxpayer and child have valid Social Security numbers.

Question 3: Maureen's 20-year-old daughter, Angie, lived with her for eight months of the year. Angie is not married and is a full-time college student. Is Angie a qualifying child for the EIC?

a. Yes

b. No

Question 4: Three children live with Mira, who cares for them as her own: Twila, the 3-year-old daughter of Mira's cousin; Chez, Mira's newly adopted 2-year-old son from Europe, who has lived with Mira since November of the tax year; and Dwight, Mira's 20-year-old son, who attends community college part time. Which of them are qualifying children?

a. Twila
b. Chez
c. Dwight
d. None

Question 5: Margie's daughter, Aimee, turned 23 early in the tax year while attending college full time. Margie is filing as head of household. Margie has an AGI of $31,000. Assuming that she and her daughter pass all other tests, can Margie claim the EIC?

a. Yes
b. No

Question 6: Rob and Laura are divorced. Laura is the custodial parent for Dawn, who lived with her all year. Laura signed Form 8332, allowing Rob to claim Dawn as a dependent until she turns 18. Can Rob claim Dawn for the EIC?

a. Yes
b. No

Question 7: Jewel and her daughter lived with Jewel's brother, Emmitt all year. Jewel earns $20,000 and claims her daughter as the qualifying child for the EIC. Emmitt is 25 years old and earned $8,500. Is Emmitt able to claim the EIC for a taxpayer without a qualifying child?

a. Yes
b. No

Question 8: Larry is 35 years old and unmarried. Larry lives with his brother, Jeff, who is unmarried and totally and permanently disabled. Jeff receives disability income that is used to pay for more than half of his support. Can Larry claim Jeff as a qualifying child for EIC?

a. Yes
b. No

EIC disallowed in a prior year

The Tax-Aide Intake Booklet asks if the taxpayer was previously disallowed an EIC, child tax credit, or American opportunity credit in a prior year. The taxpayer would have received a letter from the IRS specifying whether the disallowance is for 2 years or for 10 years and saying when they would have to complete and attach Form 8862 to claim the credit again. The letter from the IRS specifies whether the disallowance is for 2 years or for 10 years. If the taxpayer is denied EIC for the current tax year because of IRS disallowance, you will need to indicate that so the software does not compute the credit.

How is the correct EIC amount calculated?

The software computes EIC using worksheets and the Earned Income Credit tables. The EIC worksheets can be found in the Form 1040 Instructions. The software completes Sch EIC and EIC worksheets that can be reviewed with the taxpayer if they have questions about how EIC was computed.

When reviewing the Form 1040 Instructions, it is common to mistake the Tax Tables for the EIC tables. Double-check that the heading on the page you are using is "Earned Income Credit (EIC) Table."

Class Exercise

A taxpayer is filing head of household and has one qualifying child. The AGI is $19,000 and is all earned income. How much EIC is the taxpayer entitled to?

Turn to the first page of the EIC tables. Find the amount in the “At least - But less than” column. Find the correct filing status column: single, head of household, and qualifying surviving spouse, or in a separate column, married filing jointly. There are subcolumns for the number of qualifying children.

Summary

The earned income credit computation is based on filing status, number of qualifying children, earned income, and adjusted gross income. Certain individuals with no children may also qualify.

By using the Tax-Aide Intake Booklet, your QC/R Tool, the EIC charts in the NTTC 4012, and correctly entering the taxpayer’s data in the software, most of the errors that result from incorrectly computing the EIC can be avoided.

The EIC is entered on its own line of the return.

Where to find more information

Pub 596, Earned Income Credit (EIC)

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: b, No. In order to claim the credit as MFS, the taxpayer must have a qualifying child.

Answer 2: a, Yes. His investment income is below the threshold amount.

Answer 3: a, Yes. Daughter Angie meets all the eligibility tests to be a qualifying child.

Answer 4: b. Chez. An adopted child is considered to have lived with the taxpayer for more than half the year if the taxpayer's main home was the child's main home for more than half the time the child was adopted or placed with the taxpayer during the tax year. Twila does not meet the relationship test, and Dwight does not meet the age test.

Answer 5: a, Yes. Margie meets the general eligibility requirements and Aimee meets the Qualifying Child rules.

Answer 6: b, No. While Rob can claim his daughter as a dependent, the daughter did not live with him for more than half the year, so she fails the residency test. Dawn is the qualifying child of Laura.

Answer 7: a, Yes. Jewel’s daughter is not the qualifying child of Emmitt, but he can claim the EIC for a taxpayer without a qualifying child.

Answer 8: a, Yes. Jeff is Larry’s qualifying child for EIC. Jeff is not Larry’s dependent because he provides more than half of his own support; but the support test does not apply for EIC.

Refund and Amount of Tax Owed

Introduction

Taxpayers may be entitled to a refund or have a balance owing. In either case, they have several choices on how to get their refund or pay the amount they owe. It is important that volunteers are familiar with those choices to better help taxpayers understand their refund and payment options. This is especially true because of the increase in the number of taxpayers coming in to Tax-Aide sites who owe tax for the first time and need guidance.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 8888 (allocation of a refund)
- Form 9465 (installment agreement)

Feedback results indicate volunteers are less familiar with the procedures for payment options than the procedures for refund options. Be sure to identify the payment options available to taxpayers that are outlined in this lesson and in the NTTC 4012, Tab K, Finishing the Return.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify the applicable section and lines of Form 1040 for the refund or amount owed
- Report the correct amount of refund or amount owed
- Identify the refund options available
- Describe the different payment options for the amount owed
- Explain how to adjust the amount of tax withheld or make estimated tax payments to avoid underpayment of taxes

To complete these sections of the taxpayer's return, you will need to confirm answers provided on the Tax-Aide Intake Booklet, regarding direct deposit and direct debit. Also, review the NTTC 4012, Tab K, Finishing the Return, which provides guidance on refunds and balance due returns.

What if the taxpayer is due a refund?

The taxpayer's total tax and total tax payments already made, which includes refundable credits, appear on the applicable lines of Form 1040. If the payments made exceed the amount of tax liability, the amount of the overpayment is shown on the applicable line in the Refund section of the Form 1040. This is the amount the taxpayer has overpaid.

What are the options for an overpayment?

Taxpayers can choose to:

- Apply any portion of their overpayment to the following tax year
- Receive all or part of their refund as a check — usually mailed within 6 to 8 weeks after the return is filed
- Receive all or part of their refund using direct deposit

The software default is that the entire refund is to be sent to the taxpayer. Use the taxpayer's answers in the Tax-Aide Intake Booklet as a guide for software entries needed to comply with their wishes.

Why apply part of the overpayment to the following year?

Taxpayers who pay quarterly estimated taxes may find easier for some or all of an overpayment to be applied to the next year. That reduces the amount of estimated payments to be made for the next year.

What are the benefits of direct deposit?

Encourage taxpayers to use direct deposit. Direct deposit refunds are received faster than checks (usually within 10 to 21 days) and eliminate the possibility of a check being lost or stolen. Direct deposit is more convenient for the taxpayer and saves tax dollars because it costs less to process.

Taxpayers may choose to have their refund deposited directly to any financial account that has a Routing Transit Number, such as an account at a bank, credit union, or other financial institution; a prepaid debit card; or an IRA.

The taxpayer may decide toward the end of the return preparation process to allocate some or all of the refund to their IRA. Be sure to go back into the return and enter the contribution amount – the taxpayer may get additional benefit from the contribution through a deduction and/or the retirement savings credit.

How do I enter the information for direct deposit?

Make sure taxpayers show you proof of their bank account and routing information, such as a check. Bank deposit slips are not a reliable source for routing numbers for direct deposit. Enter the account number from left to right, but omit spaces and symbols. The NTTC 4012, Tab K, Finishing the Return, Pointers for Direct Deposit of Refunds, includes a diagram showing where to find the Routing Transit Number (RTN) and Depositor Account Number (DAN) information on a check.

Direct deposit of a taxpayer's refund should be made to an account (or accounts) in the taxpayer's name. IRS limits the number of electronic transfers that can be deposited to the same account to three. Taxpayers who exceed the limit will receive an IRS notice and a paper refund.

If the routing and account numbers are not valid, the refund will be delayed 4–6 weeks. If the direct deposit is rejected, a check will automatically be mailed to the address on the return.

Can the refund be deposited into more than one account?

Taxpayers may choose to have their refund deposited in up to three accounts. For example, a person expecting a refund of $600 could choose to deposit $200 into a checking account, $300 into a savings account, and $100 into an IRA account. Form 8888, Allocation of Refund is used for this purpose.

What if the IRS makes an adjustment to the return that increases the amount of the refund?

If an adjustment to the return results in a larger refund than expected, the IRS adds the difference to the last account designated for direct deposit. If a paper check is issued, IRS will automatically increase the amount on the check.

What if the IRS makes an adjustment to the return that decreases the amount of the refund?

If an adjustment results in a smaller than expected refund, the IRS will reduce the amount of a paper check. For direct deposits, IRS uses a bottom-up rule and deducts the difference from the direct deposit amount designated for the last account shown on Form 8888. If the difference exceeds the amount designated for the last account, the IRS deducts the remainder from the amount designated to the next account, until the amount due is paid.

Joan's return shows a refund of $300 and she asks the IRS to split her refund among three accounts with $100 to each account. Due to an error, her refund is decreased by $150. The IRS will adjust her direct deposits as follows:

	Requested Direct Deposits	*Actual Direct Deposits*
Account 1	*$100*	*$100*
Account 2	*$100*	*$50*
Account 3	*$100*	*$0*

What else can also reduce a taxpayer's refund?

The IRS will apply this same bottom-up rule to adjust direct deposits for refund offsets for unpaid federal taxes or if the refundable credits portion of the taxpayer's refund is withheld pending further review. After the IRS review, if a refund is allowed, it will be direct-deposited in the account listed first on Form 8888.

Bill asks that his refund of $780 be deposited into three different accounts: $300 into Account 1, $300 into Account 2, and $180 into Account 3. However, Bill owes federal taxes of $290 on an earlier tax year, and after this is offset, only $490 remains to be direct deposited. Account 3 will receive $0, Account 2 will receive $190, and Account 1 will receive $300.

Melanie is due a refund of $1,000; $700 of the refund is an earned income credit (EIC). She asks that her refund be split into three different accounts: $500 into Account 1, $300 into Account 2, and $200 into Account 3. Melanie's EIC amount of $700 was held pending a review. So, $300 went to Account 1 and $0 went to Accounts 2 and 3. Later, when the IRS allowed her EIC refund amount, it was deposited into Account 1.

When an adjustment is made to a tax refund, the IRS sends a letter explaining any errors that resulted in the adjustment, as well as any changes made to the refund amount and the amount of each direct deposit.

If the refund is decreased due to an offset to pay state income tax, child support, or certain federal nontax debts, such as student loans, then the decrease will be taken first from the account that appears first on the payment file received from the IRS. The IRS payment file orders accounts from the lowest to the highest routing number. If the debt exceeds the payment designated for the account that appears first on the payment file, the Treasury Department's Financial Management Service (FMS) will reduce the payment designated for the account that appears next.

What should I watch out for?

Double-check the RTN of the financial institution and the account number before the return is transmitted. Ask the taxpayer to review and confirm the RTN and account numbers on the return by placing their initials next to the RTN or account number.

If more than one account is selected for direct deposit, be sure that the amounts on Form 8888 equal the refund amount on Form 1040.

Financial institutions may not allow a joint refund to be deposited into an individual account.

Exercises

Answers are at the end of the lesson.

Question 1: Using direct deposit is one way to reduce the chance that a refund will be lost or stolen.

- **a.** True
- **b.** False

Question 2: When entering an account number for direct deposit, make sure to include all spaces and hyphens.

- **a.** True
- **b.** False

The IRS is not responsible if a financial institution refuses a direct deposit.

For taxpayers who are due a refund: Advise taxpayers to check Where's My Refund? at www.irs.gov/refunds or download the IRS2Go app to check the status of their refund. The taxpayer will need their Social Security number or ITIN, filing status, and the exact refund amount for the year in question. Where's My Refund? will display the status of the refund 24 hours after e-filing a return for the current filing year, 3 or 4 days after e-filing a prior year return, or 4 weeks after mailing a paper return.

Refund Anticipation Loans (RALs) and Refund Anticipation Checks (RAC) are not in scope.

What if an amount is owed?

If the amount of the tax liability exceeds the payments made, the amount owed appears in the Amount You Owe section of the Form 1040. This is the amount the taxpayer must pay.

Taxpayers who owe money on their returns are often afraid and do not know what to do next. This is a good opportunity to advise the taxpayers of the various options for payment.

Explain to taxpayers that the tax return will be filed now and that they should submit their payment of taxes due no later than the April due date to avoid failure-to-pay penalties and interest charges. To avoid a failure-to-file penalty, taxpayers with an amount owed must file their return by the due date even if they cannot pay the full amount with the return.

Remind taxpayers that filing an extension of time to file does not extend the time for payment.

What forms of payment are acceptable?

The payment options are:

- Check or money order submitted with Form 1040-V, Payment Voucher
- Electronic funds withdrawal (direct debit)
- Credit card (credit card processor's fees apply)
- Electronic Federal Tax Payment System (EFTPS)
- Direct Pay on IRS.gov
- Cash at a retail partner

Taxpayers can check the balance owed on their account by creating an account on IRS.gov or by requesting an account transcript at Your Online Account. Taxpayers can use the IRS2Go app on their mobile device to access their account and make a payment.

Taxpayers should not mail cash with their returns. They will need to go to a retail partner to pay with cash. A link to the list of retail partners is in Tab K of your NTTC 4012 and at the end of this lesson.

What if the taxpayer cannot pay?

If taxpayers state that they cannot pay, first advise them to file the return and pay as much as they can by the April due date. This will reduce penalty and interest charges.

Taxpayers who cannot pay the full amount owed, shown on Form 1040 in the Amount You Owe section, may use one of the following options:

- Request a short-term payment plan of up to 180 days using the Online Payment Agreement Application (OPA) or calling the IRS. No fee is charged, but interest and penalties are charged on payments after the April due date.
- Monthly installment payments (established online using OPA or file Form 9465, Installment Agreement Request). A fee is charged for this option, in addition to interest and penalties. The fee is less with OPA. Taxpayers may qualify for waiver or reimbursement.

- Referral to Low-Income Taxpayer Clinics (LITC). Services are offered for free or a small fee.

If the taxpayer does not use one of these options, they will receive a notice from the IRS. They can pay the remaining amount in full or choose another payment option if more time is needed.

Any amount of tax owed that is not paid by the April due date is subject to penalties and interest. Taxpayers who cannot pay should choose the option that is the least costly. For example, the 180-day short-term plan option has no user fee. Print extra vouchers for taxpayers who need to send in multiple payments or they can make their payments using Direct Pay on IRS.gov or the IRS2Go app.

Taxpayers who can show they will have a substantial financial difficulty if they pay their tax on the due date are considered to have an undue hardship. Such taxpayers can request an extension of time to pay by filing Form 1127, Application for Extension of Time for Payment of Tax Due to Undue Hardship, by the due date of the return. Remember, undue hardship is more than an inconvenience. You cannot assist a taxpayer with Form 1127 because it is out of scope.

How to establish a Form 9465, Installment Agreement Request

Taxpayers who owe can immediately establish an installment agreement online, using the Online Payment Agreement Application (OPA). For more information, go to www.irs.gov/payments/online-payment-agreement-application.

If the return is being filed electronically, Form 9465 can also be included with the e-filed return. Refer to the NTTC 4012, Tab K, Finishing the Return. When filing a paper return, Form 9465 should be completed and attached to the front of the return before mailing. The fee is higher if not done directly using OPA.

If taxpayers already have an installment agreement with the IRS, they may be able to add the current year's amount owed to the same agreement. Taxpayers in this situation should contact the IRS directly at 1-800-829-1040 or complete Form 9465 reflecting the balance of all amounts (prior and current year amounts) and indicate the new total monthly payment. You can submit Form 9465 electronically with the return.

If the request is granted, the taxpayers must pay an installment agreement user fee. The amount of the fee varies depending on whether the agreement was setup online and whether the taxpayer agreed to pay by direct debit. If the taxpayers' income is below certain limits, they may qualify for a reduced or waived fee. Taxpayers can request a reduced user fee by completing Form 13844, Application for Reduced User Fee for Installment Agreement. Taxpayers can obtain Form 13844 at irs.gov or by calling the IRS forms number at 1-800-829-3676. The fee for establishing an installment agreement using OPA is lower.

If the IRS approves the agreement, a notice is issued that provides details of the agreement and requests the user fee at that time.

If the total amount due is more than $25,000, there are additional requirements. Refer to Form 9465 instructions.

Some low-income taxpayers may qualify for a modification of user fee requirements. The IRS will waive or reimburse user fees associated with installment agreements for taxpayers who earn less than 250% of the federal poverty rate. For details, see User fee waivers and refunds on IRS.gov.

What is an offer in compromise?

An offer in compromise (OIC) allows taxpayers to settle tax debt for less than the full amount owed. It may be an option for taxpayers who cannot pay their full tax liability or doing so creates a financial hardship.

There is a nonrefundable application fee, however it may be waived for taxpayers whose AGI is at or below 250% of the federal poverty level. Assisting taxpayers with an OIC is out of scope.

Taxpayers can access additional information on irs.gov and in the Form 656-B Offer in Compromise Booklet.

What if the taxpayer can't pay and needs additional assistance?

Low Income Taxpayer Clinics (LITCs) are a potential resource for taxpayers who need additional assistance with arranging payments or collection alternatives such as installment agreements, currently not collectible

status, or offers in compromise. More information about LITCs and how to locate a local LITC is found in the NTTC 4012.

Exercises (continued)

Question 3: For which of the following will the taxpayer be charged a convenience fee?

a. Direct deposit of a refund
b. Electronic funds withdrawal of a tax payment
c. Using a credit card to make a tax payment
d. Using a personal check to make a tax payment

Taxpayer interview and tax law application

Seymour's Form 1040 shows his total tax is $450. His tax payments come to just $200. Therefore, Seymour owes $250.

Sample interview

Volunteer Says…	Seymour Responds…
The amount of tax you owe is $250. You can either mail in a check or money order with the payment voucher, use electronic funds withdrawal, IRS Direct Pay, use cash at a retail partner, or use a credit card. You'll have to pay an additional convenience fee for using a credit card.	Hmm. How does electronic funds withdrawal work? Does it come out of my account right away?
No, we can designate the date that the debit will occur, any time up to the April filing date. I would just need to see proof of account to verify your bank account information so I can include the routing and account numbers in your electronic return.	And there's no charge?
Right. And it saves you the trouble of mailing in the voucher with your payment.	Sounds good to me. But I don't have my checking account information with me. Maybe I should just mail in my payment.
You can do that too. Here's Form 1040-V, which has been completed for you. Make your check or money order payable to "United States Treasury." If it's not already printed on the check, make sure it shows your name, address, and daytime phone number. Also, print your Social Security number and "[year] Form 1040" on the front of your check. Then mail the payment with the voucher. The mailing address is right here.	That doesn't seem too hard.
You can also go to irs.gov and use the Direct Pay system to enter your bank information for a direct debit. That way you don't have to mail anything.	Oh, that sounds easier!

What is the estimated tax penalty?

Generally, taxpayers may owe a penalty for underpayment of estimated tax if they did not pay enough tax, either through withholding or by making estimated tax payments. In most cases, taxpayers must make estimated tax payments if they expect to owe at least $1,000 in tax (after subtracting withholding and credits) and their withholding and credits will be less than the smaller of:

- 90 percent of the tax shown on the current tax return or
- 100 percent of the tax shown on the prior year's tax return (110 percent for certain higher-income taxpayers; see Form 1040-ES)

There are special situations when a taxpayer will not have to pay a penalty. See Form 2210 Instructions or Pub 17 for more information.

Mark's total tax is $1,657 for the current tax year. His withholding is $417. He owes $1,240. His prior year's tax was $2,000. Mark will probably be charged an estimated tax penalty because the amount he owes is over $1,000 and his withholding and credits are less than 90 percent of his current year tax or 100 percent of his prior year tax.

Do I have to calculate the estimated tax penalty?

No, we do not volunteer a penalty amount and because Form 2210 is complicated, it is out of scope. You will leave the estimated tax penalty line blank on Form 1040. This will not prevent the IRS from calculating the penalty if it is due. Let the taxpayer know that a penalty may be owed, and if so, the IRS will send a notice.

Exercises (continued)

Question 4: Dion's total tax liability is $1,044. After withholding, she owes $640. This means Dion might have to pay a penalty for underpayment of estimated tax.

a. True

b. False

Correcting the amount of tax withheld

There are several ways to pay taxes during the year to avoid having a balance due when the return is filed. Depending on the taxpayer's situation, there are basically two options:

- Taxpayers whose income is mostly from wages, pensions, Social Security, unemployment, or some investment income (such as interest on U.S. bonds) can adjust their withholding.
- Taxpayers whose income is mostly from self-employment or investments can make or increase their estimated tax payments.

A combination of increased withholding and estimated tax payments may work best for some taxpayers

When should taxpayers submit a revised Form W-4 to their employer?

The taxpayers may submit a new Form W-4 whenever they want to increase or decrease the withholding amount. Life events such as a change in marital status, birth of a child, or purchase of a home will change adjustments, deductions, and credits on the tax return. Taxpayers with more than one job or when both spouses work may need extra taxes withheld. These taxpayers should submit a revised Form W-4 to their employer. Some taxpayers may need to adjust the withholding for state purposes on the respective state form.

Pub 17, Tax Withholding and Estimated Tax chapter, has more information on this topic. Taxpayers can also use the IRS's Tax Withholding Estimator to help calculate the correct withholding.

Mary claimed her son as a dependent on this year's return. Mary will not be able to claim her son as a dependent on next year's return. Due to the change in Mary's tax situation, she uses the Tax Withholding Estimator to help determine the appropriate amount of withholding and submits an updated Form W-4 to her employer.

John works two full-time jobs. He reviews his withholding and realizes he will not have enough tax withheld. He gives his employer a revised Form W-4 to increase his withholding so he will not owe money when he files his return.

How do taxpayers request an increase or decrease in withholding for other income payments?

Taxpayers can use the following withholding forms to request a change in their withholding on other types of income.

- Form W-4P, Withholding Certificate for Periodic Pension or Annuity Payments

- Advise the taxpayer that the Tax Withholding Estimator may help.

- Form W-4S, Request for Federal Income Tax Withholding from Sick Pay
  - Advise the taxpayer that the Tax Withholding Estimator may help.
- Form W-4V, Voluntary Withholding Request (generally used for certain government payments, including Social Security and unemployment benefits)
  - The taxpayer can select a percentage of their payments to be withheld: 7%, 10%, 12% or 22% only.
- Form W-4R, Withholding Certificate for Nonperiodic Payments and Eligible Rollover Distributions
  - The taxpayer can select any percentage from 0% to 100% to be withheld

The taxpayer should contact the payer for the appropriate form to start or increase tax withheld.

Are estimated tax payments needed?

Estimated tax is the amount a taxpayer expects to owe for the tax year after deducting any tax credits or federal withholding. If that amount is more than $1,000, the taxpayer needs to make estimated tax payments in order to avoid penalties. Taxpayers with significant income that is not subject to withholding (such as interest, dividends, capital gains, or self-employment income) will often find they need to make estimated tax payments.

Maria is retired, and her only income is from a pension and some investments. She had no withholding and is not eligible for any tax credits. When you complete her return this year, she has a balance due of $1,300. Maria should begin making estimated payments, since her balance due next year will be more than $1,000, and she has no withholding. If Maria does not want to make estimated payments, she could submit Form W-4P to request withholding from her pension instead.

How is estimated tax figured?

Form 1040-ES, Estimated Tax for Individuals, can be used compute the amount of estimated tax that should be paid over the year. This form includes worksheets to help taxpayers estimate their income and tax liability for the year. The current year's tax return can be used as a starting point, but any anticipated changes should also be taken into account. Taxpayers may also have to adjust their payments during the tax year if a change in income or the tax law will affect their tax liability.

For additional information on estimated tax payments, refer to the NTTC 4012, Tab K, Finishing the Return.

How can I avoid common errors?

Double and triple-check the routing number and account number for direct deposit and electronic funds withdrawal. Have the taxpayers compare the numbers entered on the return to their checks or other account information. If an error is made in the bank information, taxpayers must work with the bank to resolve any misdirected funds.

Summary

Overpayment or amount owed

If the payments made plus refundable credits exceed the amount of tax (after nonrefundable credits), then the amount of the overpayment is entered on the overpaid line in the Refund section of Form 1040. Taxpayers can choose to apply any portion of their overpayment to the following tax year or receive their refund as a check or direct deposit. Direct deposits can be split among as many as three different accounts by using Form 8888.

If total payments are less than the amount of tax owed, then the balance due amount is shown on the applicable line in the Amount You Owe section of Form 1040. Taxpayers are often very anxious if they owe tax on their return. Explain to taxpayers that the tax return should be electronically filed now but that they can delay their payment of taxes up to the April due date of the return.

Take the time to provide the various payment options to taxpayers in this situation. They can pay with an electronic funds withdrawal (direct debit), Direct Pay, credit card, check or money order with Form 1040-V, or cash at a retail partner. They can also download the IRS2Go app to make payments through a mobile device.

Taxpayers who are unable to pay may request an additional 180 days to pay, or complete Form 9465 for an installment agreement. This request can be made with an e-filed return, or by using the Online Payment Agreement feature on IRS.gov for a smaller fee. Interest and penalties are charged on amounts not paid by the due date of the return. There are fees associated with certain payment options.

For direct deposit of the refund or direct debit to pay an amount owed, enter the Routing Transit Number (RTN) and Depositor Account Number (DAN) in the Taxpayer Bank Account Information section of the e-File page. Use a check as proof of account. During the exit interview and before signing the 8879 authorizations to e-file, the taxpayer should place their initials next to the account number on their copy of the return after confirming its correctness.

Estimated tax penalty

If it appears taxpayers may owe an estimated tax penalty, let them know the IRS will calculate the penalty and send a bill. Completion of Form 2210 is out of scope.

Adjusting tax withholding and/or estimated payments

Advise taxpayers who did not have enough tax withheld, or had too much tax withheld, to submit a revised Form W-4 (to their employer), Form W-4P or Form W-4R (to a pension or IRA payer), Form W-4S (to a sick-pay payer), or Form W-4V (to certain governmental payers). Use the Tax Withholding Estimator to calculate the correct withholding amount.

Taxpayers with significant income that is not subject to withholding (such as interest, dividends, capital gains, or self-employment income) may find they need to make estimated tax payments. Use Form 1040-ES, Estimated Tax for Individuals, to compute the amount of estimated tax that should be paid for the next year.

Where to find more information

IRS.gov on underpayment of estimated tax penalty

Pub 505, Tax Withholding and Estimated Tax

Pub 4134, Low Income Taxpayer Clinic List

IRS.gov on Form 656, Offer in Compromise

List of retail partners

What situations are out of scope?

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Form 2210, Underpayment of Estimated Tax by Individuals, Estates, and Trusts
- Offers in Compromise

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: a, True. Direct deposit is safer since there is no check to be lost or stolen.

Answer 2: b, False. Enter the account number from left to right, leaving out all spaces and special characters.

Answer 3: c. The credit card processor covers its costs by assessing a “convenience fee” to taxpayers using this system. Taxpayers will be advised of the amount of this fee when they call the interactive voice response system.

Answer 4: b, False. The tax Dion owes is less than $1,000, so she does not have to pay a penalty.

Completing the Return

Introduction

These are important tasks to accomplish after the tax return is completed, quality reviewed, and ready to be filed. The way that you conclude the interview can impact taxpayers' attitudes toward the taxpaying experience and their satisfaction with the Tax-Aide tax return assistance program. It can also make next year's tax preparation easier for taxpayers and the volunteer who assists them.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 8822 (change of address)
- Form 4868 (extension)
- Form 8332 (release of child's exemption)
- Form 8879 (e-file authorization)
-

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine where to file a return when a taxpayer moves
- Determine when a return should be filed
- Assist with getting an extension of time to file a return
- Assemble the taxpayer's copy of the tax return
- Identify the records the site maintains
- Explain to taxpayers which records they should maintain
- End the interview

What if a taxpayer moves?

Taxpayers who changed their mailing address during the year should notify the IRS of the change on Form 8822, Change of Address, or use their new address when they file a tax return, give an oral notification or signed written statement to the IRS, or update their address with the U.S. Postal Service (USPS).

Taxpayers who move after filing a tax return should fill out and mail Form 8822 to the IRS service center based on the state where their returns were previously filed. The service centers' addresses are listed on page 2 of the form.

Exercises

Answers are at the end of the lesson.

Question 1: Tony, who is due a refund, filed his tax return from his home address in Florida on March 12. On March 30 he was transferred to Puerto Rico. Where should Tony submit his Form 8822, Change of Address?

a. To the IRS service center for Florida
b. To the IRS service center for Puerto Rico
c. Either of the above

When should taxpayers file their returns?

Most individual tax returns cover a calendar year, January through December. Calendar-year taxpayers who live in the United States or Puerto Rico should file their individual tax returns by the April due date of the following year.

If the postal service does not deliver to the taxpayer's street address and the taxpayer has a post office box, enter the post office box number on the line for the present home address.

What are the extension requirements for taxpayers within the U. S.?

Taxpayers can receive extensions of time to file their returns. Different rules apply to taxpayers who live in the U.S. and those who live outside the U.S.

The IRS will charge interest on taxes not paid by the due date, even if an extension of time to file is granted. The only exception is when the combat zone extension applies — see Military Finishing and Filing the Return lesson 32.

How does a taxpayer get an automatic extension?

Taxpayers living in the United States can receive an automatic six-month extension of time to file their federal tax returns.

To get the automatic extension, taxpayers must file Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return, by the due date for their tax return (usually April 15). Calendar year taxpayers who take the extension will have until October 15 to file their tax return.

There are three ways to request an automatic extension of time to file a U.S. individual income tax return:

- e-File Form 4868
- Pay all or part of the estimated income tax due using Direct Pay, Electronic Federal Tax Payment System (EFTPS), or a credit or debit card
- File a paper Form 4868 with payment if needed

See “How to Make a Payment” on page 3 of Form 4868.

What are the extension requirements for taxpayers outside the U.S. and Puerto Rico?

Extension requirements for taxpayers living outside the United States and Puerto Rico differ from those who live inside the U.S. Refer to the Military Finishing and Filing the Return lesson 32 for taxpayers who live outside the United States and Puerto Rico.

Will the taxpayer owe interest and/or penalties?

Form 4868 does not extend the time to pay their taxes. If taxpayers do not pay the amount due by the regular due date, they will owe interest on any amount not paid by the April due date.

In addition, taxpayers 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.

If Form 4868 is filed late, the IRS will inform the taxpayer that the request was denied.

Exercises (continued)

Question 2: True or False? Interest is charged on the balance remaining after the due date of the return.

a. True
b. False

Question 3: Which of the following calendar-year taxpayers can receive an automatic six-month extension?

a. Avery, who filed Form 4868 in February and chose to have the IRS figure his taxes
b. Benton, who filed Form 4868 on April 15 and did not pay any portion of a balance due
c. Calvin, who filed Form 4868 on April 20 and included a tax payment that was over 90% of what he owed
d. None of the above

How does the taxpayer file the return after obtaining a filing extension?

When the tax return is actually filed, any payment that was submitted with Form 4868 should be entered on the applicable line for amounts paid with extension on Form 1040, Sch 3.

What is the third party designee?

For taxpayers who want to allow a friend, family member, or another person to discuss their tax return with the IRS, the "Yes" box of the third party designee area of the return can be checked. You may see this situation in the case of an individual going overseas or elderly parents who wish to have their adult child handle their affairs. You will also need to enter the name, phone number, and any five numbers the designee chooses as their Personal Identification Number (PIN).

You, as a volunteer preparer, must never be designated as a third party designee. See Pub 17 for information on what the taxpayer is authorizing when designating a third party designee.

Rules for filing a return for decedents

A spouse, child, beneficiary, or other personal representative may have to file the final income tax return for the year of death and any returns not filed for preceding years. A surviving spouse may file jointly with the decedent for the year of death as previously discussed if the surviving spouse has not remarried. If anyone other than the surviving spouse is filing the return for a refund, Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, must be filed.

To make a claim, the decedent's representative must file:

- A tax return for each year a tax return has not yet been filed
- Form 1040-X for each year an income tax return has already been filed if an amended return is needed.

If an individual died after the tax year, but before the return for that year was filed, the return for the tax year is not the final return; it is a regular return. The return for the year the taxpayer died will be the final tax return.

Bob died in February 2024. His 2023 tax return – due in April 2024 – is not the final tax return. The final tax return would be the 2024 Form 1040, filed in 2025.

The final tax return is due at the same time the decedent's return would have been due had the death not occurred.

For information on signing a joint return if one spouse has died or cannot sign the return, see Pub 17 Index, keyword: Signatures.

A person claiming a refund for a deceased taxpayer who is not the spouse must file Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer.

What is the global carryforward consent form?

The first consent form in the Tax-Aide Intake Booklet is Form 15080, Consent to Disclose Tax Return Information to VITA/TCE Tax Preparation Sites, also called the global carryforward consent. When the taxpayer consents (both taxpayer and spouse must consent if MFJ), the software will pre-populate the next year's return with information that facilitates completing the next year's return, such as employer information from Forms W-2, payer data from Forms 1099, and capital loss carryforwards. The carryforward information will be available to any VITA/TCE site in the next year only. Signing the consent does not enable any site to access the prior year's return. Only the site that processed the original return has access to the prior year's return.

Preparing the taxpayer's copy of the return

Tax-Aide sites use the TaxSlayer Pro tax software to create and e-file tax returns. Even so, taxpayers must retain copies of their returns. Follow the steps in the NTTC 4012, Tab K, Finishing the Return, to prepare the taxpayer's paper copy. In general:

1. Use tax software to print the entire return, including all forms, schedules, and attachments, including any consent forms the taxpayer may have signed
2. Make sure the taxpayer names and Social Security numbers are correct
3. Assemble the taxpayer's copy:
   - Start with Form 1040 on top
   - Place each form, schedule, and attachment in the proper sequence, based on the sequence number shown in the upper right corner of the form
4. Show the taxpayers the printed copy of the tax return, verifying once more the name, SSN, ITIN, address, filing status, dependents, income, expenses, deductions, credits, payments, and tax refund or balance due

The taxpayer, and spouse if MFJ, must sign the authorization to e-file (Form 8879) before the return can be submitted for e-filing. The signed 8879 is attached to the taxpayer's copy of the return. It is not retained by the site.

Who keeps the records?

What forms should taxpayers keep?

Taxpayers must keep records to support their income and expenses. If they own a home or investments, their records should contain information needed to calculate the basis of the property.

Advise taxpayers to keep a copy of the following documents for at least three years (maybe longer in your state):

- Form 1040 with all forms, schedules, and attachments
- All other tax-related documents, including Forms W-2 and 1099
- If applicable:
  - Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent
  - Power of Attorney
- For e-file returns, a copy of the signed Form 8879, IRS e-file Signature Authorization

You'll use the Tax-Aide Important Tax Records Envelope to place the taxpayer's copy of their return and their supporting documents into that envelope.

Advise taxpayers to bring the tax records envelope to the site next year.

What tax return data will the site keep?

For sites using the desktop version of TaxSlayer, the site will keep the following data confidential and in a secure location until December 31 of the current year:

- A master backup disk containing all electronically transmitted returns.
- A master backup disk containing all electronically transmitted IRC 7216, Consent to Disclose and Consent to Use Notices, and Global Carry Forward Consent.

Sites using the TaxSlayer online version do not need to retain any return data.

The site is no longer required by IRS to retain signed copies of Form 8879 regardless of the software version that is used.

Does the taxpayer have to do anything else?

Give taxpayers a brief explanation of how the e-file process works or what they need to do:

- The Coordinator or designee transmits all the e-file returns.

- Taxpayers who change their mailing address during the year should notify the IRS of the change on Form 8822, Change of Address, use their new address when filing their tax return, send a signed written statement or call, or through updating their address with the U.S. Postal Service (USPS).
- The Coordinator or designee receives an acknowledgment for each successful e-file, or a reject notice if there was a problem with the electronic file. The most common problem is a name or Social Security number that does not match IRS records.
- If the e-file is rejected, the Coordinator or designee will contact the taxpayer to resolve the problem, if necessary.
- If the return is not being e-filed, taxpayers must mail the signed copy of the tax return, along with a copy of all Forms W-2 and any Forms 1099 with withholding. Taxpayers who are filing a state return may need another copy of the return and Forms W-2. Make sure taxpayers know the correct address for mailing the return(s). Advise taxpayers that the return must be postmarked by the April filing due date.

How do I close the contact?

Before seeing taxpayers off:

- Ask taxpayers, “Do you have any questions before you leave?”
- If the taxpayer is expecting a refund, provide instructions about how to check on the refund status at irs.gov “Where’s my Refund?”
- If the taxpayer has a balance due on the current or prior year return, provide information about various payment options and due dates.
- Advise taxpayers how to get answers to questions that may come up later.
- Encourage taxpayers to consider volunteering if they seem interested in learning more about tax preparation. Provide them with contact information or take their contact information, depending on your site’s procedures.
- Ensure that you have the contact information needed to reach taxpayers in case there are any problems with e-filing the return.
- Remind the taxpayer to take all of their tax records with them.
- Thank taxpayers for using the service.

Summary

Properly completing a return, including a good quality review by a second certified volunteer, is essential and required before a return is filed.

Concluding the interview properly ensures that taxpayers have a complete record of the return, understand what will happen next, and know how to get answers to questions that come up later. If you handle the interview well, it can help taxpayers develop a more positive attitude toward the tax experience, which can foster greater accuracy in returns and timeliness in filing.

You should know how to complete and assemble the tax return and how to end the interview. The taxpayers should leave with instructions on:

- Which records the site is maintaining
- Which tax records they should maintain
- The additional action the taxpayer needs to take and the timeline for such action, such as when the return is put on extension

Where to find more information

IRS.gov on good recordkeeping

Pub 17, Your Federal Income Tax

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercises answers

Answer 1: a. Because he already filed his return from his previous address, Tony should submit Form 8822 to the service center for his previous address.

Answer 2: a, True. If the tax is paid after the regular due date, interest is charged from the regular due date to the date the tax is paid.

Answer 3: b. To get the extension, taxpayers must file Form 4868 by the return's due date. They do not have to pay their tax when submitting Form 4868, but they will owe interest on any tax not paid by the due date.

Military Finishing and Filing the Return

If you are pursuing Military certification, continue with this lesson. Otherwise proceed to the next lesson in your training plan. This lesson also contains information for taxpayers living outside the United States.

Introduction

This lesson will help you address special filing concerns of members of the U.S. Armed Forces. To do this you need to determine where and when to file a federal tax return, who qualifies for a deadline extension, and who qualifies for special tax benefits.

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1040 & Instructions
- Form 2848 (power of attorney)
- Form 4868 (extension)
- Form 8822 (change of address)

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify the special tax filing concerns of members of the Armed Forces
- Describe the extensions to file that are available for members of the Armed Forces
- Determine the effect on taxes of being in a combat zone
- Identify the tax forgiveness provisions related to military or terrorist actions

Filing Armed Forces returns

Where should members of the military file their returns?

Members of the Armed Forces should send their federal returns to the service center based on where they currently live. Refer to the Form 1040 Instructions for the appropriate address.

The address may be different depending on whether the taxpayer encloses a payment or if the military member is stationed overseas with an APO or FPO address.

Many military facilities have a Volunteer Income Tax Assistance center that will e-file tax returns.

Sergeant Kane, who is stationed in Maine but whose permanent home address is in California, should send her federal return to the service center for Maine.

When should members of the military file their returns?

Special rules apply to members of the Armed Forces in combat zones as discussed below. All other members of the Armed Forces are subject to the normal rules of when to file a return as discussed in the Completing the Return lesson 31.

What action should be taken when a member of the Armed Forces moves?

Taxpayers who changed their mailing address during the year should notify the IRS of the change on Form 8822, Change of Address, or use their new address when they file a tax return, give an oral notification or signed written statement to the IRS, or update their address with the U.S. Postal Service (USPS).

Taxpayers who move after filing a tax return should fill out and mail Form 8822 to the IRS service center based on the state where their returns were previously filed. The service centers' addresses are listed on page 2 of the form.

What do members of the Armed Forces need to know about getting a refund or having an amount of tax owed on their returns?

Members of the Armed Forces you assist may be entitled to a refund or owe tax. In either case they have several choices on how to get their refund or pay the amount they owe. It is important that volunteers are familiar with those choices to better help taxpayers understand their refund and payment options. This information was covered in the Refund and Amount of Tax Owed lesson 30. Refer to that lesson to review these options.

Extensions – taxpayers outside the U.S. and Puerto Rico and members of the military

Extension requirements for taxpayers living outside the United States and Puerto Rico differ from those who live inside the U.S.

Who qualifies for an automatic two-month extension?

U.S. citizens and resident aliens are allowed an automatic two-month extension to file their return if they are:

- Living outside the U.S. and Puerto Rico on the due date of the return, and their main place of business or assigned post of duty is outside the U.S. and Puerto Rico
- Members of the Armed Forces on duty outside of the U.S. and Puerto Rico on the due date of the tax return

Although calendar-year taxpayers in this situation don't have to file or pay until June 15, they will owe interest charged from the April due date to the date the tax is paid. Form 4868 is not required to obtain this automatic two-month extension to file.

Traveling outside the United States and Puerto Rico on the due date does not qualify the taxpayer for an automatic two-month extension.

What must taxpayers attach to their return?

Taxpayers using the automatic two-month extension must attach a statement to their return stating that they meet the requirements previously discussed in the section "Who qualifies for an automatic two-month extension" above.

What is the extension rule for married taxpayers?

For married taxpayers who file jointly, only one spouse needs to meet the requirements to take advantage of the automatic extension to June 15.

For married taxpayers 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.

How can a taxpayer request an additional extension?

Taxpayers who live outside the U.S. and Puerto Rico and whose main place of business or assigned tour of duty is outside the U.S. and Puerto Rico can also request an additional extension by filing Form 4868 by the automatic extension date of June 15 and checking the "out of the country" and a U.S. citizen or resident box. The due date will then be extended to **October 15**.

Exercises

Answers are at the end of the lesson.

Question 1: Which of the following calendar-year taxpayers has until June 15 to file a tax return? (Select all that apply.)

a. Weston, who files a joint return with his wife, Sheila. She was stationed in the Philippines from January through May, and they paid their taxes by credit card on April 2.

b. Lilly, who lives in Mexico from January through April working for a company, returning to her main business in Texas on May 1.
c. Dwayne, who was stationed in South Korea from July 1 through January 31.
d. None of the above.

Question 2: Pvt. Franklin, a U.S. citizen, is a calendar-year taxpayer. What would the due date be for him to file a return if his assigned tour is in Puerto Rico?

a. April 15
b. June 15
c. June 16

Notifying the IRS about combat zone service

The IRS works with the Department of Defense to identify taxpayers who are serving in a combat zone. This may allow the IRS to suspend compliance actions, such as audits or enforced collections, until 180 days after the taxpayer has left the zone.

Taxpayers qualifying for such combat zone relief may also notify the IRS directly of their status through a special e-mail address: combatzone@irs.gov. They should provide name, stateside address, date of birth, and date of deployment to the combat zone. They should not include any Social Security numbers in an e-mail. This notification may be made by the taxpayer, spouse, or authorized agent or representative.

The IRS cannot provide tax account information by e-mail. The IRS will send responses to any questions about the taxpayer's account by regular mail to the address on record for the person, within two business days. The IRS may provide general answers to questions regarding the status of individual combat zone updates via e-mail.

Tax options for combat zone participants

For members of the Armed Forces serving in a combat zone or qualified hazardous duty area, the deadline for filing tax returns, paying taxes, filing claims for refunds, and taking other actions with the IRS is automatically extended.

The deadline for taking action with the IRS is extended 180 days after the later of:

- The last day in a combat zone/qualified hazardous duty area
- The last day of any continuous hospitalization for injury from service in a combat zone or qualified hazardous duty area

In addition to the 180-day extension, the deadline is also extended by the number of days that were left to take the action with the IRS when the taxpayer entered a combat zone (or began performing qualifying service outside the combat zone). For example, the taxpayer has 3 1/2 months (Jan. 1 - April 15) to file the tax return. Any days left in this period when the taxpayer entered the combat zone (or the entire 3 1/2 months if they entered it before the beginning of the year) are added to the 180 days.

Generally, spouses of individuals who served in a combat zone are entitled to the same deadline extension. There are two exceptions:

- Any tax year beginning more than two years after the date the area ceases to be a combat zone
- Any period the qualifying individual is hospitalized in the U.S. for injuries incurred in a combat zone

In these instances, the extension does not apply to a spouse.

Captain Chloe Maple, a resident of Maryland, entered a combat zone on December 1, 2020. She remained there through March 31, 2022, when she departed for the United States. She wasn't injured and didn't return to the combat zone. The deadlines for filing Captain Maple's 2020, 2021, and 2022 returns are figured as follows:

- *The 2020 tax return. The deadline is February 11, 2023. This deadline is 317 days (180 plus 137) after Captain Maple's last day in the combat zone (March 31, 2022). The 137 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–May 17, 2021).*
- *The 2021 tax return. The deadline is January 13, 2023. The deadline is 288 days (180 plus 108) after Captain Maple's last day in the combat zone (March 31, 2022). The 108 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 18, 2022).*
- *The 2022 tax return. The deadline isn't extended because the 180-day extension period after March 31, 2022, plus the number of days left in the filing period when she entered the combat zone (108) ends on January 13, 2023, which is before the due date for her 2022 return (April 18, 2023).*

Pub 3 provides additional information for combat zone extension of deadlines.

Exercises (continued)

Question 3: If a member of the Armed Forces served in a combat zone from December 30, 2022 through May 31, 2023 and was not injured, the deadline for filing a 2022 tax return would be extended by how many days?

Request or download Pub 3 if you prepare returns at a military site. There are many special provisions that apply to service personnel and this publication is a valuable reference.

Tax options for combat zone participants

Other situations that count as time served in a combat zone or qualified hazardous duty area are:

- Missing status such as missing in action or prisoner of war time counts as time served
- Support personnel including Red Cross, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces
- Hospitalization outside the U.S. and up to five years of hospitalization in the U.S. as a result of an injury while serving in a combat zone or a contingency operation

When can taxes be deferred?

Reservists called to active duty and enlistees in the Armed Forces might qualify for a deferral of taxes owed if they can show that their ability to pay taxes was affected by their military service. The Service Members Civil Relief Act provides this benefit. The act covers active duty members of the military services and commissioned officers of the uniformed services.

What are rules for deferment?

The deferral is not automatic; a taxpayer must apply for it. A taxpayer must have received a notice of tax due, or have an installment agreement with the IRS, before applying for the deferral. When applying, the taxpayer must:

- Be performing military service, and
- Show how the member’s ability to pay the income tax has been materially affected by military service

The IRS will review each request and advise the taxpayer in writing of its decision. The service member will then be allowed up to 180 days after termination or release from military service to pay the tax. If the tax is paid in full by the end of the deferral period, no interest or penalty will be charged for that period.

Can other parties assist with a tax return?

If a taxpayer wants a third party designee to discuss a tax return with the IRS, the "Yes" box in the Third Party Designee area of the return must be checked. Also, the taxpayer must provide the designee's name, phone number, and any five numbers the designee chooses as a personal identification number. **Volunteers may not be named as a "Third Party Designee."**

Form 2848, Power of Attorney and Declaration of Representative, may also be used to grant authority to an individual to represent the taxpayer before the IRS and to receive tax information only when that representative is authorized to practice before the IRS.

Use caution when allowing a representative to sign for someone. See Signatures in the Filing Information chapter in Pub 17 for more information.

If it is not possible to obtain a signature for a joint return from a spouse serving in a combat zone, a signed authorization to act on the taxpayer's behalf can be accepted. The IRS also accepts a written statement explaining that the spouse is serving in a combat zone. The statement must be signed by the spouse who is not serving in a combat zone and attached to the return.

Tax forgiveness for military decedents

Special tax-forgiveness provisions apply to individuals who die:

- While serving in a combat zone, or from wounds, disease, or other injury incurred while serving in a combat zone
- As a result of wounds or injuries incurred in a terrorist or military action while working for the U.S. government

Only the decedent's part of the joint income tax liability is eligible for the refund or tax forgiveness.

The forgiveness applies to:

- The tax year death occurred and
- Any earlier tax year in the period beginning with the year before the year in which the wounds or injury occurred

Any forgiven tax liability that has already been paid, will be refunded.

In addition, any unpaid taxes for years ending before the member began service in a combat zone will be forgiven, and any of those taxes that are paid after the date of death will be refunded.

The tax forgiveness provision also applies to those taxpayers serving outside the combat zone if the service:

- Was in direct support of military operations in the zone and
- Qualified the member for special military pay for duty subject to hostile fire, imminent danger, and/or terrorist actions

Exercises (continued)

Question 4: Army Private Shiloh Kane died in 2024 of wounds incurred in a terrorist attack in 2022. For what tax years are Private Kane's income tax liabilities forgiven?

a. 2021 through 2022
b. 2022 through 2024
c. 2021 through 2024

Rules for filing a return for decedents

The personal representative must file the final income tax return for the year of death and any returns not filed for preceding years. If anyone other than the surviving spouse is filing the return, Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, must be filed. Refer to the Completing the Return lesson 31 regarding rules for returns for decedents.

Summary

This lesson identified special filing concerns for members of the U.S. Armed Forces.

- Members of the Armed Forces should send their federal returns to the service center for where they currently live.
- Most taxpayers who live in the U.S. or Puerto Rico should file their individual tax returns by April 15, unless that date falls on a weekend or holiday.
- Taxpayers who changed their mailing address should notify the IRS of the change on Form 8822, Change of Address, or use their new address when they file a tax return, give an oral notification or signed written statement to the IRS, or update their address with the U.S. Postal Service (USPS).
- The extension rules vary depending on whether the taxpayer lives in the U.S. or outside the U.S.
- The taxpayer, spouse, authorized agent, or representative can notify the IRS about combat zone service by sending an email to combatzone@irs.gov. Social Security numbers should not be included in the email.
- For members of the Armed Forces serving in a combat zone or Qualified Hazardous Duty Area, deadlines for taking action with the IRS are automatically extended until 180 days plus up to 3 1/2 months if the taxpayer entered the combat zone before the beginning of the year from the time the member leaves the combat zone/qualified hazardous duty area.
- 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 U.S.
- The terrorist or military action forgiveness also applies to an individual who is a U.S. employee at death and dies from wounds or injuries incurred in a terrorist or military action regardless of where the action occurred.

Where to find more information

Pub 3, Armed Forces' Tax Guide

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: a. For Weston and Sheila, who file jointly, only one spouse needs to meet the requirements to take advantage of the automatic extension. In scenario B, Lilly does not qualify for the two-month automatic extension since her main place of business is Texas. In scenario C, Dwayne does not qualify for the automatic two-month extension because he was back in the U.S. on the due date.

Answer 2: a. April 15. Taxpayers who live and/or assigned in the U.S. or Puerto Rico should file their individual tax returns by April 15, unless that date falls on a weekend or holiday.

Answer 3: The deadline for filing the 2022 tax return is 180 days plus the number of days remaining for the Armed Forces member to take action after entering the combat zone. The deadline for 2022 is extended for

288 days (180 plus 108) after leaving the combat zone. The 108 additional days are the number of days in the 3-1/2 month filing period that were left when the taxpayer entered the combat zone on December 30 (January 1 - April 18, 2023).

Answer 4: c. His income tax liabilities are forgiven for all tax years from 2021 through 2024

Amended and Prior Year Returns

Introduction

This lesson will help you determine when to amend a federal income tax return regardless of where the original return was prepared. In addition, this lesson provides guidance on preparing prior year returns for the previous three years, provided the taxpayer has the applicable required information. Tax-Aide sites may prepare returns beyond the three previous years if taxpayers have the required information and the preparer and reviewer have certified for those years.

To amend a return, tax preparation software for the year being amended must be used to complete Form 1040-X, Amended U.S. Individual Income Tax Return.

What do I need?

- Tax-Aide Intake Booklet for the year being prepared
- NTTC 4012 for the year being prepared
- Form 1040-X & Instructions (in TaxSlayer for the year being prepared)

Optional:

- Form 8379 (injured spouse)

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify when it is appropriate to prepare an amended return
- Determine the time limits for filing an amended return or a prior year return that claims a refund
- Identify how to assemble and submit a paper-filed amended return or a prior year return
- Provide guidance when preparing prior year returns

When is an amended return needed?

If a taxpayer requests your help in filing an amended return, first confirm the original return is within our scope or that it will be in scope after the amendment. Ask the taxpayer what errors or omissions they wish to correct. Examine the originally filed return, any prior amended returns for that year, and any IRS correspondence carefully to determine if the original return is, in fact, incorrect.

An amended return is not always required when the original return has an error. For example, the IRS will usually correct a math error on a return, or they will write the taxpayer and request a missing schedule or form. In these cases, do not amend the return. If taxpayers receive a notice from the IRS requesting additional information or clarification, tell the taxpayers to provide the requested information to the IRS or refer them to the contact person and telephone number on the notice.

Before preparing an amended return, be sure you have any and all IRS changes to the originally filed return.

Taxpayers should file amended returns using Form 1040-X to correct errors or omissions on a return they have already filed. File an amended return if taxpayers:

- Have more income or less income to report, such as
  - Another Form W-2 or a corrected Form W-2 with new amounts that affect the tax return
  - An additional or corrected Form 1099 with new amounts that affect the tax return
    - For example, interest 1099-INT, dividends 1099-DIV, 1099-K, 1099-NEC, etc.
  - Other income
- Claimed dependents, deductions or credits they should not have claimed
- Did not claim dependents, deductions or credits they could have claimed
- Should have used a different filing status

- Have a change in their tax liability

After the due date of the original return, a taxpayer can change from married filing separately to married filing jointly, but cannot change from married filing jointly to married filing separately. However, an executor may be able to make this change for a deceased spouse. Refer to Pub 17 for more information.

If the federal return has to be amended, often the state return must also be amended.

Two weeks after Bernard's current-year tax return was filed, he received another Form W-2 in the mail. The volunteer tax preparer reviews Bernard's file to be sure the Form W-2 wasn't included on the original return. The volunteer then helps Bernard prepare Form 1040-X to include the additional Form W-2 on the current-year return.

Is an amended return needed for injured spouse situations?

When a joint return is filed and only one spouse owes a past due amount such as child support, an education loan, or prior year's taxes, the spouse who is not obligated for the debt can be considered an "injured spouse." The couple should have filed Form 8379, Injured Spouse Allocation, with their original return. If they did not file Form 8379, and one of them qualifies as an injured spouse, Form 8379 can be filed by itself. An amended return is not required.

However, if the couple is filing Form 1040-X for an additional refund not associated with the original injured spouse claim, and they do not want the injured spouse's portion of the overpayment to be applied to the offset against the spouse, then complete and attach another Form 8379 to Form 1040-X.

How do I start?

To file an amended return, you need a copy of the original return, any subsequent changes, and the information that needs to be changed.

- Begin by researching and verifying the changes requested by the taxpayer to confirm an amended return is needed.
- Use the Tax-Aide Intake Booklet and the NTTC 4012 for the year being amended or prepared.
- Ask probing questions, using the interview techniques and tools discussed in the NTTC 4012, to get all the facts before preparing Form 1040-X.
- Ask taxpayers if they have received any correspondence from the IRS making changes to the original return and all the reasons, they want to amend the return.

When amending a return, it is important to correct all known errors, regardless of whether correcting the error increases or decreases a refund or balance due.

Prior year Tax-Aide Intake Booklets and NTTC Pubs 4012 are available through links in the Portal Library and from NTTC's Useful Tax Prep Links easily accessed from a Tax-Aide laptop computer.

Taxpayers can obtain a free transcript of their original or amended return for the last three years using the IRS2Go phone app or filing Form 4506T or Form 4506T-EZ, Request for Transcript of Tax Return. They can also request a complete copy of their filed return for a charge.

What is Form 1040-X?

Look at the format of Form 1040-X, page 1; there are three columns:

- Column A is used to show the **original** or as **previously adjusted** figures
  - The adjusted figure could be from a previous amendment or maybe the IRS made adjustments to the return as filed

- Column C is used to show the figures that would have been reported on the original return if it had been done correctly
- The differences between the figures in columns A and C are shown in column B (Net change)

In explaining the changes included the amended return, be clear and concise. For example, “taxpayer received another W-2 after they filed original return,” or “taxpayer qualifies to claim child care expenses of $600 for their 10-year-old dependent child on Form 2441,” or “taxpayer meets the qualifications to file as head of household instead of married filing separately.”

Taxpayers can easily check the status of a Form 1040-X, Amended U.S. Individual Income Tax Return, using the Where’s My Amended Return? tool. It’s available in English and Spanish, and tracks the status of the amended return for the current year and up to three prior years.

Time limits to file amended returns for refunds

There is a statute of limitations on refunds being claimed on amended returns. In general, if a refund is expected on an amended return, taxpayers must file the return within three years of the due date of the original return, or within two years after the date they paid the tax, whichever is later. An original return filed before the due date (without regard to extensions) is considered filed on the due date. The three years period for an original return under extension filed before the extended due date begins on the date actually filed.

Robert’s 2022 tax return was due April 18, 2023. He filed it on March 20, 2023. He amends the 2022 return, expecting the correction to result in a refund. If he gets it postmarked on or before April 18, 2026, it will be within the three-year limit, and the return will be accepted. But if the amended 2022 return is postmarked after April 18, 2026, it will fall outside the three-year period and he will not receive the refund.

Alicia filed an extension (Form 4868) for her 2022 tax return and actually filed her 2022 tax return on June 1, 2023. Alicia has until Jun 1, 2026 to amend her return to claim a refund.

Due to COVID and other disaster declarations, the original return filing deadline may have been postponed. Whether a postponement extends the statute is not clear. Taxpayers should not assume that such a postponement extends the time within which to file an amended return claiming a refund.

There are a few exceptions to the three-year limit. For example, a taxpayer has a longer period of time to claim a loss on a bad debt or worthless security, or for a foreign tax credit or deduction. The exceptions are explained in more detail in Pub 17 and the Form 1040-X Instructions. If you think the taxpayer may qualify for an exception to the three-year time limit, their return is out of scope.

Amended returns can be prepared using tax software. However, only the current tax year and two preceding years amended returns can be filed electronically using Form 1040-X.

Amended return with a tax refund

If the amended return indicates the taxpayer is due a refund, be sure to advise that:

- Before filing the amended return, the taxpayer should allow time for the original return to be processed.
- The taxpayer can cash the original refund check, if any, while waiting for any additional refund.
- Interest may be paid on claims not processed within 45 days of the due date of the return.
- Generally, it takes 8-16 weeks to process an amended tax return. However, in some cases, processing could take longer.

Direct deposit is available for electronically filed amended returns.

Amended return with an amount owed

If the amended current year return indicates the taxpayer owes money, file Form 1040-X and instruct the taxpayer to pay the amount by the April due date to avoid interest and penalties. Direct debit and direct deposit are now available on electronically filed amended returns.

Taxpayers who cannot pay the balance in full by the April due date should file their return on time anyway. Encourage taxpayers to pay as much as they can on time, because the IRS will calculate and bill for interest on the amount of tax owed. Refer to the Refund and Amount of Tax Owed lesson 30 for more information on payment options.

Refer taxpayers to IRS.gov/Payments for payment options.

Exercises

Answers are at the end of the lesson.

Question 1: John e-filed his 2020 Form 1040 on March 29, 2021. John found an error on the 2020 return and mailed an amended 2020 return on April 15, 2023. Is this too late to qualify for the refund?

a. Yes
b. No

Question 2: Brenda discovers an error on her 2020 tax return that she filed in March 2021. Correction of this error would result in a refund. She mails an amended return on May 6, 2024. Is this too late for Brenda to claim a refund?

a. Yes
b. No

How do I assemble and submit Form 1040-X?

What should be attached when the return cannot be e-filed?

Remember, Form 1040-X should be prepared using tax software. However, only the current tax year and the immediately preceding two years' can be e-filed. Other years will need to be paper filed. Generally, Form 1040-X is always the lead form. After that, attach any form that reflects the item changed. For example, Form 2441 would be attached if the child and dependent care credit was the subject of the amendment. All W-2s or any 1099 form showing federal tax withheld not previously submitted should be attached.

Print two copies of the federal amended return, Form 1040-X, from the tax software, and if there is a state return, two copies of that form: one for the taxpayers' records and one to mail.

Explain to taxpayers that the IRS will automatically add interest to their refund. If they owe money and are not paying the balance due by the original due date of the return, the IRS will send a bill that will include any interest or penalty amounts.

Who can prepare prior year returns?

The information for a prior year amended return above generally applies to a prior year return being filed late. A Tax-Aide volunteer and reviewer may prepare a prior year return if both have been certified for the year being prepared at the appropriate certification level.

SPEC may be able to support sites that have the resources, motivation, and ability to go back as many years as needed, while maintaining quality standards. Tax-Aide sites are encouraged, but not required to prepare prior year returns only if the tax software is available for that year.

What technical resources are required?

If your site chooses to prepare prior year returns, the Coordinator should be aware of the requirements. The SPEC Relationship Managers and Prior Year Forms and Instructions on IRS.gov are critical resources for administrative and technical resources.

The Partner and Volunteer Resource Page at www.irs.gov/individuals/partner-and-volunteer-resource-center includes hot topics for partners and volunteers.

At a minimum, the following tools are required:

- Prior year tax preparation software
- Reference material, including Pubs 17 and the NTTC 4012 and volunteer quality alerts/volunteer tax alerts at www.irs.gov/individuals/quality-and-taxalerts-for-irs-volunteer-programs.
- The respective year's Tax-Aide Intake Booklet must be completed for each prior year return and will be used to determine the scope of each return.

If your site does not have the necessary tools to prepare prior year returns, seek guidance from your Coordinator.

The Interactive Tax Assistant (ITA) is an online tool that provides consistent answers to many current and prior year tax law questions using a probe and response process. ITA is available on IRS.gov.

How do I file a prior year return?

Tax returns for the two most current prior years can be filed electronically. Older prior year returns must be mailed by taxpayers to the appropriate IRS address listed in the NTTC 4012, Tab P, Partner Resources. Also, see the information about balance due returns in Tab K, Finishing the Return, of the same guide.

Summary

You can help taxpayers prepare amended or prior year tax returns provided your site offers this service. Use the interview process and research tools to prepare accurate amended returns.

Amended returns should be filed to correct any error or omission that is within scope.

Additional notes:

- When a taxpayer does not or cannot opt for direct deposit for a refund on an amended or prior year return, a check is mailed to them.
- If you are amending the federal return, you usually have to amend the state return.
- Volunteers may only prepare returns within Tax-Aide scope and only if the tax issues come within the volunteer's level of training and certification for the year being prepared or amended.
- If a taxpayer requests return preparation assistance for a prior year return, the preparer and reviewer must be certified for that year.

Where to find more information

Pub 17, Your Federal Income Tax

IRS.gov on getting a transcript and types of transcripts

IRS.gov on Form 1040-X, Amended U.S. Individual Income Tax Return

Prior year forms and instructions

What situations are out of scope?

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness.

- Taxpayers who may qualify for an exception to the three-year time limit for filing an amended return for a refund

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.

Exercise answers

Answer 1: b. No, it is not too late. Returns filed before the due date are considered filed on the due date of the return. Therefore, John's amended return was filed within the three-year period allowed for refunds.

Answer 2: a. Yes, it is too late. The postmark must be three years from the due date of the return. The IRS's postponement of the due date for 2020 returns to May 17, 2021 did not extend the statute for amended returns. The IRS will disallow Brenda's amended return requesting a refund because it was filed more than three years after the due date of the original return (without regard to the postponement).

Index

ABLE account
  Distributions, 15-4
ACA. See Premium tax credit
Accrued interest, 8-11
Additional child tax credit, 24-1, 24-3
  Earned income - combat pay, 24-4
  Earned income – MWP, 8-6, 9-7
  Earned income – scholarships, 8-7
Additional taxes, 27-1
  Early distributions, 27-4
  Excess contributions, 27-6
  First-time homebuyer credit repayment, 27-6
  HSA distributions, 27-6
  Required minimum distribution, 27-6
  Roth IRA nonqualified distribution, 11-6
  SIMPLE - SEP, 27-4
Address change, 31-1
Adjusted basis
  Capital gain or loss, 10-3
  Foreclosures, 15-12
  Nondividend distributions, 8-14
  Sale of home, 10-11
Adjusted gross income, 2-1, 17-1
Adjustments to income, 17-1
  Alimony, 17-4
  Early withdrawal penalty, 17-4
  Educator expenses, 17-1
  Health savings accounts, 17-9
  IRA contributions, 17-5
  Jury duty pay, 17-14
  Olympic and other prizes, 17-14
  S-E tax, 17-3
  Self-employed health insurance, 17-3
  Student loan interest, 17-12
  W-2 code H, 17-15
Adopted child
  Foreign born, 7-7
  Qualifying child, 6-3
  Qualifying surviving spouse, 4-8
  Relationship test, 6-7
  Self-employed health insurance, 17-4
Affordable care act. See Premium tax credit
Alimony
  As compensation, 17-6
  Income, 8-15
  Paid, 17-4
Allocated tips, 8-5
  Other taxes, 27-2
Amended return, 33-1
  Attachments, 33-4
  Change filing status, 4-3
  Injured spouse, 33-2
  Time limits to file, 33-3
  When required, 33-1
  Who can prepare, 33-4
American opportunity credit, 22-4
Amount owed, 30-1, 30-4
  Installment agreements, 30-5
  Offer in compromise, 30-5
  Options for payment, 30-4
  Taxpayer cannot pay, 30-4
Annuity
  Loss on termination, 11-16
  Nonqualified, 11-11
Applicable taxpayer, 26-9
ATIN, 3-5
  As a dependent, 7-7
  Credit for other dependent, 24-5
  Foreign born, 7-7
Balance due. *See* Amount owed
Basic Allowance for Housing (BAH), 16-1
Basis
  Home, 10-11
  Other than cost, 10-3
  Stocks, 10-2
  Wash sales, 10-3
Bonds, 10-5
Business expenses, 9-7
  De minimis safe harbor, 9-10
  Inventory small business exception, 9-10
Business income, 9-1
  Expenses, 9-7
  Form 1099-K, 9-6
  Gross receipts, 9-5
  Medicaid waiver payments, 9-6
  Recordkeeping, 9-11
  Scope, 9-2
  What is a business, 9-1
Canadian or German social security, 14-1
Cancellation of debt income
  Credit card, 15-6
  Exclusion - principal residence, 15-10
  Insolvency, 15-7
  Principal residence, 15-9
Capital gain distributions, 8-13
Capital gain or loss, 10-1
  Adjusted basis, 10-3
  Basis, 10-2
  Basis other than cost, 10-3
  Bonds, 10-5

Carryover losses, 10-6
Holding period, 10-4
Sale of home, 10-8
Worthless securities, 10-5
Capital loss carrover, 10-6
Cash method of accounting, 9-2
Certification, 1-2
Charitable contribution deductions, 19-11
Recordkeeping, 19-13
Child / dependent care credit, 21-1
Child tax credit, 24-1
Combat pay
Additional child tax credit, 24-4
Child / dependent care credit, 21-3
EIC, 29-3
Combat zone, 16-3, 16-4
Notification to IRS, 32-3
When to file, 32-3
Credit for other dependents, 24-5
Credits
Additional child, 24-3
American opportunity, 22-4
Child / dependent care, 21-1
Child tax, 24-1
Earned income, 29-1
Education, 22-1
Elderly or disabled, 25-6
Excess Social Security, 28-3
First-time homebuyer, 27-6
Foreign tax credit, 23-1
Lifetime learning, 22-6
Miscellaneous, 25-1
Mortgage interest, 25-7
Other dependents, 24-5
Premium tax credit, 26-1
Prior year overpayment, 28-2
Repayments of income, 28-4
Residential energy, 25-4
Retirement savings contributions, 25-1
Deceased dependent, 6-4
Deceased taxpayer / spouse, 31-3
Decedents, 31-3
Deductions, 19-1
Itemized deductions, 19-4
Qualified business income, 19-16
Standard deduction, 19-2
Dependents, 6-1
Deceased child, 6-4
Divorced or separated parents, 6-9
Multiple support agreements, 6-9
Qualifying child, 6-3
Qualifying child of more than one person, 6-5
Qualifying relative, 6-6
Tests for all, 6-2
Using the NTTC 4012, 6-2
Using the QC/R Tool, 6-2
Who are not dependents, 6-1
Disability pension income, 11-12
Disallowed credit
American opportunity, 22-8
EIC, 29-6
Dividend income, 8-13
Capital gain distributions, 8-13
Patronage dividend, 8-14
Qualified, 8-13
Sec 199A, 8-13
Unrecaptured Sec 1250, 8-14
Divorced or separated parents, 6-9
Due diligence, 1-4
Early distribution additional tax, 27-4
Earned income credit, 29-1
Combat pay, 29-3
Disallowed, 29-6
Election workers, 24-4, 29-3
Medicaid waiver payments, 24-4, 29-3
Penal income, 29-3
Rules for everyone, 29-2
Statutory employee income, 29-3
Strike benefits, 24-4, 29-3
With a qualifying child, 29-4
Without a qualifying child, 29-5
Education credit, 22-1
American Opportunity, 22-4
Disallowed, 22-8
Eligible institution, 22-2
Expenses, 22-2
Lifetime learning, 22-6
Education expenses, 22-2
Education loan repayments, 8-7
Educator expenses, 17-1
Elderly or disabled credits, 25-6
Eligible institution, 22-2
Energy efficient home improvement credit, 25-4
Estimated tax payments, 28-2
Next year, 30-8
Estimated tax penalty, 30-6
Excess contribution withdrawal, 11-15
Exchange rates, 15-18
Extension of time to file, 31-2
Extension payments, 28-3
Federal tax law, 2-1
Filing status, 4-1
Deceased spouse, 4-4
Head of household, 4-5
Married filing jointly, 4-2
Married filing separately, 4-3
Qualifying surviving spouse, 4-7

Single, 4-2
First-time homebuyer credit repayment, 27-6
Foreign currency conversion, 15-18
Foreign income, 15-17
Earned income exclusion, 15-19
Foreign tax, 23-1
Credit on Form 1116, 23-3
Itemized deduction, 19-7
Sanctioned country, 23-5
Form 1099-G
Other state payments, 13-2
State tax refund, 13-1
Unemployment, 13-1
Form W-2, 8-3
Global carryforward consent, 31-3
Head of household, 4-5
Considered unmarried, 4-7
Health savings account
Additional tax on distributions, 27-6
Contributions, 17-9
Deceased owner, 15-4
Distributions, 15-3
Excess contribution, 17-11
Last-month rule, 17-10
Married taxpayers, 17-11
Mistaken distribution, 15-4
Rollovers, 15-4
ICHRA, 26-3
Identity protection PIN (IP PIN), 3-6
Important changes, viii
Income
Business income, 9-1
Dividends, 8-13
Interest income, 8-9
Land rents, 12-2
Military, 16-1
Other income, 15-1
Rental, 16-6
Royalties, 12-2
Schedule K-1, 12-1
State payments 1099-G, 13-1
State tax refund, 13-1
Unemployment, 13-2
Income tax withheld, 28-1
Injured spouse, 4-4
Interest deductions, 19-8
Interest income, 8-9
Bond sold, 8-11
Tax-exempt interest, 8-10
International
Automatic extension, 32-2
Converting foreign currency, 15-18
Foreign income exclusion, 15-19
Foreign tax credit, 23-3
Worldwide income, 15-17
IP PIN. See Identity protection PIN
IRA distribution, 11-5
Excess contribution, 11-15
Qualified charitable distribution, 11-8
Roth IRA, 11-5
Self-certification, 11-7
SIMPLE and SEP, 11-6
Traditional IRA, 11-5
IRAs
Contributions, 17-5
Excess contribution, 17-8
Excess contribution tax, 27-6
Other taxes, 27-4
Itemized deductions, 19-4
Charitable donations, 19-11
Interest, 19-8
Medical, 19-4
Miscellaneous deductions, 19-14
Taxes, 19-6
ITIN, 3-5
No SSN or ITIN, 3-6
Jury duty pay adjustment, 17-14
Kiddie tax, 20-1
Lifetime learning credit, 22-6
Low income taxpayer clinic (LITC), 1-8
Main home
Definition, 10-8
Married filing jointly, 4-2
Married filing separately, 4-3
Community property state, 4-3
Injured spouse, 4-4
Medical deduction, 19-4
Military
Adjustments to income, 18-1
Child / dependent care credit, 21-3
Combat pay, 16-3
Combat pay for EIC, 29-3
Combat zone exclusion, 16-4
Community property state, 16-5
Disability severance pay, 16-2
Extensions, 32-2
Five-year test suspension, 10-13
Homeowners assistance program, 16-2
Income, 16-1
Moving expenses, 18-2
Qualified plan provisions, 18-5
Qualified plan repayments, 16-5
Rental income, 16-6
Reservist expenses, 18-1
Tax deferral, 32-4
Tax forgiveness, 32-5
Where / when to file, 32-1

Miscellaneous deductions, 19-14
Mortgage interest credit, 25-7
Multiple support agreements, 6-9
Nondividend distribution, 8-14
Nonresident alien, 7-1
  Dependents, 7-6
  Filing status options, 7-5
  Resident or nonresident alien decision chart, 7-2
Not a dependent, 6-1
Notary public, S-E tax, 27-2
Other income
  ABLE distribution, 15-4
  Cancellation of debt, 15-6
  Education savings accounts, 15-5
  Election workers, 15-2
  Expense recoveries, 15-6
  Form 1099-K, 15-3
  Gambling, 15-1
  Health savings account, 15-3
  Long-term care benefits, 15-5
  Medicaid waiver payments (MWP), 15-2
  Strike benefits, 15-2
  Worldwide income, 15-17
Other taxes, 27-1
  HSA distributions, 27-6
  IRAs, 27-4
  Qualifed plans, 27-4
  Self-employment tax, 27-1
  Unreported tips, 27-2
Overpayments, 30-1
Penal income, 8-7
  Not earned for EIC, 29-3
Pensions and annuities
  Nonqualified annuity, 11-11
  Substitute From 4852, 11-2
Personal exemptions, 5-1
Points paid, 19-10
Premium tax credit, 26-1
  Coordination with itemized deduction, 19-6
  Household income, 26-5
  Repayment cap, 26-6
  Repayments, 26-6
  Terms to know, 26-9
Prior year returns, 33-1
Public safety employees
  Exception to early distribution tax, 27-5
Public safety officers
  Health insurance premiums, 11-13
Qualfied business income deduction, 19-16
Qualifying child
  As a dependent, 6-3
  Of more than one person, 6-5
Qualifying relative, 6-6
Qualifying surviving spouse, 4-7
Railroad retirement benefits
  Social Security equivalent, 14-1
Refunds, 30-1
  Offsets, 30-3
  Options for an overpayment, 30-1
Rental expenses, 16-7
  Depreciation, 16-9
Rental income
  Land, 12-2
  Losses, 16-12
  Residential, 16-6
  Use by taxpayer, 16-10
Required minimum distribution, 11-14
  Additional tax, 27-6
Reservist expenses, 18-1
Residential energy credits, 25-4
Retirement income, 11-1
  Coronavirus, 11-17
  Disability, 11-12
  Disaster distributions, 11-17
  Early distributions, 11-14
  Emergency expenses, 11-17
  Employer plans, 11-10
  First-time homebuyer, 11-17
  IRA distributions, 11-4
  Loss on termination, 11-16
  Lump-sum distributions, 11-15
  Minimum distribution, 11-14
  Public safety officers, 11-13
  Qualified birth or adoption, 11-16
  Terminally ill, 11-17
  Transfers, rollovers, and conversions, 11-6
  Victim of domestic abuse, 11-17
Retirement savings credit, 25-1
Reverse mortgages, 19-10
Rollovers
  Self-certification, 11-7
Royalty income, 12-2
Sale of home, 10-8
  At a loss, 10-12
  Compute gain or loss, 10-10
  Exclusion, 10-12
  Five year suspension, 10-13
  Ownership and use tests, 10-9
  Surviving spouse, 10-9
  Taxable gain, 10-12
Schedule K-1, 12-1
Scholarship income, 8-7
Scope of service, 2-2
Self-employment tax, 27-1
Social Security income, 14-1
  Canadian or German, 14-1

Lump-sum benefits, 14-3
Social Security number, 3-5
No SSN or ITIN, 3-6
Standard deduction, 19-2
Dependents, 19-3
State tax refund income, 13-1
Statutory employee, 9-3
Earned income for EIC, 29-3
S-E tax, 27-2
Student loan interest, 17-12
Surviving spouse
Sale of main home, 10-10
Tax computation, 20-1
Tax deductions, 19-6
Tax payments
Estimated tax, 28-2
Excess Social Security tax, 28-3
Extension, 28-3
Withholding, 28-1
Tax withheld, 30-7
Taxable and nontaxable income, 8-1
Decedent's income, 8-1
Taxpayer Advocate Service, 1-8
Taxpayer civil rights, 1-7
Taxpayer identification numbers, 3-4
Taxpayer identity, 3-4
Decedents, 3-4
Third party designee, 31-3
Unemployment income, 13-2
Unreported tips, 8-5
Voluntary retirement contribution, definition, 25-1
Volunteer
Certification, 1-2
Legal liability, 1-4
Responsibilities, 1-4
W-2
Substitute Form 4852, 8-3
Wages, 8-3
Disability pension, 8-6, 11-12
Household employees, 8-6
Medicaid waiver payments (MWP), 8-6
Members of the clergy, 8-8
Other wage Income, 8-6
Penal income, 8-7
Scholarship income, 8-7
Tip income, 8-5
When to file, 31-1
Combat zone participants, 32-3
Who must file, 3-1
Who should file, 3-3
Worthless securities, 10-5
Wrongful incarceration award, 8-7

Link & Learn Taxes

Link & Learn Taxes is web-based training designed specifically for VITA/TCE volunteers. Each volunteer's ability to prepare complete and accurate returns is vital to the credibility and integrity of the program. Link & Learn Taxes, as part of the complete volunteer training kit, provides the path to achieving this high level of quality service.

Link & Learn Taxes and Publication 4012, VITA/TCE Volunteer Resource Guide, work together to help volunteers learn and practice.

Link & Learn Taxes for 2024 includes:

- Access to all VITA/TCE courses
- Easy identification of the VITA/TCE courses with the course icons
  - As you progress through a lesson, the content for Basic, Advanced, Military, or International will display, depending on the level of certification you selected
- PowerPoint presentations that can be customized to fit your classroom needs
- VITA/TCE Central to provide centralized access for certification, training materials and reference links
- The Practice Lab
  - Gives volunteers practice with an early version of the IRS-provided tax preparation software
  - Lets volunteers complete sample practice problems
  - Lets volunteers prepare test scenario returns for the test/retest

Go to **https://apps.irs.gov/app/vita/**. You'll find a detailed overview and links to the courses.

FSA (Facilitated Self Assistance) empowers taxpayers to prepare their own returns with the assistance of a certified volunteer. Taxpayers complete their own returns using interview-based software supplied by leaders in the tax preparation industry. Volunteers assist taxpayers with tax law questions.

Virtual VITA/TCE model includes any site where face-to-face activities are not used during the tax preparation process. That is, the intake specialist, IRS-tax law certified preparer (who prepares the return) and/or the quality reviewer are not face-to-face with the taxpayer. By incorporating this flexibility partners can provide taxpayers with more convenient locations to file their taxes.

For more information contact your SPEC Relationship Manager to see if you should start a FSA or Virtual VITA site in your community.

IRS.gov

Your online resource for volunteer and taxpayer assistance

Partner and Volunteer Resource Center
www.irs.gov/Individuals/Partner-and-Volunteer-Resource-Center

- What's Hot!
- Site Coordinator's Corner

Quality and Tax Alerts for IRS Volunteer Programs
www.irs.gov/individuals/quality-and-tax-alerts-for-irs-volunteer-programs

- Volunteer Tax Alerts

Volunteer Training Resources
www.irs.gov/Individuals/Volunteer-Training-Resources

Outreach Connection
www.irs.gov/Individuals/Outreach-Connection

Interactive Tax Assistant (ITA)
www.irs.gov/help/ita

Online Services and Tax Information for Individuals
www.irs.gov/Individuals

Tools & Applications
www.irs.gov

- **Document upload tool**
  https://www.irs.gov/help/irs-document-upload-tool
- **Your account**
  https://www.irs.gov/your-account
- **IRS Free File**
  https://www.irs.gov/irs-free-file-do-your-taxes-for-free
- **Where's My Refund**
  https://www.irs.gov/wheres-my-refund
- **Pay Directly From Your Bank Account**
  https://www.irs.gov/payments/direct-pay
- **Get Your Tax Records**
  https://www.irs.gov/individuals/get-transcript
- **Identity Protection Pin (IP PIN)**
  https://www.irs.gov/identity-theft-fraud-scams/get-an-identity-protection-pin
- **Tax Withholding Estimator**
  https://www.irs.gov/individuals/tax-withholding-estimator
- **Taxpayer Assistance Center Locator**
  https://www.irs.gov/help/contact-your-local-irs-office

eBooks

Want to view our training products on your mobile or tablet devices? Click here to access our eBooks: **www.irs.gov/individuals/site-coordinator-corner**

Mobile App

Another device to use for additional information is IRS2Go. Click here to download IRS2Go mobile app: **www.irs.gov/irs2go**

and much more!

Your direct link to tax information 24/7: **www.irs.gov**