AARP Foundation
Tax-Aide

National Tax Training Committee

NTTC 4491 Tax Training Guide

Tax Year 2025
Release 1

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Director's Letter

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

TAXPAYER SERVICES

October 1, 2025

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.

Richard Rodriguez
Director, Stakeholder Partnerships,
Education and Communication

Important Changes for 2025

Due dates

The due date for filing 2025 individual income tax returns is April 15, 2026.

Estimated tax payment due dates for tax year 2026 are:

1st payment .... April 15, 2026

2nd payment .... June 15, 2026

3rd payment .... Sept. 15, 2026

4th payment .... Jan. 15, 2027

Tax form and publication changes

Refer to NTTC 4012 for guidance.

- Form 1040, U.S. Individual Income Tax Return, new checkboxes or fields for:
  - Combat zone filers
  - Deceased filers with field for date of death
  - Separate line for "other" special processing write-ins
  - Filers whose main home was in the U.S. for more than half of 2025
  - Filers who elect to treat a nonresident alien spouse or dual-status alien spouse as a resident
  - More information on qualifying children and dependents who would qualify the taxpayer to claim the earned income (EIC), child and additional child (ACTC), or other dependents credits
  - Married filing separately (MFS) or head of household (HOH) filers who meet the requirements for the special rule for claiming the EIC
  - Filers who include a child's dividends or capital gains
  - Rollovers, qualified charitable distributions, and public safety officer exclusion from retirement plan distributions
  - The lump-sum election or to affirm that an MFS filer lived apart from their spouse the entire year for Social Security benefits purposes
  - New line 13b for new Schedule 1-A
  - A former spouse's SSN when estimated payments were made
  - Filers who don't want to receive the EIC and ACTC
  - The refundable adoption credit on Line 30
- Schedule 1 (Form 1040), new checkboxes or fields for:
  - Part I, Line 4, other gains: for Forms 4797 and 4684 to replace "F4684" write-in
  - Part I, Line 7, unemployment: checkbox and entry space to replace "Repaid" unemployment write-in
  - Part II, Line 14, moving expenses: checkbox to replace "Storage" write-in that indicates no Form 3903 is required
  - Part II, Line 20, IRA deduction: checkbox to replace "D" write-in for married filing separately and lived apart from spouse all year

- Schedule 1-A (Form 1040) (new) includes certain deductions that are allowed in addition to itemized deductions or the standard deduction.
- Form 1098-VLI, Vehicle Loan Interest Statement: recipient/lenders who receive at least $600 will report interest received and other specifics of vehicle loans. Appears to be required for TY2026, though some lenders may adopt earlier.
- Form 1099-R (retirement income):
  - New box 7 code Y is used for a qualified charitable distribution. It can be used in conjunction with codes 7, 4, or K (code K is out of scope). Use of code Y is optional.
  - Code W is used for charges or payments for purchasing qualified long-term care insurance contracts under combined arrangements.
- Form 5695, Residential Energy Credit, Part II now requires additional qualifying expenditure information.
- IRS addresses for paper returns or payments may have changed. Refer to NTTC 4012 for the latest.

Tax law and other updates

Refer to the respective lesson for details.

- The Treasury Department announced an intent to not issue or receive paper checks after September 30, 2025, with exceptions. [Lesson 30, Refund and Amount of Tax Owed]
- Public Law 118-146 (H.R. 1432), VSO Equal Tax Treatment Act (VETT Act), expands the deductibility of charitable contributions to include all Veterans Services Organizations (VSOs). [Lesson 19, Deductions]
- IRS requires an individual for whom advance premium tax credits (APTC) were paid to file a return to reconcile the APTC when that individual cannot be claimed as a dependent. [Lesson 26, Premium Tax Credit]
- Public Law 119-21, One Big Beautiful Bill Act (OBBBA), made several changes effective for 2025:
  - Reverts to prior filling thresholds for Form 1099-K of $20,000 and 200 transactions and will result in fewer forms being issued
  - Increased standard deductions [Lesson 19, Deductions]
  - Increased cap on itemized state and local tax deductions [Lesson 19, Deductions]
  - New deduction for qualified tip income [Lesson 19, Deductions]
  - New deduction for qualified overtime income [Lesson 19, Deductions]
  - New deduction for qualified new vehicle loan interest [Lesson 19, Deductions]
  - New senior deduction [Lesson 19, Deductions]
  - Redefines qualified education expenses for §529 plans [Lesson 22, Education Benefits]
  - Increased child tax credit [Lesson 24, Child Tax Credit and Credit for Other Dependents]
  - Terminated new and used clean vehicle credits – out of scope
  - Various changes to the eligibility and verification requirements for premium tax credits to be implemented by the health insurance marketplaces
  - A portion of the adoption credit is now refundable – out of scope

  Numerous provisions of the Act are scheduled to take effect in 2026 or later and will be incorporated into our NTTC 4491 when effective.

- Filing Relief for Natural Disasters Act (H.R. 517) allows qualified state-declared disasters to be eligible for filing deadline relief of 120 days (was 60 days) effective for declarations after July 24, 2025 [Lesson 19, Deductions]

Annual inflation adjustments

Exemption amount

The deduction for personal exemptions has been reduced to zero permanently. For 2025, the gross income limitation for a qualifying relative is $5,200 ($150 increase).

Standard deduction

The standard deduction amounts for 2025 are:

- $31,500 – Married filing jointly (MFJ) or qualified surviving spouse (QSS) (increase of $2,300)
- $23,625 – Head of household (HOH) (increase of $1,725)
- $15,750 – Single or married filing separately (MFS) (increase of $1,150)

Taxpayers who are 65 and older or are blind

For 2025, the additional standard deduction amounts for taxpayers who are 65 and older or blind are:

- $2,000 for single or HOH (increase of $50)
- $1,600 for married taxpayers or QSS (increase of $50)

Dependents

For 2025, the standard deduction amount for an individual who may be claimed as a dependent by another taxpayer cannot exceed the greater of (1) $1,350, or (2) the sum of $450 and the individual's earned income.

Qualified retirement plan distributions

For 2025, eligible distributions to victims of domestic abuse that are not subject to the early distribution additional tax is $10,300 (an increase of $300).

Qualified charitable distributions

For 2025, the maximum amount of qualified charitable distributions that are excludible from gross income is $108,000 (an increase of $3,000).

Foreign earned income exclusion

For 2025, the maximum foreign earned income exclusion is $130,000.

Certain expenses of elementary and secondary educators

The amount of the deduction allowed for qualifying expenses by an eligible educator is $300 (no change).

Individual retirement accounts (IRA)

For 2025, the general limitation for combined traditional IRA or Roth IRA contributions is $7,000.

Traditional IRAs

For taxpayers who are covered by a retirement plan at work, the deduction for contributions to a traditional IRA is reduced (phased out) based on the filing status and MAGI:

- MFJ or QSS: MAGI more than $126,000 but less than $146,000
- Single, HOH, or MFS who did not live with the spouse at any time during 2025: MAGI more than $79,000 but less than $89,000
- MFS who lived with the spouse at any time during 2025: MAGI less than $10,000.

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 $236,000 and $246,000.

Roth IRAs

For 2025, maximum Roth IRA contribution phases out based on the filing status and MAGI as follows:

- MFJ or QSS: MAGI between $236,000 and $246,000
- Single, HOH, or MFS who did not live with the spouse at any time in 2025: MAGI between $150,000 and$165,000
- MFS who lived with the spouse at any time during the year: MAGI is between $0 and $10,000

Standard mileage rate

For 2025, the following rates are in effect:

- 70 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 $85,000 ($170,000 for joint returns) and is completely phased out for taxpayers with MAGI of $100,000 or more ($200,000 or more for joint returns).

Health savings account (HSA) contribution

For 2025, the annual contribution limit for HSAs for individuals with self-only coverage is $4,300 (increase of $150) and $8,550 for family coverage (increase of $250).

Long-term care (LTC) 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 2025: (each amount is per person)

- Age 40 or under: $480 (increase of $10)
- Age 41 to 50: $900 (increase of $20)
- Age 51 to 60: $1,800 (increase of $40)
- Age 61 to 70: $4,810 (increase of $100)
- Age 71 and over: $6,020 (increase of $140)

Taxable LTC benefits

For calendar year 2025, gross income includes the amount received under a long-term care policy in excess of the per-diem amount of $420 (increase of $10) or the actual cost of long-term care services, if more.

Qualified business income deduction

For 2025, the threshold amount is $394,600 for MFJ returns and $197,300 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 2025 (increase of $100).

Kiddie tax

To be subject to the kiddie tax, the individual must have unearned income of at least $2,700 in 2025 (increase of $100).

Retirement savings contribution credit

The credit is based on the taxpayer's filing status and MAGI, which must not be more than:

- MFJ: $79,000 (increase of $2,500)
- HOH: $59,250 (increase of $1,875)
- Single, MFS, or QSS: $39,500 (increase of $1,250)

Earned income credit (EIC)

For 2025, the maximum credit is based on the number of qualifying children:

- $8,046 with three or more children
- $7,152 with two children
- $4,328 with one child
- $649 with no children

Earned income and AGI amounts 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:

- $61,555 ($68,675 if MFJ) with three or more qualifying children
- $57,310 ($64,430 if MFJ) with two qualifying children
- $50,434 ($57,554 if MFJ) with one qualifying child
- $19,104 ($26,214 if MFJ) with no qualifying child

Investment Income for EIC

Taxpayers whose investment income is more than $11,950 in 2025 cannot claim the EIC.

Child tax credit/additional child tax credit

The maximum amount of the child tax credit is $2,200 for 2025 (an increase of $200) and the refundable portion of the credit is $1,700 per child for 2025 (no change).

Premium tax credit

Advance Premium Tax Credit (APTC) repayment caps for 2025 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%	$975	$1,950
At least 300% but less than 400%	$1,625	$3,250
400% and above	No cap (full repayment)	No cap (full repayment)

The federal poverty line tables are adjusted for inflation.

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 responsibilities of preparing tax returns.
- 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.

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!

Course structure

First, a word about the icons that you will see throughout this training guide. They are used to emphasize specific types of information that are important for your learning experience:

Caution | Tip | Example | Note | Exercises | Tax Law Application

This training guide supports the Basic, Advanced, Military (optional), and International (optional) certification paths that are available to Tax-Aide Counselors. Material not marked with the following icons is part of the Basic certification:

(A) *Advanced covers all topics that can be present in an in-scope tax return.*

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 any 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 Advanced, 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.

Throughout 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 of 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 NTTC 4012, IRS forms and their instructions, and IRS 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 to properly enter data into the tax software.

- 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 so you can practice with NTTC Workbook exercises during the training.

Certifications

After completing your course of study, 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	Coordinators who do not prepare taxes
Volunteer Standards of Conduct	✓	✓	✓
Intake/Interview and Quality Review	✓	✓	✓
Basic or Advanced Test		✓	
Site Coordinator Test			✓
Military		Optional	
International		Optional	
Foreign Student or Scholar *		Optional	
Puerto Rico *		Optional	

* Training and tests are available separately (see the end of this lesson).

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 for your course of study online. 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 (open-book). Volunteers who prefer to complete the test on paper first, using Form 6744, Volunteer Assistor's Test/Retest, 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 the 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 Basic or Advanced certification test. You do not have to take the Basic Certification test in order to take the Advanced 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.

Preparing tax returns

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 or outside 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 tax 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.

- 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 Tax-Aide 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.

Exercises (Answers are at the end of this lesson.)

Question 1: You have just completed a return for a very grateful taxpayer. They offer to buy you lunch at your favorite restaurant. What should you do?

a. Accept and pick a very expensive restaurant.
b. Accept and pick a restaurant within walking distance.
c. Decline and graciously thank them, explaining that it is not allowed for you to accept the gift.

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 (MFJ)) 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 materials (i.e. NTTC 4012, Pub 17, etc.)
- Seek assistance from a Counselor with more experience
- Seek assistance from your Coordinator
- Research guidance on 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.

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

- *He is 26 years old and his filing status is head of household*
- *He wants to claim his 2-year-old nephew for the earned income credit*
- *He has no childcare expenses*
- *He earned $22,000 in wages*

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

- *Why is the uncle claiming the child and not the parents?*
- *Why aren't there childcare 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?*

EXAMPLE *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 $21,000*

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, stepsons?*
- *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 in the 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.
- Preparing returns that are completely in scope only.
- Preparing returns for which you have been trained and certified only.
- 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.
- Making changes or corrections to a tax return after the taxpayer leaves the site only with the taxpayer's consent and providing them with a corrected copy.

In conclusion, as an IRS-certified volunteer preparer and a member of the Tax-Aide program, 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.

Exercises (continued)

Question 2: The taxpayer, age 55, does not want to include the cash income they received in their business; they want to just report what the Form 1099 shows. Which of the following might you do (select all that apply)?

a. Yell out that the taxpayer is a tax cheat.
b. Emphasize that the tax law requires each taxpayer to report all their income.
c. Confer with your Coordinator to decide whether the tax return should be prepared at your site.
d. Prepare the tax return as the taxpayer wishes.

How to 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.
- Maintain the confidentiality of taxpayer documents, including electronic documents. The tax software provides a Customer Portal that can be used to securely transfer electronic documents in and out with a taxpayer. See NTTC 4012, Tab K.

- The tax software stores the documents for a limited period of time. Print copies of the electronic documents received and put them in the taxpayer's documents envelope for the reviewer and for possible reference in the following year.
- Email is not a secure way to transfer electronic documents and must not be 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 at 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. 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, discuss the matter with your Coordinator. Tax-Aide has an incident reporting process that may be appropriate. 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 the IRS supports. Taxpayers with a disability may request 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 these addresses.

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.

Resources

A tax return is accurate when tax law is applied correctly and it is free from error. The Tax-Aide 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.
- The NTTC has published Gold Standard suggestions for Interviews and Quality review. IRS's Intake/Interview and Quality Review training is in Pub 5101 and the handbook is Pub 5838.
- Adhering to the VITA/TCE Volunteer Standards of Conduct. Ethics Training is in Pub 4961.
- Adhering to Tax-Aide Policy and Procedures, including preparing returns that are in scope only as detailed in the Tax-Aide Scope Manual.
- Tax law training – understanding and applying tax law is the primary role for this Training Guide. 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.
- Tax return preparation using the IRS-provided tax software is addressed in NTTC 4012. 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.
- Local Coordinator training for volunteers acting in this role.

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

You can 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.

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 the hotline at 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.

Summary

Welcome to the Tax-Aide program. Remember:

- 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 role and responsibilities, adhere to the Volunteer Standards of Conduct, Tax-Aide Policy and Procedures, and exercise due diligence.
- Make sure you have the resources and support you need to provide each taxpayer with high-quality service and an accurate tax return.
- 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.

Situations that 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 federal return with an item of income, deduction, or credit that is beyond your certification level
- A state return for which you have not been trained

Where to find more information

NTTC's Gold Standards for Intake & Interview

NTTC's Gold Standards for Quality Review

Tax-Aide Policy and Procedures Manual

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

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

Pub 4299, Privacy, Confidentiality, and Civil Rights

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

Pub 1, Your Rights as a Taxpayer

Foreign student certification: IRS Link & Learn online training and tests, Pub 5876, VITA/TCE Foreign Student and Scholar Volunteer Training Guide, Pub 4011, VITA/TCE Foreign Student and Scholar Volunteer Resource Guide

Puerto Rico certification: IRS Link & Learn online training and test, Pub 4696 (PR), VITA/TCE Puerto Rico Resource Guide

Exercise answers

Answer 1: c, as a Tax-Aide volunteer, you are not allowed to accept compensation, either monetary or in kind.

Answer 2: b, and if the taxpayer insists on not including their cash income, then c. You should always maintain confidentiality by not saying anything personal loud enough that others might hear. You should check with your Coordinator before declining the return. And you should not prepare a return that you believe to be untrue.

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 are contained in the Internal Revenue Code and 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.

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

Gross income

The term "gross income" has a very important definition for federal tax purposes. Gross income is all income or gains received in the form of money, goods, property, and services that is not exempt from tax. It includes income from sources in the U.S. or outside the U.S. for U.S. citizens and residents. Gross income includes gains from, for example, the disposition of securities; gross income does not include losses, for example, from disposition of securities. Gross income does not include gain from the sale of a main home that can be excluded; gross income does include the gain from the sale of a home that is not excluded. Gross income includes the part of Social Security benefits received that is taxable; gross income does not include the part that is not taxable.

Gross income is used as a measuring stick to determine whether an individual is required to file a tax return. It is also used to determine whether an individual can be claimed as a dependent by another taxpayer.

EXAMPLE *Harry earned $25,000 from his job and also received a gift from his father of $5,000. The $25,000 is included in Harry's gross income; the $5,000 is not included in gross income.*

Taxable and nontaxable income

Our federal tax laws provide that some income is specifically taxable and some income is specifically not taxable or tax-exempt.

- 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 not subject to tax as a rule.

Generally, income that is taxable will be reported on a tax form (W-2, 1099, K-1, etc. or a substitute form). The payer is responsible for issuing these forms on a timely basis in accordance with IRS instructions. Taxpayers will receive their tax forms in the U.S. mail or they may have to download them.

However, just because there is no tax form does not mean that it is not taxable. You should ask the taxpayer about all their income or receipts during the tax year (gambling, side job, etc.).

Some receipts, such as gifts and inheritances, are excludible (not taxable) and do not need to be shown on the return.

Some nontaxable income does have to be shown on the return. For example, tax-exempt municipal bond interest income and the full amount of Social Security benefits or retirement income are shown on the return even though none or only a portion is taxable. Only the taxable amounts are included in the income tax computation

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 Pub 525, Taxable and Nontaxable Income.

A related tax law principle deals with expenses that may be deductible. If an expense is incurred to produce tax-exempt income, that expense is not deductible.

Silvia paid a lawyer to sue the other driver and their insurance company after a terrible car accident. She received a large settlement for her medical expenses and pain & suffering. The settlement for personal injury is not taxable. None of the lawyer fees is deductible.

Remember that for any item to be deductible, there must be a tax law provision that allows it.

Earned or unearned income

The classification of income as earned or unearned is significant for federal tax purposes. Earned income may qualify the taxpayer for special benefits, such as the earned income credit. When relevant, a tax provision will have a specific definition of earned income that may differ from the definition for other purposes. Generally,

- **Earned income** is income received for work, such as wages or business/self-employment income.
- **Unearned income** is income not earned from work, such as unemployment income, interest on savings, dividends on stocks, gains on the disposition of investments, or rental income.

This Training Guide will point out relevant definitions, though you don't need to memorize them. The software will follow your entries in reporting the income as earned or unearned. Pay close attention if your taxpayer has income that is specially categorized as discussed here and in NTTC 4012, such as prisoner income.

The Earned Income Table in our NTTC 4012, Tab I, includes examples of earned and unearned income for earned income credit purposes. The tax code may have slightly different definitions for other purposes.

Jesse works as an accounting clerk. His W-2 shows $35,000 of wages. Jesse also earned $800 from his investments. The wages are earned income. The $800 from his investments is unearned income.

Separate property or community property states

A taxpayer who was married at any time during the year and is not filing a joint return with that spouse may need to allocate income between the spouses. Federal tax law follows state law, which governs whether separate or community property rules apply. Any such allocation between spouses can be a difficult legal determination. Check with your Coordinator before attempting such an allocation as the tax return may be out of scope.

Form 8958, Allocation of Tax Amounts Between Certain Individuals in Community Property States, requires Advanced certification.

Decedent's income

Taxpayers receive inheritances including inherited income, such as interest on investments or royalties. When there is no estate, 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 or when there is no tax form, 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).

Irene's mother, Venessa, passed away last year. Irene was her mother's sole beneficiary. The bank sent a 1099-INT to Venessa showing $35 of interest paid on her savings account. Of the $35, $30 was interest earned after Venessa's death but before Irene closed the account. Venessa's final tax return will report $5 of interest (if a return is filed). Irene will report $30 of interest income since she is the rightful owner.

Exercises (Answers are at the end of this lesson.)

Question 1: Interest income from savings accounts and dividends from stocks are examples of unearned income.

a. True
b. False

Adjusted gross income

The next most important term is "adjusted gross income." As you can see in the chart above, AGI is gross income less certain deductions that are allowed to arrive at AGI. We often refer to these deductions as adjustments or above-the-line deductions. Of the many adjustments available in the law, Tax-Aide volunteers are trained only on those adjustments that are most likely to occur in tax returns for low-or-middle-income individuals and tax returns for seniors.

AGI is often used as a measuring stick for other tax purposes. Eligibility for a tax deduction or credit, or the amount thereof, may depend on the amount of AGI. For example, the first 7.5% of medical expenses is not deductible when itemizing deductions. Several tax provisions define a "modified AGI" or MAGI. That is AGI is plus or minus certain items. The MAGI will then be used to determine eligibility or the amount of a tax deduction or credit. For example, a taxpayer's MAGI may limit the amount of a traditional IRA contribution that is deductible or the amount of the retirement savings credit that can be claimed. We will highlight these MAGI definitions for your awareness; but again, the software will generally handle the calculations based on your entries.

Taxable income

AGI is then reduced for specifically allowed deductions to arrive at taxable income, appropriately referred to as "below-the-line deductions." "Taxable income" is another very important term to understand. It does not include any excluded income; it is not reduced by any nondeductible item. Taxable income is the amount that is subject to the income tax.

Taxes, credits, and payments

Our income tax is imposed at progressive tax rates, meaning that lower taxable income is taxed at rates that are lower than the tax rates applied to higher levels of taxable income. Some income will be taxed at preferential rates, such as qualified dividends. Generally, the tax rates used to compute the income 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.

The IRS issues tax tables that are used by most taxpayers to compute their income tax. If not eligible to use the tax tables, taxpayers use the tax rate schedules. Both are updated each year by the IRS for the appropriate inflation adjustments. The software will make the appropriate tax calculation and prepare any worksheets that are needed.

Other taxes may apply, depending on the taxpayer's specific facts. These can include additional taxes on things like a retirement account distribution if taken too early or too late. These other taxes are sometimes referred to as penalties but are in the law as "additional taxes."

Then we get to income tax credits, which can reduce the amount of tax due or even result in a refund. To claim any credit, the taxpayer must satisfy the various rules that apply to the credit.

If a taxpayer prepaid any part of their tax, such as having tax withheld from their paycheck, those prepayments are claimed on the return and reduce the amount of tax that is owed. Taxpayers must generally prepay their net tax liability throughout the year through withholding tax or by making estimated tax payments.

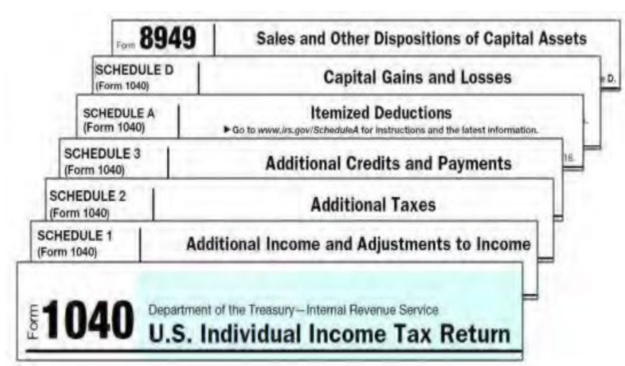
When total taxes exceed total payments and credits, the result is a net tax liability or balance due. When credits and payments exceed total taxes, there is an overpayment. A balance due must be paid on time to avoid interest and possibly penalties. The taxpayer will receive a refund of their overpayment or can apply some or all of an overpayment to their next year's taxes.

Bobbi's tax return shows total tax after nonrefundable credits of $1,750. It also shows $2,200 of taxes withheld. Bobbi has an overpayment of $450 ($2,200 - $1,750) that he can apply to the next year or receive as a refund.

Federal income tax compliance

The U.S. Department of the Treasury, through its IRS enforcement arm, has primary responsibility for enforcing the income tax laws as enacted by the U.S. Congress and the President.

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, tax credits, and payments to arrive at the amount of balance due or overpayment.



IRS provides a great number of tax forms and worksheets with detailed explanations or instructions. IRS also issues "publications" or "pubs" that present a deeper dive into particular topics. These pubs sometimes get very lengthy and very technical. We will refer you to some pubs if you wish to dive deeper into a topic. Generally, though, this NTTC 4491 Training Guide will have all the information you need to certify and prepare the tax returns you may see at your tax site. If, after looking up an item in your NTTC 4012, you do not feel comfortable with a possible issue in a tax return, you will have more experienced Counselors and your Coordinator to help you.

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 Tax-Aide and other 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 taxpayers and 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. Be sure to mark up the Intake Booklet with notes during your interview with the taxpayer. When you think you're done with the return, go back to the Intake Booklet to make additional notes or double check that all items you noted during the interview have been addressed.

Scope of service

This NTTC 4491 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.

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, or 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. If the taxpayer presents any 1099-DA, their tax return is out of scope.

At your tax site, you will refer to our NTTC 4012 often. It will help you determine how to prepare a tax return and, importantly, how to enter items into the tax software so the return is accurate and can be e-filed.

Exercises (continued)

Question 2: All income is taxable if the taxpayer is a U.S. citizen or resident.

a. True
b. False

Question 3: You should use the scope of service as shown in the printed IRS Pub 4012 as your sole guide to determine what is in scope or out of scope.

a. True
b. False

Roadmap

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 **2025** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2025, or other tax year beginning , 2025, ending , 20 See separate instructions.

☐ Filed pursuant to section 301.9100-2 ☐ Combat zone ☐ Deceased MM / DD / YYYY Spouse MM / DD / YYYY — Lessons 3 and 4

☐ Other

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. | Check here if your main home, and your spouse's if filing a joint return, was in the U.S. for more than half of 2025. ☐

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
☐ Married filing jointly (even if only one had income)
☐ Married filing separately (MFS). Enter spouse's SSN above and full name here:
☐ Head of household (HOH)
☐ Qualifying surviving spouse (QSS)
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 2025, 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

Only "No" is in scope

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

	Dependent 1	Dependent 2	Dependent 3	Dependent 4
(1) First name				
(2) Last name				
(3) SSN				
(4) Relationship				
(5) Check if lived with you more than half of 2025	(a) ☐ Yes (b) ☐ And in the U.S.	(a) ☐ Yes (b) ☐ And in the U.S.	(a) ☐ Yes (b) ☐ And in the U.S.	(a) ☐ Yes (b) ☐ And in the U.S.
(6) Check if	☐ Full-time student ☐ Permanently and totally disabled	☐ Full-time student ☐ Permanently and totally disabled	☐ Full-time student ☐ Permanently and totally disabled	☐ Full-time student ☐ Permanently and totally disabled
(7) Credits	☐ Child tax credit ☐ Credit for other dependents	☐ Child tax credit ☐ Credit for other dependents	☐ Child tax credit ☐ Credit for other dependents	☐ Child tax credit ☐ Credit for other dependents

Lesson 6

☐ Check if your filing status is MFS or HOH and you lived apart from your spouse for the last 6 months of 2025, or you are legally separated according to your state law under a written separation agreement or a decree of separate maintenance and you did not live in the same household as your spouse at the end of 2025.

Lessons 4 and 29

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 31 . . . 1f
g Wages from Form 8919, line 6 . . . 1g
h Other earned income (see instructions). Enter type and amount: 1h
i Nontaxable combat pay election (see instructions) . . . 1i
z Add lines 1a through 1h . . . 1z

Attach Sch. B if required.

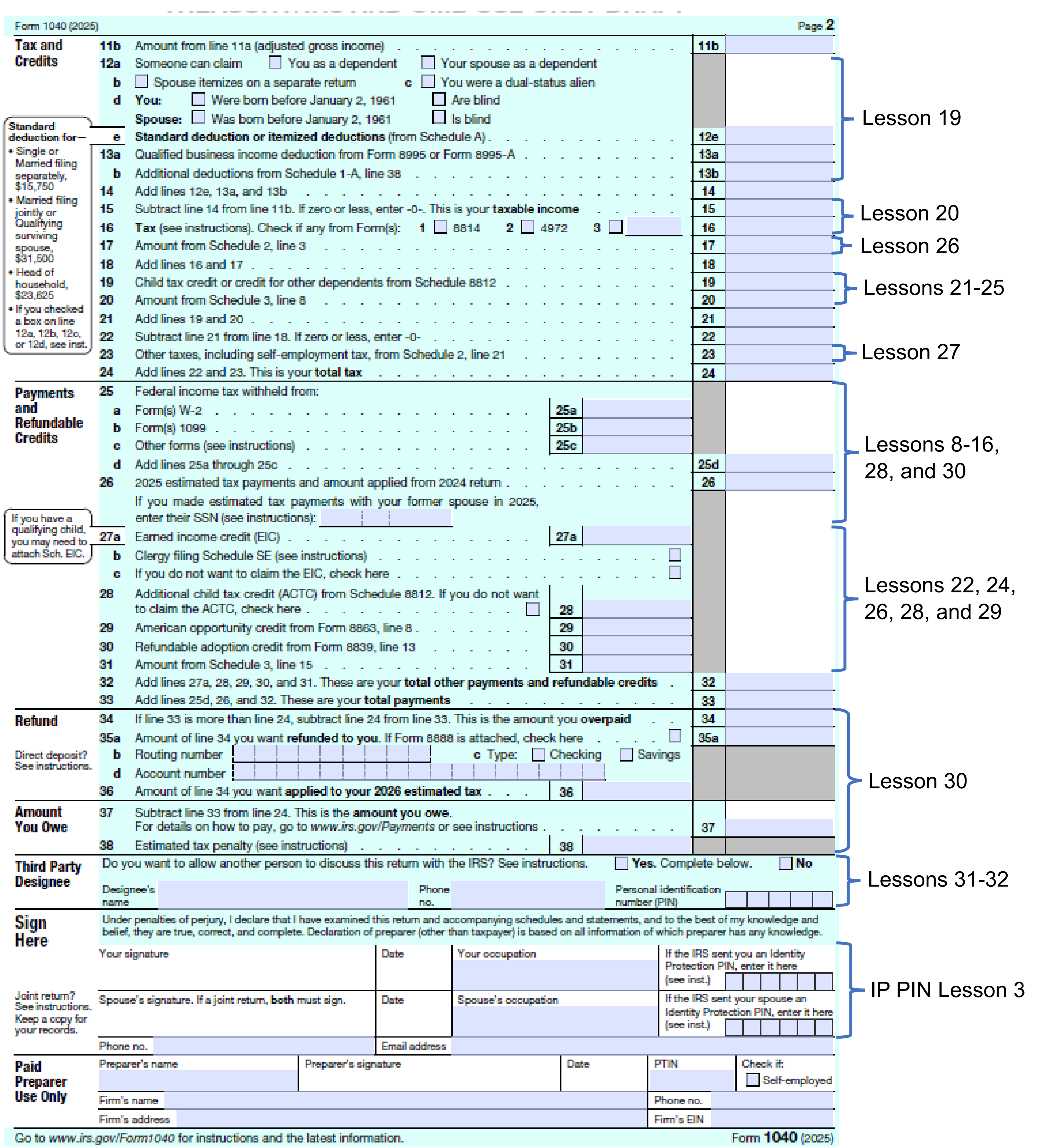
2a Tax-exempt interest . . 2a | b Taxable interest . . . 2b
3a Qualified dividends . . 3a | b Ordinary dividends . . . 3b
c Check if your child's dividends are included in 1 ☐ Line 3a 2 ☐ Line 3b
4a IRA distributions . . 4a | b Taxable amount . . . 4b
c Check if (see instructions) . . . 1 ☐ Rollover 2 ☐ QCD 3 ☐
5a Pensions and annuities . . 5a | b Taxable amount . . . 5b
c Check if (see instructions) . . . 1 ☐ Rollover 2 ☐ PSO 3 ☐
6a Social security benefits . . 6a | b Taxable amount . . . 6b
c If you elect to use the lump-sum election method, check here (see instructions) . . . ☐
d If you are married filing separately and lived apart from your spouse the entire year (see inst.), check here ☐
7a Capital gain or (loss). Attach Schedule D if required . . . 7a
b Check if: ☐ Schedule D not required ☐ Includes child's capital gain or (loss)
8 Additional income from Schedule 1, line 10 . . . 8

Lessons 8 through16

9 Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7a, and 8. This is your **total income** . . . 9
10 Adjustments to income from Schedule 1, line 26 . . . 10
11a Subtract line 10 from line 9. This is your **adjusted gross income** . . . 11a

Lessons 17and 18

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2025) Created 9/5/25



Form 1040 (2025) Page **2**

Tax and Credits

11b Amount from line 11a (adjusted gross income) . . . 11b

12a Someone can claim ☐ You as a dependent ☐ Your spouse as a dependent

b ☐ Spouse itemizes on a separate return c ☐ You were a dual-status alien

d **You:** ☐ Were born before January 2, 1961 ☐ Are blind

Spouse: ☐ Was born before January 2, 1961 ☐ Is blind

e **Standard deduction or itemized deductions** (from Schedule A) . . . 12e

13a Qualified business income deduction from Form 8995 or Form 8995-A . . . 13a

b Additional deductions from Schedule 1-A, line 38 . . . 13b

14 Add lines 12e, 13a, and 13b . . . 14

15 Subtract line 14 from line 11b. If zero or less, enter -0-. This is your **taxable income** . . . 15

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

Standard deduction for—
- Single or Married filing separately, $15,750
- Married filing jointly or Qualifying surviving spouse, $31,500
- Head of household, $23,625
- If you checked a box on line 12a, 12b, 12c, or 12d, see inst.

Payments and Refundable Credits

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

26 2025 estimated tax payments and amount applied from 2024 return . . . 26

If you made estimated tax payments with your former spouse in 2025, enter their SSN (see instructions):

27a Earned income credit (EIC) . . . 27a

b Clergy filing Schedule SE (see instructions) . . . ☐

c If you do not want to claim the EIC, check here . . . ☐

If you have a qualifying child, you may need to attach Sch. EIC.

28 Additional child tax credit (ACTC) from Schedule 8812. If you do not want to claim the ACTC, check here . . . ☐ 28

29 American opportunity credit from Form 8863, line 8 . . . 29

30 Refundable adoption credit from Form 8839, line 13 . . . 30

31 Amount from Schedule 3, line 15 . . . 31

32 Add lines 27a, 28, 29, 30, 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

b Routing number c Type: ☐ Checking ☐ Savings

d Account number

36 Amount of line 34 you want **applied to your 2026 estimated tax** . . . 36

Direct deposit? See instructions.

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.)

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

Joint return? See instructions. Keep a copy for your records.

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** (2025)

Summary

You now have a general understanding of how the income tax laws work and how an income tax return is structured. You also learned how to differentiate taxable income from nontaxable income and earned income from unearned income.

- Taxable income is usually reported on a tax form. Tax exempt income may have to be shown on the return, but it will not be taxed.

- Generally, earned income is income received for work, such as wages or business/self-employment income.
- Generally, unearned income is income produced by investments, such as interest on savings, dividends on stocks, or rental income.

Taxpayers must report all their taxable income, including income that has been erroneously reported to another individual, such as a decedent, if the taxpayer is the rightful owner of the income.

The lessons in this NTTC 4491 Training Guide will cover the tax law regarding 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.

Guidance on preparation of tax returns is covered by our NTTC 4012, including software how-to's.

Situations that 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
- Preparing an MFS or HOH tax return for a taxpayer in a community property state when income splitting is required if so specified for your state

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

Exercise answers

Answer 1: a, True.

Answer 2: b, false. Not all income is taxable. Refer to the chart in NTTC 4012 Tab D.

Answer 3: b, false. Tax-Aide scope varies from the general VITA/TCE scope. You should refer to the NTTC 4012 and the Tax-Aide Scope Manual to determine if an item is in or out of scope. Even if it is in scope, if you have not been trained in the particular topic and cannot comfortably research the issue, the item is out of scope for you. Check with a more experienced Counselor or your Coordinator for guidance.

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
- Qualifying Child or Relative Resource Tool
- 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:

- Age
- Gross income
- Filing status

There are special rules for dependents and surviving spouses. The special rules for U.S. citizens and residents living outside the U.S., residents of Puerto Rico, and individuals with income from U.S. possessions are covered by the International or Puerto Rico certification materials.

The taxpayer's age

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

The taxpayer's gross income

An approximation of gross income is enough to determine whether or not to prepare 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.

We'll go through the various types of income in lessons 8 through 16. You can also refer to the Income tab of the NTTC 4012 where you'll find a list of the sources of income that should be included or excluded in determining a person's gross income.

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.

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.

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 Qualifying Child or Relative Resource Tool (QC/R Tool) to determine if the taxpayer can claim a dependent or a more favorable filing status without a dependent. The Determination of Filing Status – Decision Tree on the last page of the QC/R Tool can also be used after you have determined whether the taxpayer has a dependent.

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. Note that the filing threshold is generally equal to the standard deduction as shown in the Important Changes lesson; individuals filing MFS have a minimal $5 threshold.

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.

An individual who can be claimed as a dependent by another taxpayer has to compute their standard deduction to determine whether they are required to file a return. See Lesson 19, Deductions.

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 Sch C profits of $400 or more.
- Taxpayers for whom advanced payments of the premium tax credit (APTC) were made for themselves, their spouse if filing MFJ, or their dependent.
- Taxpayers who owe special taxes – discussed later in Lesson 27, Other Taxes.

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 (Answers are at the end of this lesson.)

Refer to the Who Must File section of the NTTC 4012 to answer these questions.

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?

c. Yes
d. 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 qualifying surviving spouse. She is 47 years old. Her gross income was $35,000. 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:

The taxpayer could claim	What to look for
A refund of withheld taxes or estimated taxes paid in	Federal or state income tax was withheld on any income form or the taxpayer made estimated tax payments
The earned income credit	The taxpayer had earned income
The additional child tax credit	The taxpayer has a qualifying child
The American opportunity credit	The taxpayer or their dependent paid higher education expenses
The premium tax credit	The taxpayer purchased health coverage through the marketplace.

Sometimes, it is not obvious that a deduction, credit, or favorable filing status is available to the taxpayer, especially when the taxpayer is not able to claim a dependent but can still claim the deduction, credit, or favorable filing status. By using the Qualifying Child or Relative Resource Tool, you will find all the benefits that a taxpayer can claim.

EXAMPLE

Jack lives with his disabled brother, Bill, and earned $15,000 from his job. Bill receives disability benefits that are used to pay more than 50% of his support. Using the QC/R Tool, you conclude that Jack cannot claim Bill as his dependent; however, Bill is Jack's qualifying child for the earned income credit. You will add Bill to Jack's return and indicate that he is disabled but is not a dependent.

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 $0 AGI return cannot be e-filed so you need to add $1 as interest income. Also, individuals who are not required to file a federal return may benefit by filing for state purposes.

Verify the taxpayer's 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.

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 and 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 they cannot, their return is out of scope.

Deceased taxpayers

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.

If you are unsure, check with a more experienced Counselor or your Coordinator. You will find more information about tax returns for decedents and their surviving spouse (if any) throughout this guide.

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)

Social Security numbers

Any individual who is legally eligible for employment in the United States must have an 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 an 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.

Individual taxpayer identification numbers (ITIN)

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.

An 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.

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.

Adoption taxpayer identification numbers (ATIN)

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.

Acceptable documents if the taxpayer does not have their Social Security card

For individuals who do not bring their original or a copy of their Social Security card, you may accept one 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.

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.

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 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 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.

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 a 6-digit Identity Protection Personal Identification Number (IP PIN). Every December, the IRS mails Notice CP01A to taxpayers previously identified as identity theft victims. The notice includes a new IP PIN to be entered on any income tax return that the taxpayer files (until they receive the next year's IP PIN). Taxpayers are mailed Notice CP01A every year as long as the identity theft indicator remains on their account (3 years or more).

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 each year. No letter is sent to them and IRS will not send mail them the IP PIN if they call and ask for it.

Since a new IP PIN is issued each year, do not use an IP PIN from a prior year. Always 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 on IRS.gov 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.

As a last option, the return can be paper filed without the IP PIN. Processing will be delayed. Refer to Tab P, Partner Resources, in the NTTC 4012, for further information and guidance.

IRS's 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.

Return preparation

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

All returns are filed electronically 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 last page of the NTTC 4012. Your Coordinator and fellow volunteers are also good resources.

Due diligence

As discussed in Lesson 1, Course Introduction, you should do your part to assure that a tax return is accurate and free from fraud:

Be alert to the following possible indications of fraudulent activity:

- 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

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, Tab A, Who Must File section.

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.

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.

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

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.

Situations that 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.

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.

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

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. You can also refer to 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.

Start with marital 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.

A marriage of two individuals is recognized for federal tax purposes if the marriage is recognized by the state or territory of the United States in which the marriage is entered into, regardless of legal residence. Two individuals who enter into a relationship that is denominated as marriage under the laws of a foreign jurisdiction or an American Indian tribe are recognized as married for federal tax purposes if the relationship would be recognized as marriage under the laws of at least one state or territory of the United States, regardless of legal residence. Individuals who have entered into a registered domestic partnership, civil union, or other similar relationship that isn't denominated as a marriage under the law of the state or territory of the United States where such relationship was entered into aren't lawfully married for federal tax purposes, regardless of legal residence.

Requirements for each filing status

Single filing status

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.

Other possible status for single taxpayers

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.

Married filing jointly (MFJ) filing status

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 MFJ 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 amend their return to file separate returns for that year after the due date of the return. See Lesson 33, Amended and Prior Years Returns 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 Lesson 7, Unique Filing Situations.

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.

Responsibility and liability of filing MFJ

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.

Married filing separately (MFS) filing status

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

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

Married taxpayers who file 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. (Amended returns will be covered in Lesson 33.)

Spouse died during the tax year

As noted above, a taxpayer whose spouse died during the tax year is 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.

A surviving spouse who remarried during the year must file with the new spouse, either jointly or separately. The deceased spouse's filing status becomes married filing separately.

Other possible filing status for a married taxpayer

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 (discussed below), which may result in a lower tax than married filing separately.

Drawbacks of filing MFS

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.

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.

We will highlight whenever the MFS status disqualifies a taxpayer for a particular tax benefit throughout this Training Guide.

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 Alaska, 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 are out of scope. The issues occur when either spouse was domiciled in a community property state. Your Instructor or Coordinator will let you know the limitations that apply to tax returns prepared at your site. If in scope, the return will need to include Form 8958 to show the allocation between the two spouses.

Why file separately if married

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 return to elect filing jointly — any additional refund will likely be offset, but the outstanding debt causing the offset will be reduced.

(A) ***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.

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.

Qualified surviving spouse (QSS) filing status

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 QSS 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 rates are the same for QSS and MFJ 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.

Head of household (HOH) filing status

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 – discussed in Lesson 6 - Dependents).

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

Cost 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.

EXAMPLE *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.*

EXAMPLE *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.

Qualifying person for HOH 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 Lesson 6, Dependents, 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.

EXAMPLE *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.*

EXAMPLE *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 this 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.

Advantages of filing as HOH

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

Considered unmarried for HOH

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 Lesson 6, Dependents.

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. See Lesson 7, Unique Filing Situations lesson 7 for more information.

The correct filing status

To determine the correct filing status, use your QC/R Tool during the interview with the taxpayer (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 answers.

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 he 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 all their 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
- Qualifying surviving spouse
- Head of household

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.

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.

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. The taxpayer's dependent parent may be a qualifying person for HOH status even if the parent does not live with the taxpayer.

Situations that 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)

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

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 permanently set at zero. 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

Exemptions basics

Historically, an **exemption** was a dollar amount that could have been deducted from an individual's total income, thereby reducing the taxable income. As a result of OBBBA, the dollar amounts for personal and dependency exemptions are permanently set at zero. Even though there will not be a deduction shown on the return, whether a taxpayer could claim the exemption is still relevant for other purposes of the tax law, which still reference exemptions.

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

Personal exemption

To claim a personal exemption, the taxpayer must be able to answer "no" to question "Can anyone else claim you 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 Lesson 19, Deductions for more information on this topic.

The next lesson will cover who is and who is not a dependent.

Dependency exemption

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

Senior personal exemption deduction

Although the Code provides for this new temporary deduction as an exemption deduction, IRS refers to it as the "enhanced deduction for seniors." Discussion of this new deduction is included in Lesson 19, Deductions to follow IRS's Sch 1-A.

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.

Volunteer Says…	Ray Responds…
And you were under age 24 at the end of the tax year and a full-time student?	That's right.
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, including a new senior personal exemption
- Dependency

If a taxpayer can be claimed as a dependent on another taxpayer's return, you need to 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, the taxpayer should answer "no" to "can anyone else claim you 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.

Situations that 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 taxpayers who cannot provide sufficient information to determine whether they can be claimed as a dependent

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. Examples of tax benefits that are associated with having a dependent include the child tax credit, additional child tax credit, credit for other dependents, earned income credit, child and dependent care credit, and head of household filing status.

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 qualifying child (QC) dependent or qualifying relative (QR) 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 QC or QR dependent

Who are dependents

Dependents are either a qualifying child or a qualifying relative of a taxpayer. A 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

To be a classified as a dependent, the individual must be a QC or QR of a **taxpayer**. An individual is not a dependent of a person if that person is not a **taxpayer**. To be a **taxpayer**, the person must be required to file an income tax return. If 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, they are not a taxpayer and the individual is not a dependent.

A person who wants to claim a benefit (such as the earned income credit), must file a tax return. So even if initially they were not required to file a return, once they choose to file a return (that is more than claiming a refund of taxes paid in or withheld), they are a taxpayer.

EXAMPLE

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.

Tools for 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.

Using 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).

In the case of a multi-generational household (such as grandparents, parents, and children), start with the in-between generation (the parents). Then proceed to the grandparents.

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.

You will have the QC/R Tool at your site, either in print or digitally through a link on your Tax-Aide computer. Be sure to refer to it to confirm the taxpayer's ability to claim a dependent and the tax benefits that they may claim, especially when a taxpayer's situation changes.

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.

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.

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.

While Tab C will help you determine if an individual can be claimed as a dependent, it does not identify when an individual who is not a dependent might qualify the taxpayer for a tax benefit. We strongly recommend using the QC/R Tool — it will identify all the tax benefits that can be claimed with respect to an individual who is not a dependent.

Tests that 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 the question: "Can anyone else claim you or your spouse on their tax return." If the answer is yes, the taxpayer cannot claim a dependent. However, the taxpayer can use the person as a qualifying child for the benefits detailed in Block C of the QC/R Tool. Be sure to enter the nondependent's information in the software.

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, the answer should be "no" to the question on the 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.

Your child and your child's spouse had wages of $4,000 from part-time jobs. They lived with you all year and you provided more than half of their support. They file a joint return only to get a refund of withheld taxes. You can claim each of them as a dependent if the other tests are met.

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 Lesson 19, Deductions.

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.

Tests for a qualifying child dependent

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. 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.
  - 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.
- 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.

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 (including juvenile facilities).

Jonas was in a horrible accident and spend over 10 months in the hospital and rehab facilities. Jonas is treated as temporarily absent for determining if he lived with his son for the residency test.

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 child was alive. This exception applies equally to an individual who is not a child, such as a disabled adult brother.

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 with the birth certificate, death certificate or hospital record included.

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

An adopted child or foster child meets the residency test if the child was adopted during the year, the child was lawfully placed for legal adoption during the year, or the child was an eligible foster child during the year. The child is considered to have lived with the taxpayer for more than half of the year if the taxpayer's main home was this child's main home for more than half the time since the child was adopted or placed with the taxpayer.

There is also an exception for a child who was kidnapped during the year, as long as the other dependency tests are met. Refer to Pub 501 for the requirements for a kidnapped child.

Because of the residency test, a child is initially 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. 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.

The support test for a qualifying child is different from the support test for a qualifying relative.

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 (that is, the scholarship is disregarded, as are the expenses paid with the scholarship).

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 all the following tax benefits.

- 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

This all-or-nothing rule does not apply if the special rule for children of divorced or separated parents or parents who live apart discussed below applies.

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.

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 of them 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.

EXAMPLE

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 above, if Dorothy otherwise 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's parent.

EXAMPLE

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.

EXAMPLE

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.

Tests for a qualifying relative dependent

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.

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.

Recall that an individual who is not a dependent as described in the first page of this lesson is not a dependent for any purpose. So even if the individual could be a qualifying child, they are not a qualifying child if they are not a dependent.

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.

In this example, assume instead that Ann files a return to claim the earned income credit (with or without Bobby as her qualifying child). Bobby no longer meets the "not a dependent" requirements. 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 this lesson.)

Question 1: All the facts are the same as in the previous example concerning Todd and Eva, 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 the 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 another 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. Ted's parents meet the relationship part of 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, institutionalized care for a child who is permanently and totally disabled, incarceration (including juvenile facilities), and placement in a nursing home to receive constant medical care.
- 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 qualifying relative dependent's gross income for the tax year must be less than the threshold amount as shown in the Important Changes lesson. Gross income was defined in Lesson 2, Introduction to Federal Tax Law, and is all income in the form of money, property, and services that is not exempt from tax. Remember this gross income test applies only to qualifying relative dependents, it does not apply to a qualifying child dependent.

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 qualifying 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, or loans). Refer to the Worksheet for Determining Support in the NTTC 4012, Tab C, Dependents.

EXAMPLE *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.*

EXAMPLE *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 each provide more than 10% of the person's total support and collectively provide more than 50% of the person's total support (and who meet the other tests for a qualifying relative), can agree which 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.

A person claimed as a dependent only because of a multiple support agreement is not 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, because of the residency test, 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 a decree of divorce or separate maintenance;
   - are separated under a written separation agreement; or
   - lived apart at all times during the last six months of the 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. 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.

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).

EXAMPLE *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.

The noncustodial parent is the one who is not, or is deemed to not be, 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.

EXAMPLE *When Troy turned age 18 in May, he became emancipated under the laws 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.*

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?

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.

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.

Step1: Elaine's son (it's best to start with the middle generation)

Use the QC/R Tool* to apply the tests to Elaine's son.

Step 2: Elaine's granddaughter

Use the QC/R Tool* to apply the tests to Elaine's granddaughter.

Dependent/Nondependent Determinations

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.

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.

* Or if using the NTTC 4012, use the tables in Tab C, Dependents.

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.

Situations that 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 the identity of a dependent

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 the higher adjusted gross income.

Unique Filing Situations

Introduction

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1040-NR

This lesson addresses some filing status issues you may encounter when helping taxpayers who are not U.S. citizens.

This lesson also covers dependency 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 are 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 for tax purposes
- 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

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.

The interview

A good interview is critical for accurate tax returns. Too often, the citizenship question is overlooked. When the taxpayer or spouse indicates that they are not a citizen or if they indicate a possible dependent is not a citizen, you need to stop and determine whether each is resident for tax purposes. Further, if they are resident, you need to determine whether they are resident for the entire year or for part of the year only.

First start with the taxpayer and spouse. You many quickly realize that the tax return is in scope because both are permanent residents and have been in the past. Then, determine the status of possible dependents who are not U.S. citizens.

On the other hand, if you find that the resident status of the taxpayer or the spouse is not clear, additional information is needed to determine the tax status of each. That is covered in this lesson.

These can be complicated determinations and you may ask that the taxpayer be re-assigned to a more experienced Counselor.

Resident Aliens

Resident aliens and U.S. citizens must report worldwide income on their Form 1040. Most tax rules that apply to a U.S. citizen will also apply to the resident alien, including filing status and dependent issues.

An individual is a resident alien of the United States for tax purposes if they meet either the green card test or the substantial presence test for tax year. Even if they do not meet either of these tests, they may be able to choose to be treated as a U.S. resident for part or all of the year. Filing a tax return as a resident alien does not affect the person's immigration status in any way.

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 must still follow the tax rules for married persons.

Nonresident aliens

Nonresident aliens are individuals who not resident aliens. Examples include students, teachers, trainees, or undocumented immigrants who do not meet the green card test, the substantial presence test, or have a special provision the treats them as nonresident. Your role is to determine if the nonresident alien can be treated as a resident alien for tax purposes.

A person who appears to be resident may instead be treated as nonresident under certain circumstances or under a treaty. These situations are described in Pub 519, U.S. Tax Guide for Aliens, and are out of scope.

Nonresident aliens may have a filing requirement using Form 1040-NR in certain situations and are out of scope, except for foreign students or scholars if the preparer and reviewer have the required certification.

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:

- Permanent resident or green card test
- Substantial presence test

Permanent resident or 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. Most green card holders have valid Social Security numbers and must follow the same tax laws as U.S. citizens.

Green cards are approximately the size of driver licenses. Some prior versions may not be green in color but still hold the name.

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.

An individual is a resident for tax purposes if they meet the substantial presence test for the tax year. To meet this test, the individual must be physically present in the United States on at least:

1. 31 days during current tax year; and
2. 183 days during the 3-year period that includes the current tax year and the two preceding years counting the days that the individual was present in the U.S.:
   a. All the days in the U.S. in the current year
   b. 1/3 of the days in the U.S. in the immediately preceding year, and
   c. 1/6 of the days in the U.S., in the year two years ago.

The term "United States" includes the following areas.

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

The term does not include U.S. territories or U.S. airspace.

Use the charts and trees in the NTTC 4012, Tab L, Resident/NR Aliens, to determine an individual's residency status for tax purposes. The detail information found in Pub 519 must be consulted for the first year and last year of presence in the U.S.

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. Also, do not count days the person is an exempt individual. The full list of exceptions and an explanation of each can be found in Pub 519.

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.

Generally, exempt individual 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. Tax returns for individuals wishing to utilize treaty provisions are out of scope.

All persons listed on the return must have either a Social Security number or an individual tax identification number (ITIN). 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, their 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

Dual-status aliens

An individual 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. Aliens who have dual status may need to file both a Form 1040 for the period of residency and Form 1040-NR for the period they are nonresidents.

Refer to the footnotes in the charts and trees in the NTTC 4012 and Pub 519 to determine when an individual begins being a U.S. tax resident or when they end being a U.S. tax resident.

On their Tax-Aide Intake Booklet, Gail indicated that her husband, Alexi, is not a U.S. citizen. During the interview, you learn that Alexi 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 chart in Tab L of NTTC 4012, we can determine whether Alexi is a resident alien under the substantial presence test for the tax year.

The calculation is: current tax year: 150 days, plus prior year: 1/3 of 150 = 50 days, plus two years prior: 1/6 of 150 days = 25 days, for a total = 225 days.

The decision chart indicates that Alexi does meet the substantial presence test and is considered a resident alien for tax purposes. However, it is possible that Alexi is a dual-status alien if this is his last year if he established a tax home in a foreign country – see Pub 519. If so, the return is out of scope.

Dual status is different than an individual who is nonresident for part of the year and elects to be treated as a full-year resident. As a full-year resident, they are taxed the same as a citizen.

Scope limitations

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.

U.S. citizen or resident married to a nonresident alien spouse

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

Filing separately

The U.S. citizen or resident 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. If the couple's domicile is a community property state, the return may be out of scope – check with your Coordinator.

Filing 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 to not be a U.S. resident. Both spouses are taxed on worldwide income.

In the example on the prior page, 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 and attach the required signed statement that the taxpayer must prepare. You can assist Paul and Gabriella in preparing their joint return but cannot prepare the required statement for them. 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.

Filing 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 taxpayer must have a qualifying person in order to be eligible for this filing status. The spouse is **not a qualifying person** for head of household purposes.

Exercises (Answers are at the end of this 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 to not 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.

Claiming the earned income credit

Generally, a married 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, U.S. resident alien, and, if the spouse is nonresident, the spouse chooses to be treated as a U.S. resident. If they make this choice, both spouses are taxed on their worldwide income.

There is an exception: a U.S. citizen or resident married taxpayer who meets the special rules for separated spouses (discussed in Lesson 29, Earned Income Credit) may claim EIC even though they are married to a nonresident alien and are filing a separate return.

Family members as dependents

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.

Child born overseas 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.

EXAMPLE

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 an 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.

Foreign-born stepchild 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.

EXAMPLE

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

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 charts and trees 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.

Situations that 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

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

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. Because his wife is a U.S. nonresident all year, he is allowed to claim head of household even though they reside together. 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, and Dividends

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 identifying the different types of taxable income and knowing where to report them 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 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

Getting 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.

Income from partnerships, S-corporations, trusts, or estates is reported on the respective Sch K-1. Sch K-1 interest or dividend income may be in scope. These are discussed in Lesson 12, Income – Sch K-1, Royalties, and Land Rents.

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

Part I: Wages, salaries, tips, etc.

Classification of a worker as an employee is made by the payer based on the facts and circumstances. IRS has issued guidance to assist in that determination. State law may also have an impact on whether an individual is an employee or not an employee.

There is a new deduction for qualified overtime income. It is discussed in Lesson 19, Deductions.

Employees get 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.

As part of your due diligence, 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

Employee did not get Form W-2

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.

If it's after February 15 and 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. Also, taxpayers may order transcripts from IRS.gov and receive the information by mail.

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. (This link is also in your NTTC 4012!)

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 would 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 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 a different employer. Her return will report her wages as the total of the amounts in Box 1, but each Form W-2 must be entered into the tax software separately.

*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.*

Taxpayer has an ITIN, but Form W-2 shows a different TIN

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

Boxes on 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.

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. These benefits are taxable unless and until you complete Form 2441, Child and Dependent Care Expenses. See Lesson 21, Child and Dependent Care Credit for a complete discussion.

Vic's W-2 shows $2,500 in box 10. Vic's income is increased by the $2,500 until he completes Form 2441 showing what he spent for child care. Assuming Vic's childcare expenses totaled $3,500, none of the $2,500 is taxable and his Form 2441 will reflect the $1,000 net expenses he incurred.

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.

Box 12 codes

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

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

Code II reflects qualified Medicaid waiver payments that are not included in box 1, wages. See below.

Employer and pre-tax employee contributions to a health savings account (HSA) have code W. This is discussed in Lesson 17, Adjustments to Income.

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.

Box 13 checkmarks

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 Lesson 9, Business Income for more information.
- The retirement plan box 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 Lesson 17, Adjustments to Income 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.

Box 14 information

This box may be used by employers for other information, such as union dues, uniform payments, health insurance premiums paid through payroll deduction, nontaxable income, educational assistance payments, or a minister's parsonage allowance and utilities. Mandatory contributions to state disability, paid family leave programs, and certain other state programs qualify as state income taxes and should be deducted on Sch A as a state income tax — your instructor should provide guidance on this as it varies by state. 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
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 this lesson.)

Question 1: Devon worked for a small employer who is out of business and he 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 2: Bernie did not receive his W-2 from his employer and wants to file his return without it. Which are viable options (select all that apply):

a. Bernie should contact his employer. He may be able to download his W-2.
b. Bernie should contact the IRS to get a copy of the W-2.
c. You can prepare Bernie's return without the W-2.
d. After Bernie has unsuccessfully tried to get his W-2, you can use a substitute form if Bernie has the required information.

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). Should she complete Form 2441?

a. Yes
b. No

Tip 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 must be included in gross income, 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.

The new deduction for qualified tip income is discussed in Lesson 19, Deductions.

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. Refer to the NTTC 4012 for instructions on how to enter the taxpayer's actual amount of tips according to their tip log.

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.

EXAMPLE *Jerry's W-2 shows $4,500 in allocated tips. He maintained a daily tip log that showed he actually received $4,750 in tips. Jerry will not use the allocated tip amount and instead he will be taxed on his actual $4,750 tips received.*

(A) 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 and are not subject to Social Security and Medicare taxes, but must be included as taxable wage income at their fair market value.
- Tips of less than $20 per month are not required to be reported to the 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.

Special rules for other types of pay

Disability pension treated as wages

An employer retirement plan may provide benefits for an employee in the event they become disabled. An individual who has not reached their employer's minimum retirement age and is receiving a disability pension reports the disability pension as wages. This can be a significant benefit in that it may allow the taxpayer to qualify for certain benefits, such as the earned income credit or an IRA deduction. This is discussed in Lesson 11, Income – Retirement.

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 for the current tax year 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.

EXAMPLE *Alice worked as an occasional housekeeper for three different families receiving $1,500 from each one. Her tax return will show the total of $4,500 as household employee income on page 1 of her tax return. She will not owe Social Security or Medicare tax on those wages.*

Election workers

An election worker may be referred to by other terms and titles, such as, poll worker, moderator, machine tender, checker, ballot clerk, voting official, polling place manager, absentee ballot counter, or deputy head moderator. The IRS has information for governmental employers of election workers that can be summarized as:

- Payments for services are taxable income, regardless of how small and even if not reported on a Form W-2 or 1099. Expense reimbursements are generally not taxable.
- When the payments amount to $600 or more, Form W-2 reporting is required. If the worker also provides other services to the payer (e.g. as an employee), the payer must consider the overall income paid to the worker.
- Until the payments exceed a certain threshold amount, FICA taxes (Social Security and Medicare) are not required to be withheld. This is the responsibility of the payer and not a concern for Tax-Aide.
- If the payments are less than $600 and are subject to FICA, W-2 reporting is required.

Payments under $600 typically do not result in a W-2 or Form 1099. While greater amounts should result in W-2 reporting, some localities erroneously report election worker income on Form 1099-MISC or 1099-NEC. Regardless of reporting, the nature of the income is the same for all workers: compensation, which is earned income. Reporting this as earned income can impact the earned income, additional child, and child/ dependent care credits.

Qualified Medicaid waiver payments

As an alternative to expensive nursing home care, Medicaid may pay providers of home-based care for the elderly or disabled directly. Such payments are called Medicaid waiver payments (MWP) and may be excluded from gross income if the care provider lives in the same home as the care recipient. When the care provider and the care recipient do not live together in the same home, the MWP is fully taxable and cannot be excluded. A care provider may not exclude MWP for the care of more than 10 individuals under age 19 or more than five individuals who are age 19 or older.

A taxpayer may choose to include qualified Medicaid waiver payments in the calculation of earned income for the earned income credit (EIC), additional child tax credit (ACTC), and the child and dependent care credit (CDCC) 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 EIC, ACTC, and CDCC.
- A taxpayer and spouse can each make separate elections to include or not include their respective Medicaid waiver payments in earned income.

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, ACTC, and CDCC if not so treated originally.

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

See Lesson 15, Income – Additional, 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

Question 5: Harry's only income is $25,000 of qualified Medicaid waiver payment income. He does not have any dependents. He would like to include only $13,000 as earned income on his return. Is he allowed to do that?

a. Yes
b. No

Penal 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 EIC or ACTC purposes (prisoner income **is** treated as earned income for CDCC purposes). 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.

Harold earned $10,000 while on a work-release program and received a W-2 for that amount. He will report the $10,000 of income but it will not be treated as earned income for either EIC or ACTC purposes.

*A wrongfully incarcerated individual does **not** include in income any civil damages, restitution, or other monetary award received that relates to their incarceration. Such income is exempt for federal purposes. Check with your instructor for state treatment.*

Scholarship and fellowship income (Form W-2 and Form 1098-T)

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

- Payment for services
- Amounts used or applied toward 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 Lesson 22, Education Benefits, 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 all other purposes, such as the kiddie tax, earned income credit, or additional child tax credit. The software handles this.

Loan repayment assistance programs (LRAPs) for health care professionals

Education loan repayment assistance is not taxable if it is made to a taxpayer 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.

Employer education benefits and student loans

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 employer-provided 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. The employer may report the amount of excluded education benefits in box 14.

The discharge of certain student loan debt is generally excluded from gross income. If excludible, the lender will not issue Form 1099-C.

Ministers, other members of the clergy, and non-clergy church workers

Information regarding members of the clergy is provided for awareness only. Tax returns for members of the clergy are out of scope.

The ministry profession presents unique issues that are discussed in detail in Publication 517, 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. Training for these special rules is not provided as part of Tax-Aide and returns for members of the clergy are out of scope.

(A) ***Non-clergy church workers***

A 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 Lesson 27, Other Taxes.

Eileen works at her local church as a part-time accountant. She receives a Form W-2 with $15,000 in wages but no Social Security or Medicare wages. Eileen has to pay self-employment tax on her $15,000 of wages.

Part II: Interest income

Common sources of taxable interest income are checking and savings accounts, certificates of deposit (CDs), U.S. government bonds, corporate 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, in which case 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.*

Some individuals 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 a Form 1099-INT, 1099-DIV, or any other income reporting document, the taxpayer may have to file Form 8938. Other foreign financial assets may require Form 8938, such as a Swiss bank account. Form 8938 is out of scope.

Interest income tax forms

During the interview, review all Form(s) 1099-INT and year-end summary statements from institutions that pay interest with the taxpayer. On a consolidated brokerage tax statement, there will be a Form 1099-INT section with all the line items that appear on a Form 1099-INT. Additional information for federal or state tax purposes may be needed, such as supplemental information on U.S. obligation interest or tax-exempt interest. When the needed information is not included on the brokerage tax statement, the information may be available for download on the payer’s website.

Some taxpayers may also receive original Issue Discount (OID), which is a form of interest income.

Bonds can be issued at a price lower than their face value—known as a discount. Original issue discount (OID) is the difference between the original face value and the price paid for the bond when instrument is first issued. As the discount is amortized into interest income, the basis of the instrument increases.

Form 1099-OID (or the 1099-OID section of a brokerage tax statement) will report the amount of OID that is currently taxable, that is, the portion of the OID that is amortized in the current year. The amount of OID represents additional interest income to be reported over the life of the instrument or bond. If the OID is not taken into income on an annual basis, it will be taxed when the instrument matures or is otherwise disposed. Brokerages handle these calculations.

The 1099 forms will specify the person to whom interest from a U.S. savings bond was paid. That may be the person that bought the bond, the person that received the bond as a gift, or the person that received the bond as an inheritance. The interest reported is fully taxable unless the owner previously included the amortized discount in taxable income.

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

- The taxpayer wants to report a lesser amount of interest than that shown on the 1099.
- If the amount reported as premium on Form 1099-INT is greater than the gross amount of the related interest:

- Box 11 exceeds Box 1 for interest income
- Box 12 exceeds Box 3 for interest on U.S. obligations

- 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.
- The net investment income tax applies to individuals that have certain investment income and whose AGI is more than $250,000 for MFJ or QSS, $125,000 for MFS, or $200,000 for HOH and Single. If Form 8960, Net Investment Income Tax – Individuals, Estates and Trusts, is required, the return is out of scope.

For in-scope returns, interest from U.S. government obligations is fully taxable for federal purposes and not taxable by any state.

Ask the taxpayer if they made any loans to someone else or hold 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 are required to e-file a return.

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

EXAMPLE

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 the interest he received from Stan on his tax return.

EXAMPLE

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.

Tax-exempt interest income

Certain types of interest are exempt from federal income tax; however, they may be taxable on the state tax return. 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

Although tax-exempt interest is not taxable for federal purposes, 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. Also, each state may or may not tax interest from municipal obligations. Your local instructor will guide you through your state's rules.

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. Read the taxpayer's Form(s) 1099-INT and 1099-DIV carefully; both taxable and tax-exempt interest may be listed. Specific software entries are needed based on the source of the municipal interest income.

A consolidated brokerage statement will show the details of who paid the interest. If a mutual fund has a state name in its title, the interest will likely be wholly from that state and may be exempt from your state's tax.

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.

Bonds sold between interest payment dates

Bonds pay interest at specified intervals, such as every 6 months. 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 buyer of the bond may receive a 1099-INT reflecting the full amount of interest paid, including the accrued interest. The buyer is allowed to reduce their interest income for the amount that was accrued on the date of purchase. Payers and brokers will report the correct amount of interest on the Form 1099-INT/OID for all covered securities.

"Accrued interest" on the consolidated brokerage statement (may be in the supplemental information section) means that the taxpayer bought or sold a noncovered bond between interest payment dates. 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.*

**An American Depositary Receipt (ADR) is a financial instrument that allows U.S. investors to buy shares in foreign companies.*

Interest on an IRA

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

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. Lesson 11, Income – Retirement, will cover this material in detail.

Mike makes contributions to a traditional IRA each year. Throughout the year, he gets statements showing the interest earned. Because it is tax-deferred, he does not receive a Form 1099-INT for it and he does not report any of the interest income from his traditional IRA on his tax return.

Other 1099 information

The software simplifies entering the various types of interest income. The information from each tax form is entered so that the software will include the interest income in the proper parts of the return and complete Schedule B if it is required.

A taxpayer who receives interest income that should be reported by another taxpayer is a "nominee." Nominees must issue a Form 1099 to the person that should report the income. If a taxpayer indicates 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.

While not married, Alex and Bonnie have a committed relationship and have pooled their savings into one interest-bearing account. The payer issued the 1099-INT form to Bonnie since she was first listed on the account. The interest needs to be split between Alex and Bonnie so that each reports the correct amount of interest income. Bonnie is a nominee and her return is out of scope. Alex's return can remain in scope if he reports his correct amount of interest income.

Amounts shown in the early withdrawal penalty box will appear in the Adjustments section of Form 1040 (see Lesson 17, Adjustments to Income) and any federal income tax withheld is shown in the Payments section of Form 1040. Entries shown in the foreign tax paid and foreign country boxes will be discussed in Lesson 23, Foreign Tax Credit.

Interest income reported on a Schedule K-1 is in scope and covered in Lesson, 12 Income – Sch K-1, Royalties, and Land Rents.

Taxpayer interview and tax law application

Barbara Smith is a clerk with the United States Postal Service.

Sample interview

Volunteer Says…	Barbara Responds…
Let's discuss 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 1099-INT.
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. 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.

Exercises (continued)

Question 6: Interest earned on state municipal bonds is **always** treated as tax exempt for both Federal and state income tax purposes. True and False

a. True
b. False

Part III: Dividend income

A taxpayer receives dividend income from the investments they make. These investments can be shares in a company, such as IBM, or in a pooled fund situation, such as a mutual fund. Often, these investments are held in a brokerage account. The year-end consolidated brokerage tax statement will have a 1099-DIV section and supplemental information on the payers of the dividends. Be sure to review all during the interview to make sure the return is in scope and within your level of certification.

Form 1099-DIV

Dividends can have several different designations that impact how the dividend is taxed for federal purposes. Dividends are generally reported on Form 1099-DIV (or substitute form) and you will generally transfer the information from Form 1099-DIV to the software. The following describe the relevant dividend designations.

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.

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.

Qualified dividends

Qualified dividends are ordinary dividends that qualify for lower, long-term capital gains tax rates. Taxpayers who have questions about why a dividend is qualified or not qualified should contact their broker or the company that paid the dividend.

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). Enter the amount shown as Sec. 199A dividends and the software will handle the QBID form and calculations. See Lesson 19, Deductions, 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.

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 REIT. Both made capital gain distributions that year. The following January she received Forms 1099-DIV listing these capital gain distributions.

(A) *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 on Form 1099-DIV for Sec. 1250 distributions and the tax software will make the proper tax calculation.

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.

(A) Patronage dividends – 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 to be entered into the software. Dividends on purchases for non-personal use, e.g. for a self-employed business, are out of scope.

Other dividend information

Dividends reported on a Schedule K-1 are in scope. Refer to Lesson 12, Income – Sch K-1, Royalties, and Land Rents.

If the taxpayer received dividend income that should be reported by another taxpayer, they are a nominee. Nominees must issue a Form 1099 to the person that should report the income. Tax returns for taxpayers who receive income as a nominee are out of scope.

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 the taxpayer is filing Form 1040-NR, these items make the return out of scope. This 897 information does not need to be entered into the software for U.S. citizens and residents.

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 Lesson 23, Foreign Tax Credit.

Exercises (continued)

Question 7: Dividends from a municipal bond fund are always taxable for federal tax purposes.

a. True
b. False

Summary

This lesson covered three main categories of income that are reported on Form 1040. Form W-2 is used by employers to report wages and other information related to the employment. Even if not reported on Form W-2, the taxpayer must report all their wage income.

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

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. Even if not reported on Form 1099-INT, the taxpayer must report all their interest income.

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.
- REIT dividends may entitle the taxpayer to a qualified business income deduction.

Situations that 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.

- Form W-2 with codes FF, R, T, or Z in box 12
- Form W-2 code Q is out of scope; it's in scope only if the preparer and reviewer are certified in Military
- Tax payers subject to the additional Medicare tax, the net investment income tax, or the alternative minimum tax
- Tax returns for taxpayers who use the accrual method for reporting income
- Form 1099-INT premium amount (boxes 11 or 12 only) is greater than the respective amount of interest reported.
- Tax returns for taxpayers who buy or sell noncovered bonds between interest payment dates
- Form 1099-DIV with an amount reported as Section 1202 gain, Collectibles (28%) gain, Cash liquidation distributions, or 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
- Tax returns for ministers and members of the clergy because of unique tax issues
- 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
- The FATCA filing requirement box is checked on any 1099 form or Form 8938 is required for foreign financial assets held by the taxpayer
- Allocation of community property income between spouses in some states

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

Pub 555, Community Property

Exercise answers

Answer 1: False. You can use Form 4852 as a substitute Form W-2.

Answer 2: a, then b and/or d. Bernie should start with his employer. The next step is to contact the IRS. Lastly, you can use a substitute Form 4852 to file his return. In no event should you complete Bernie's return knowing that income has been omitted.

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.

Answer 5: b, No. The election to include MWP as earned income is all-or-nothing. Harry cannot include only a part.

Answer 6: False. Although exempt for federal tax purposes, interest on municipal bonds is typically tax-exempt for state purposes only for bonds issued by the same state; if the issuer is a different state, interest on municipal bonds is usually taxed.

Answer 7: False.

Introduction

What do I need?
• Tax-Aide Intake Booklet
• NTTC 4012
• Form 1040 Sch C & Instructions

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 a tax return with Sch C is in scope with certain limitations as detailed below.

Remember that most transactions involving digital assets (virtual currency, cryptocurrency, Bitcoin, etc.), such as a disposition, sale, exchange, or transfer, are out of scope. Be sure to ask about digital assets during the interview.

Objectives

You will learn how business profit 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
- Determine which business expenses are within scope

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 may not think of themselves as “self-employed” if they have a small home business or work part-time as an independent contractor. However, 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.

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. A one-time activity, such as election poll work or jury duty, is not a business, even if payment is documented on a 1099.

Special rules apply to certain activities and are, therefore, out of scope. Out-of-scope activities include professional gamblers, day traders*, illegal activities, or activities that are a hobby or otherwise not for profit.

* If you see a lot of trades in the detail to the brokerage statement, ask the taxpayer if they are a day trader. That is a special designation that they must establish with the brokerage.

Here are some questions taxpayers can consider to determine whether their side gig is a business or a hobby:

- Is there an intent to make a profit or is the activity primarily for enjoyment?
- Does the taxpayer engage in the activity on a regular basis?
- If the activity makes a profit, how much is it?
- If there is a loss (out of scope), is it normal for the startup phase of this kind of business or due to circumstances beyond their control?

- Do they expect to make a profit in the future?
- Do they depend on the income from the activity for their livelihood?
- Is the activity carried out like a business with accurate books and record keeping?
- Do the taxpayer and any advisors have the knowledge and expertise to carry out the activity as a successful business?

No single question is a deciding factor. All the questions should be taken into account to make the best decision.

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.

Ariel is retired and enjoys painting landscapes. She views her creations as an artistic exercise done for pleasure, but occasionally sells some of her paintings. A Sch C would not be prepared as this is not an activity that qualifies as a business because Ariel's primary purpose for engaging in the activity is not for income or profit. Her return is out of scope.

Jointly run business

If the taxpayer and spouse own the business 50/50 and are filing jointly, enter all the information on a single Schedule C. The software is capable of splitting the Schedule C between the two spouses and computing the self-employment tax accordingly. If the ownership is other than 50/50 or the taxpayer and spouse are not filing jointly, a Schedule C must be prepared for each person with the income and expenses pro-rated based on their respective ownership.

Scope limitations

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 or credited to an account (such as PayPal), not when deposited
    - Expenses when paid by cash, check, credit card, etc., not when the check clears or the credit card is paid off
  - 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
  - An exemption allows small business cash-basis taxpayers to 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 that must be capitalized

Short-term rentals where the taxpayer provides substantial services are properly reported on Sch C and not Sch E. The taxpayer is therefore allowed a depreciation deduction with respect to the rented property. These short-term rental situations are out of scope.

  - 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.

Form of doing business

An individual may have set up a limited liability company (LLC), S Corp, 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.

State issues

Many states have enacted laws that reach out to tax individuals who are not resident in their state. When a taxpayer has receipts from activities outside their state, there may be a filing requirement in such other state. Additionally, some states have tax laws that significantly vary from federal tax law, such as treating a business owner as an employee for state purposes.

Check with your Coordinator whether a tax return for a taxpayer with state tax issues should be declined. You may be able use the State Tax Assistance Program (STAP) if your state participates.

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.

Volunteer Says…	Jason Responds…
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.	

Exercises (Answers are at the end of this lesson.)

Question 1: Based on the information in the sample interview above, is Jason's return in scope?

a. Yes
b. No

Question 2: Leslie has been running her business buying and selling products for several years and has an opening inventory (goods that she purchased in a prior year and has not yet claimed as an expense). Is Leslie's return in scope?

a. Yes
b. No

Question 3: Harini is a working mother of a college student. She uses Airbnb to rent out her son's room when he is at school (more than 14 days). Is Harini's return out of scope?

a. Yes
b. No

Due diligence

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 Sch C situations raise a "red flag"?

As a volunteer preparing a tax return with Sch C, watch for examples of potentially 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 few 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 full-time 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.
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.

Volunteer Says…	Dana Responds…
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 Dana 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.

Taxpayers can use the NTTC Self-Employed Schedule C Worksheet to summarize their business income and expenses.

Business income

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

The payer (the issuer of the form) does not know if the taxpayer does or does not run a business. Regardless of the form received: if the taxpayer has a business, it is reported on Sch C and all business income is reported on line 1 of that form. Individuals who receive less than the applicable 1099 filing threshold may not receive a tax form, but must still report all their income. A brief explanation of the various forms follows.

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.

Form 1099-NEC, Nonemployee compensation

Taxpayers who are independent contractors should receive Form 1099-NEC showing the income they earned for services from payers who are required to file Forms 1099. Be sure to confirm that the taxpayer has established a business; if not, the income might be reportable elsewhere or the return may be out of scope if it is from a hobby.

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.

Ernesto gave a speech at his college reunion for which he received a $1,000 honorarium. This was a one-time event and does not constitute a business. He will report his $1,000 honorarium as other income on Sch 1, not subject to self-employment tax and not as earned income.

Form 1099-MISC, Miscellaneous income

Taxpayers may receive business income reported on Form 1099-MISC, Boxes 2 or 3. Box 2 royalties from the taxpayer's own personal services are generally reported on Sch C. Examples include authors and composers. A royalty from another person's services (such as inherited royalties) is reported as other income on Sch 1 (not on Sch C).

Royalties that are not business income are discussed in Lesson 12, Income – Sch K-1, Royalties, and Land Rents.

Rental income (Box 1 of Form 1099-MISC) is discussed in Lesson 12, Income – Sch K-1, Royalties, and Land Rents and Lesson 16, Income – Military Members — refer to those lessons for proper reporting of rental income that is in scope. Income from renting personal property, such as a vehicle, is out of scope.

Form 1099-K, Payment card and third-party network transactions

Form 1099-K is used by third-party networks to report transactions processed for taxpayers. Companies, primarily online marketplaces or gig economy operators, also issue Form 1099-K for transaction they process. You may see Forms 1099-K from Visa, Venmo, Amazon, eBay, Airbnb, Uber, and many others.

If the taxpayer uses a third-party processor to collect their income, it is possible that Form 1099-K will report the same income that the payer reports on Form 1099-NEC or 1099-MISC. Taxpayers are responsible for keeping good books and records as describe later in this lesson.

Josie uses Venmo to collect her consulting fees. She received a 1099-NEC from her client and a 1099-K from Venmo for the same income. Josie needs to keep good books and records to determine her actual income. Josie should report the correct amount of income. She could use Sch 1 to indicate the 1099-K was in error (because it was duplicative). Or she could include both on her Sch C and back out the duplicative amount.

The filing threshold was scheduled to decrease, meaning that more Forms 1099-K were to be issued. OBBBA restored the former $20,000 and 200 transactions threshold, so we are likely to see far fewer Forms 1099-K.

Business income

The taxpayer will decide whether the amount reported on Form 1099-K relates to their business (fully or partially). Amounts reported on Form 1099-K that do not relate to a business should not be reported on Sch C.

Some payments may be reported on Form 1099-K that make the return out of scope are:

- Selling personal property (including event tickets) for more than the original cost when such activity is not a business reported on Sch C
- Selling property that was used in the taxpayer's business (it may have been depreciated or written off when purchased)
- Payments received for hobbies or other not-for-profit activities
- Rental income if not excludible and except as provided for land rents and members of the military (noted above)
    - Residential rental of less than 15 days during the year may be excludible.

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.

Personal proceeds

Amounts reported on Form 1099-K that are for the sale of personal assets at a loss, for personal receipts, due to an error, or otherwise not taxable can be reported on in a special box of Sch 1. IRS will thus know that such proceeds are not taxable. The taxpayer is responsible for distinguishing personal receipts from business receipts.

The details of Forms 1099 are not transmitted to the IRS. You should make sure that all business income is included on the business owner's Sch C for that business as gross receipts or sales.

A taxpayer can have more than one business and more than one Sch C. Each should stand on its own and be complete.

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.

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
- Full-time traveling salespersons
- Those who work at home on materials or goods supplied and returned to the employer who specifies the work to be done

A small employer might check the statutory employee box in the W-2 box 13 in error. Confirm the taxpayer's activities qualify for statutory employee reporting during the interview.

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.

Reimbursements

In broad terms, a reimbursement consists of a payment made and a payment received. If the payment received is included in income on Schedule C, then the payment made can be included in expenses. If the payment received is not reported as income, then the payment made cannot be included in expenses — that would be double-dipping.

Josh is a ride-share driver and often drops off at the airport. The airport charges a fee each time, which the ride-share company charges to the rider and pays directly to the airport. Josh also paid for tolls for which the rider was charged by the ride-share company. The 1099 income reported to Josh includes both the airport fees and the tolls that were charged to the rider. The year-end statement *shows the amount of airport fees and the tolls that he can claim as deductions. Josh will report the gross payments received and claim expenses for the airport fees and tolls.*

Medicaid waiver payments

As an alternative to expensive nursing home care, Medicaid pays providers of home-based care for the elderly or disabled directly. Such payments are called Medicaid Waiver Payments (MWP) and may be excluded from gross income *if qualified*. The MWP is qualified so long as:

- The care provider and the care recipient live together in the same home
- A care provider cares for no more than 10 individuals under age 19 or more than five individuals the age 19 or older

If either test is not satisfied, the MWP is fully taxable and cannot be excluded.

Taxable caregiving income reported on Form 1099 is reported on Sch C if the taxpayer is in the business of providing care. Taxable caregiving income reported on Form 1099 that is not a business is reported as other income on Sch 1 that is **not** subject to self-employment tax and **not** treated as earned income.

IRS guidance on when family caregivers are liable for self-employment tax concludes that payments family members receive are not subject to self-employment tax. However, if the care provider is engaged in a trade or business of providing care giving services, such as a sole proprietor operator of an adult day care and a family member uses these services, the payments received for that family member are subject to self-employment tax.

Refer to Lesson 8, Income – Wages, Interest and Dividends, for MWP reported on Form W-2.

Refer to Lesson 15, Income – Additional, for MWP reported on Form 1099 or MWP not reported on a Form 1099 and your state normally reports MWP on Form 1099.

Tips and gratuities

Tips and gratuities received for self-employment activity are included in line 1, Gross Receipts, on Sch C. The taxpayer will need to track their tip income if they are eligible for the tips deduction discussed in Lesson 19 – Deductions.

Business expenses

Taxpayers deduct the costs of running their business on Sch C. 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. 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.

All ordinary and necessary expenses incurred in a self-employed taxpayer's business must be reported. Discussion of possible of business expenses follows, though this list is not all-inclusive.

Advertising

Advertising expenses are the costs associated with promoting the business through various means including internet ads, newspapers, magazines, billboards, racing sponsors, television spots, etc.

Car and truck expenses

A taxpayer who uses a car, van, pickup or panel 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 for an owned vehicle. The calculation of depreciation is outside our scope. Similarly, the lease payments for a leased vehicle are part of actual expenses. If the taxpayer has used actual expenses in the past for the vehicle used in the current year 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. The standard mileage rates apply equally to gas, diesel, fully-electric and hybrid-powered cars, vans, pickups or panel trucks. It **cannot** be used for other vehicles, such as motorcycles or scooters.

Business owners, including gig drivers, may have other car expenses that can be deducted in addition to the standard mileage amount, such as those listed below in Other expenses.

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 it 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.

Education or training: Taxpayers can deduct the cost of their education expenses 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. Deductible expenses include:

- Tuition, books, supplies, lab fees, and similar items
- Transportation and travel costs
  - The purpose of the travel must be mostly educational (determined by relative time spent)
  - There is a 50% limit on meals
  - Limits apply to education on cruises or conventions
  - Travel itself is not a form of education that can be deducted, even if it is related to the business
- Other education expenses, such as costs of research and typing when writing a paper as part of an educational program

Expenses that do **not** qualify are those for education that is needed to meet the minimum qualifications of the taxpayer's trade or business or when the education is part of a program that would qualify the taxpayer for a new trade.

Taxpayers may be able to use some education costs, primarily tuition, to claim an education credit, see Lesson 22, Education Benefits, and take other costs, such as travel to a workshop, as a business expense. But they cannot use the same expenses in both places (no double dipping).

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 are discussed in Lesson 17, Adjustments to Income.

Other interest

This category can include interest paid on business operating loans, but not home mortgage interest (that would be a home office). 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. Payments over $600 to a single payee may require a Form 1099-MISC or 1099-NEC to be filed, which would make the return out of scope.

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.

Office expense

Office expense generally includes supplies such as pens, paper, and postage.

Rent or lease

This category includes rental fees for cars, trucks, vans, machinery, equipment, and other personal property. Vehicle leases or rentals of more than 30 days are out of scope if the taxpayer wants to deduct the cost of the rental. If the taxpayer uses the standard mileage rate method for business miles of a vehicle leased or rented for more than 30 days, the return remains in scope.

Rent also includes, for example, an office rented for the business. Rent payments may trigger a 1099-MISC filing requirement when the rent is paid to an individual. Rent paid to a management company or corporation does not trigger a 1099-MISC requirement. If the taxpayer is required to file 1099s, the return is out of 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 D.

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.

EXAMPLE *Kiana runs a small business from her home. She has only one cell phone and frequently makes business calls. She can pro-rate the cost of her cell phone plan between business use and personal use.*

Other expenses

Taxpayers may deduct other ordinary and necessary business expenses not deducted elsewhere on Sch C. Here are a few examples.

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 and if the cost of such property is 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 clearly labeling the expense as "Section 1.263(a)-1(f) de minimis safe harbor election" in the Other Expenses section of Sch C.

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.

Felix is a handyman and has a complement of tools that include items such as portable saws, paint sprayers, and nail guns. He purchased an expensive tool this year that is over the de minimis amount of $2,500. Felix must claim a depreciation deduction or make an immediate Section 179 expense election for this new tool. Once the Counselor learns that Felix has purchased the new tool, the return becomes out of scope because Form 4562 is required and it is out of scope in its entirety.

Inventory exception for small business taxpayers: A small business taxpayer can choose to not 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.

Bob sews drapes on a made-to-order basis. He buys the fabric selected by the client and delivers and installs the finished drapes. He expenses all his purchases immediately and has never had inventories. Bob's return is in scope and the fabric is a raw material for the finished product and is deducted as materials purchased for resale on Sch C, Other Expenses.

Gig drivers and others claiming business miles: Gig drivers and other taxpayers must determine the expenses that can be claimed in addition to the standard mileage method using any reasonable method, such as relative mileage, to determine the business portion. Examples of expenses, the business portion of which can be claimed in addition to the standard mileage rate amount, include (this list is illustrative, not limiting):

- Interest on a car loan
- Personal property tax on the car
- Parking, airport, and toll fees
- Transponders
- Cell phone and service
- Dash camera
- Roadside assistance plans
- Ride-sharing insurance, commissions, or fees (not requiring Form 1099 to be filed)
- Passenger amenities (beverages, snacks, phone chargers, music services, first aid kit, etc.)
- Trunk organizers or delivery bags
- Floor mats to keep the car clean
- Mileage tracking apps

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. This is true even if claiming all allowable deductions means that the business had a net loss and therefore the return is out of scope.

Exercises (continued)

Question 4: David, a full-time college student who lives at home, also drives part-time three days a week after school as an independent contractor for Uber. He uses an app to keep track of all business mileage, parking, tolls, and other business-related expenses. Can David deduct his mileage from home to school or from his last customer to home?

a. Yes
b. No

The self-employed taxpayer may be able to also claim the new qualified tips deduction or a qualified business income deduction in addition to their standard or itemized deductions. See the [Lesson 19, Deductions](#).

Other terms to know

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. If the taxpayer does not materially participate or is uncertainty about materially participating in the business, their return is out of scope.

Cost of goods sold: this is for taxpayers who maintain inventories. They do not expense the cost of their goods until they are sold and their tax returns are out of scope. Tax returns for cash-basis taxpayers who elect to expense their purchases or costs of production are in scope.

Home office: the portion of expenses related to the part of the home used for business can be deductible if that part of the home is used:

- Exclusively and regularly as the taxpayer's principal place of business;
- Exclusively and regularly as a place where the taxpayer meets or deals with patients, clients, or customers in the normal course of a trade or business;
- In the case of a separate structure that is not attached to the home, in connection with the trade or business;
- On a regular basis for certain storage use;
- For rental; or
- As a daycare facility.

The home office deduction may be limited and is out of scope.

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 Lesson 27, Other Taxes and Lesson 17, Adjustments to Income for additional information.

Self-employed health insurance (SEHI) deduction: A self-employed taxpayer may be able to deduct their health premiums even though they do not itemize their deductions. Using the Self-employed Sch C Worksheet helps to identify and document whether the taxpayer is eligible for this deduction. SEHI is fully discussed in Lesson 17, Adjustment to Income.

Net earnings from self-employment: Generally, the "net earnings" from the business are the profit shown on Sch C less the deduction for one half of the self-employment tax. Net earnings represent "compensation" for IRA contribution and deduction purposes. Refer to the Lesson 17, Adjustment to Income for IRA rules. Both the SEHI and an IRA can be claimed for the same net profit.

Very importantly, the net earnings are earned income for the earned income, additional child tax, and child/dependent care credits. These credits are discussed in later lessons

Sales tax: A state or municipality may impose a sales tax responsibility on a business owner, that is they must charge the customer sales tax. Whether sales tax collected should be included in gross receipts depends on how the tax is levied. Whether the sales tax is levied on the seller or the buyer, the net result should be the same — no net income or expense. If the sales tax is included in income, there should be an offsetting expense entry. The taxpayer is responsible for complying with local sales tax collection requirements and Counselors can merely remind the taxpayer of possible sales or other local tax obligations.

Exercises (continued)

Question 5: 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 6: Ellen has a small business. The gross income from her business is $40,000 and her business expenses total $11,500. Is Ellen's tax return in scope?

a. Yes
b. No

Recordkeeping

Taxpayers are responsible for maintaining records needed to determine their correct tax liability. That includes records of income and expenses for their business. Good records will help the taxpayer do the following:

- Monitor the progress of their business
- Prepare their financial statements
- Identify sources 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, finance software, accounting journals, and ledgers). The books and records must show the gross income, as well as the deductions and support for credits. For most small businesses, the business bank account, checkbook, or credit card statements are the main sources 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, and bank or credit card statements. These documents contain information that must be recorded in the business books and records.

When a business involves the use of a car, 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. This is normally three years, but can be longer.

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.

Summary

This lesson explained:

- What is or is not a business

- Certain situations involving Sch C and EIC that should raise "red flags"
- Where to get business income and expense information
- 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 including cash income
- The business expenses that are within scope
- Additional inquiries about the taxpayer's income and expenses may be necessary to ensure an accurate return
- The records that should be maintained
- How to complete a simple record reconstruction

Situations that 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 name, image, or likeness (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 or for contract labor
  - Business use of home deduction
  - Casualty losses
  - Vehicle expenses reported as actual expenses
  - Depletion
  - 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

Where to find more information

Pub 17, Your Federal Income Tax

Pub 334, Tax Guide for Small Business

Pub 463, Travel, Gift, and Car Expenses

Pub 583, Starting a Business and Keeping Records

Pub 587, Business Use of Your Home

IRS.gov on crowdfunding

IRS.gov with information for gig workers

IRS.gov with information on family caregivers who may have a business

Exercise answers

Answer 1: a, Yes. Jason meets all requirements to be considered in scope.

Answer 2: b, No. Leslie's return is out of scope until such time as Leslie changes her method of accounting and after the tax year the change method of accounting adjustment has been fully flushed through her tax returns.

Answer 3: b, Yes. Harini's return is out of scope.

Answer 4: b, No. David's mileage to his first job (ride) and from his last job (ride) are commuting miles and not deductible.

Answer 5: 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 6: a, Yes. Ellen's total business expenses are within the scope limit.

(A) 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, exchange traded funds (ETFs), 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.

As stated before, sales or other dispositions 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.

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.

Brokerage statement, Form 1099-B, and the interview

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. During the interview with the taxpayer, be sure to carefully examine all pages of a brokerage statement, including supplemental information pages. A brokerage statement can be many pages long – make sure you have all the pages. You're looking for possible out-of-scope items and to make sure all needed information is provided. To recap out of scope items:

- If the taxpayer must answer "yes" to the digital asset question on Form 1040.
- Disposition of securities other than stocks, mutual fund shares, ETFs, and some bonds as discussed in this lesson.
- Disposition of a bond showing accrued interest (that is, ordinary income on the disposition).
- Missing information on dispositions that cannot be resolved.

- Income, deductions, or credits other than those covered in this publication as in scope.
- Dispositions or trading in collectibles, options, futures, commodities, bartering, or qualified small business stock.
- 1099-B showing amounts for any of these:
  - 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
  - Bartering
- Tax returns for day traders — day traders will know if that is what they are doing. They are eligible for special elections for which we are not trained. Day traders often have hundreds of transactions during the year and may use options to hedge their positions.
- Taxpayers operating a business as a dealer in stocks or securities.
- If a FATCA box is checked or the taxpayer has foreign accounts (assets) for which Form 8938 would be required.
- Disposition of a home that was not used as a residence by the taxpayer (or spouse if MFJ). See the detailed discussion later in this lesson.
- Foreign tax credits that exceed the limitation for the simplified election method, unless the foreign tax is claimed as an itemized deduction on Sch A. Full foreign tax credit Form 1116 is allowed if the preparer and reviewer are certified in International.
- Investment interest expense or margin interest reportable on Form 4952 and Form 1040 Sch A. If the taxpayer is itemizing deductions or if, assuming all the investment interest was deductible on Sch A, the taxpayer could itemize, the return is out of scope.
- "Miscellaneous income" may be from an investment that is out of scope, such as disposition of a virtual currency or a collectible. You may find some details on the nature of the income in supplemental pages. If in doubt, check with your Coordinator whether the return is in scope.

The last two items and other pertinent information may be in a separate "miscellaneous" section or in a footnote or another section of the consolidated brokerage tax statement. With more experience, you'll be able to identify out of scope issues more easily.

Be sure to note state-only items:

- Investment expenses that would be possible itemized deductions (not deductible on the federal return), such as management fees.
- Whether interest income or money market dividends from a federal or municipal fund are 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.

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 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 for one year or less
  - Long-term property is held for 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.

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 or missing information as early as possible.

Tax Basis of Securities

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.

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.

***Covered securities** are various types of investment for which brokers are required to report the cost basis to both the investor and the IRS. This designation applies to securities purchased on or after specific dates set by Treasury regulations. Securities acquired prior to the effective date of the additional reporting requirements are called noncovered securities.*

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 Lesson 8, Income – Wages, Interest, and Dividends. 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.
  - This includes shares purchased using a DRIP.
- 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 elects a different method, such as first-in-first-out or specific identification.

EXAMPLE

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 in supplemental pages to the year-end tax statement furnished to the taxpayer. Form 1099-B or the broker's statement identifies noncovered security sales. You may see that information is missing, particularly the cost or basis. The taxpayer must provide their basis, adjusted as necessary, for 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 the taxpayer's responsibility to keep track of the basis per share of all their securities.

In some cases, the basis is not determined by a purchase price. These special rules are covered in this lesson in the topic, "Basis other than cost" below. 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.

The long-term capital gains tax rate can be as low as 0%. If the taxpayer cannot provide missing cost information, check whether using a zero cost will increase the taxpayer's federal or state tax. If the tax return is filed with a zero cost and it does increase the tax liability, the taxpayer can file an amended tax return to claim a refund if they get the basis information before the statute runs.

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. As background, 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 is 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 for the above events. Still, taxpayers should keep track of their basis.

Basis other than cost

There are times when cost is not 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 fair market value (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. Generally, property held as separate property is stepped to FMV for the decedent's interest in the property. Whereas if the property is wholly held as community property, the entire property is stepped to FMV at the death of first co-owning spouse.
    - 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 (extremely rare for typical Tax-Aide taxpayers).
    - 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) (extremely rare for typical Tax-Aide taxpayers).
- 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 provides the basis of property that was acquired in one of the situations listed above, the return is in scope. If they cannot provide the basis of the property, the return is out of scope (assuming using zero basis is not acceptable).

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 (maybe 0%). Brokers will break down the dispositions between short-term and long-term on their tax statements.

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

The software will calculate the holding based on the entries you make for the sale date and the purchase date.

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 brokerage 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 holding period 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.
- 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 the return is out of scope.
- 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.

Taxpayers should consult with their broker or financial advisor for missing information. Sometimes, using zero for the cost basis gives an acceptable tax result. You are not expected to assist the taxpayer in researching their basis.

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. That means that if you see "accrued interest" on the statement, there is some interest income (plus or minus) that needs to be reported and the return is out of scope.

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.

Exercises (Answers are at the end of this lesson.)

Refer to the Tax-Aide Scope Manual to answer this exercise.

Question 1: Which of the following found on a broker's consolidated tax statement are in scope (select all that apply)?

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

Question 2: Kevin sold XYZ shares that he had purchased in 1979. His brokerage statement lists this as a noncovered security with no basis. Kevin has the original purchase ticket showing the total price of $925 for the shares and a broker fee of $75. What is the amount Kevin reports as his purchase price assuming no adjustments to basis are needed?

a. $925
b. $1,000
c. $850
d. $75

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 minus 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 have been 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 so, you can compare the amount brought forward to the carryover worksheet to make sure it is correct.

If the worksheet is not in the prior year's return, you'll need to compute the amount of capital loss carryover from the previous year. You can use the Capital Loss Carryover Worksheet from the Form 1040, Sch D instructions, or you can use the Colorado Resource Toolbox Capital loss carryover worksheet. To complete either 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 in the software and on the outside of the taxpayer's tax return record envelope to alert next year's preparer.

Reporting capital gains and losses

The NTTC 4012, 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.

Of the various adjustment codes shown in our NTTC 4012, code W for wash sales is the most commonly seen. 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.

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.

EXAMPLE *Bertha inherited her mother's house in February 2025 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 reports a sale of a home on their tax return

Taxpayers must report the sale of a home on Form 8949 / Schedule D if ANY of the following is true:

- The taxpayer received Form 1099-S
- 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

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 the disposition.

Generally, if the taxpayer transferred the home (or share of a jointly owned home) to a spouse or ex-spouse as part of a divorce settlement, the taxpayer is considered to have no gain or loss. The taxpayer has nothing to report from the transfer. Refer to Pub 523, Selling Your Home for additional guidance.

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 if MFJ or an eligible surviving spouse). 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.

EXAMPLE *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.*

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 test rules for members of the Armed Forces, intelligence personnel, and Peace Corps volunteers. 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 (but if rented, the return is out of scope).

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.

EXAMPLE

Helen lived in a rented apartment in 2017. The apartment building was later changed to a condominium, and she bought her unit on December 1, 2021. In 2023, Helen became ill and on April 14 of that year she moved into her daughter's home. On July 10, 2025, while still living in her daughter's home, she sold her unit.

For the 2025 tax year, Helen can claim the exclusion on the sale of her condominium because she met the ownership and use tests. Her five-year period is from July 11, 2020, to July 10, 2025, the date she sold the condominium. She owned her unit from December 1, 2021, to July 10, 2025 (over two years). She lived in the unit from July 11, 2020 (the beginning of the five-year period) to April 14, 2023 (over two years).

Exercises (continued)

Question 3: Emily, who is single, bought a home in 2011. She lived in the home until January 1, 2020, when she accepted a temporary job assignment in Venezuela and left the house vacant. Emily returned to her home on December 31, 2021 and lived there until she sold the house on January 10, 2025. Does Emily meet the ownership and use test?

a. Yes
b. No

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) and their tax return is out of scope.

Sale of main home by a surviving spouse

A surviving spouse may take advantage of two special provisions:

1. 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.
2. 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 provides the basis of an inherited home they used as a residence, the return is in scope. If they cannot provide 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.

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.

Computing the gain (or loss) from the sale of a home

After determining that a taxpayer is eligible for the exclusion, calculate the gain (or loss) on the sale based on the selling price 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 MFJ 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.

You can use this calculator in the Colorado Resource Toolbox to determine and document the various ownership, residency, and look back tests. In addition, you can enter data regarding the home sale, purchase, and improvements to determine the amount of gain. Be sure to print a copy for the taxpayer's records.

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, the sale must be reported on Form 8949 and Sch D.

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 as discussed above.

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 an addition or a renovation. 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 will 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.

The following decreases to basis make the return out of scope:

- 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 a residential energy credit.

Selling expenses

Selling expenses reduce the gain or increase the loss. Selling expenses 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 association 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.

The possible exclusion

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.

Reporting 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. NTTC 4012, Tab D shows how to enter the data into the software.

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.

Exercises (continued)

Question 4: Jose and Maria received Form 1099-S for the sale of their home. A Volunteer must have Advanced Certification in order to prepare their return.

a. True
b. False

Question 5: Which of the following are allowable adjustments to basis on the sale of a home (select all that apply)?

a. The cost of adding a bathroom
b. A kitchen renovation
c. Selling expenses, such as broker commissions
d. Pro-rated property taxes

Question 6: Jose and Maria received Form 1099-S on the sale of their home. The Volunteer determined that the allowable exclusion was greater than the gain on the home; therefore, the volunteer did not feel that Form 8949 and Sch D were required. Is the volunteer correct?

a. Yes
b. No

The five-year test period suspension (military and others)

Specified 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 services
- 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 2015 and lived in it for 2½ years. Beginning in 2019, he was on qualified official extended duty in the U.S. Army. He sold his home in 2025 and had a $12,000 gain. Peter would normally not meet the use test in the five-year period before the sale (2020-2025). 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 7: John purchased a home in 2010. Through your interview process, you discover that he sold his main home in 2025. 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.

If the taxpayer receives Form 1099-S, the sale of a principal residence must be reported on the tax return – it does not matter whether the gain is excludible or the loss is not deductible.

Situations that 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

Where to find more information

Pub 544, Sales and Other Dispositions of Assets

Pub 551, Basis of Assets

Pub 550, Investment Income and Expenses

Capital loss carryover worksheet in the Colorado Resource Toolbox

Pub 523, Selling Your Home

Home Sale Worksheet in the Colorado Resource Toolbox

Exercise answers

Answer 1: b, c, and d are in scope. A sale of a collectible (28%) is out of scope.

Answer 2: b. Kevin can add the broker’s fee paid on the purchase to his cost basis.

Answer 3: a, Yes. Emily meets the ownership and use tests 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: True.

Answer 5: a, b, and c are allowed adjustments to the basis of a home. Property taxes would be reported on the taxpayers Sch A, if itemizing.

Answer 6: No. When a taxpayer receives a Form 1099-S, it must be reported on Form 8949 / Schedule D.

A**nswer 7:** 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

What do I need?
• Tax-Aide Intake Booklet • NTTC 4012 **Optional:** • Form 1099-R (retirement) • Form 8606 (basis in IRA)

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.

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 Lesson 14, Income – Social Security Benefits.

You should also be able to recognize when taxpayers should adjust their withholding.

Objectives

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

- Understand the various types of retirement accounts that an individual may have
- 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

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.

Be sure to review all 1099-R forms to determine if the return is in scope and whether you have the appropriate certification to prepare the return. For example, if Form 1099-R does not show the taxable amount or if the taxpayer has indicated they made a qualified charitable distribution, Advanced certification is required.

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, 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

- (A) 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.

Retirement income distributions

Retirement plans are funded by either before-tax or after-tax contributions. "Before-tax" or "pre-tax" simply means that the individual (often an employee) did not pay taxes on the money at the time it was contributed. This happens when an employee's contribution to their company's retirement plan reduces their taxable wages (a salary-reduction plan) or when a taxpayer takes a full deduction for their traditional IRA contribution. When an employee uses funds that are or were taxable to make their retirement contribution it's called "after-tax", 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 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.

Distributions from an employer plan designated Roth account are wholly nontaxable if the distribution is qualified, 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 income is 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 Lesson 25, Miscellaneous Credits).

New provision

Effective for distributions after December 29, 2025, charges or payments for purchasing qualified long-term care insurance contracts are not taxable. These will be identified with Code W in box 7 of Form 1099-R. The custodian will apply the charges or payments first to reduce the taxpayer's basis in their account (shown in box 8), then to earnings in their account. If the distribution amount is solely for qualified LTC, the taxable amount on Form 1099-R will be zero.

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.

(A) 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.

Lesson structure

The rest of this lesson is in four parts:

- Part I: Individual retirement accounts
- Part II: Employer retirement plans
- Part III: Other retirement income issues
- Part IV: Special retirement income provisions

Part I: Individual retirement accounts

An individual retirement account (IRA) is a tax-advantaged savings account designed to help individuals save for retirement. An IRA can be set up directly by an individual with their own contributions or by rolling over amounts from an employer qualified plan. An employer can adopt an IRA-based plan for themselves and their employees. An IRA allows the funds to grow either tax-deferred or tax-free, depending on the type of IRA — traditional or Roth IRA.

There are three kinds of pre-tax IRAs:

- Traditional IRA
- Savings Incentive Match Plans for Employees (SIMPLE) IRA
- Simplified Employee Pension (SEP) IRA

With respect to distributions, we will refer to all three as traditional IRAs.

There are also three kinds of after-tax IRAs

- Roth IRA
- Roth IRA under a Savings Incentive Match Plans for Employees (SIMPLE) IRA
- Roth IRA under a Simplified Employee Pension (SEP) IRA

With respect to distributions, we will refer to all three as Roth IRAs.

Savings incentive match plans for employees (SIMPLE) 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 SIMPLE plan. The employer is also generally required to make contributions on behalf of eligible employees. The general contribution limitation for a SIMPLE IRA is more than double that of a traditional IRA. Generally, SIMPLE IRA contributions are not included in an employee's income when paid into an IRA and the distributions are fully taxable when the employee receives them in later years. If the distribution is from a designated Roth SIMPLE IRA, see the Roth IRA discussion below.

As discussed later in Lesson 27, Other Taxes, the additional tax for an early distribution may be higher for a SIMPLE distribution.

Simplified employee pension (SEP) IRA

Some employers offer their employees the chance to contribute part of their pay to an IRA as part of a SEP plan. Self-employed individuals may set up an SEP for themselves (and their employees, if any). The general contribution limitations for an SEP IRA are **substantially** higher than for a traditional IRA. Generally, SEP IRA contributions are not included in an employee's income when paid into the IRA. Because of this, distributions from a SEP IRA are in scope and generally fully taxable when the employee receives them in later years. If the distribution is from a designated Roth SEP IRA, see the Roth IRA discussion below.

Contributions to SIMPLE IRAs, SEP IRAs, or other employer plan (e.g. a 401(k)) are out of scope. However, distributions from SIMPLE IRAs and SEP IRAs are in scope.

Traditional IRA distributions

(A) Advanced certification is required if the taxable amount is not shown in Box 2a and Box 2b is checked.

When you learn about IRA accounts in Lesson 17, Adjustments to Income, 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.

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.

Additionally, the taxable amount of an IRA distribution can be reduced for a rollover or qualified charitable distribution as discussed below.

Basis in a traditional IRA

The taxpayer's basis in their traditional IRA increases when a contribution is not deducted for federal tax purposes. That basis is recovered a bit at a time as distributions are made from the traditional IRA thus reducing the amount of the distribution that is taxable.

Form 8606 Parts I and II are in scope for Tax-Aide. Use Part I to track an individual's aggregate basis for 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 early distribution penalty. A conversion of a traditional IRA 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 particular 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 rollovers and 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 *Lesson 27, Other Taxes* *for more information.*

Exercises (Answers are at the end of this lesson.)

Question 1: Distributions from all IRAs discussed in this topic are fully taxable with the exception of Roth IRAs.

a. True
b. False

Roth IRA distributions

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, and T are specific to Roth IRAs. The IRA/SEP box should not be checked for a Roth IRA.

Qualified Roth distributions

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) – out of scope

The 5-year rule starts with the first Roth IRA the taxpayer sets up for qualified distribution purposes.

However, the 5-year rule is applied differently for the early distribution tax. Each Roth conversion, or rollover has its own 5-year rule for purposes of the early distribution tax.

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.

Marcus rolled over a distribution from a designated Roth account to a new Roth IRA. He did not previously have a Roth IRA. The period that the rolled-over funds were in the designated Roth account does not count toward the 5-year test for determining qualified distributions from the Roth IRA.

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, the return is in scope for Tax-Aide. If the Roth distribution is not qualified, the return is out of scope. Refer to the discussion of designated Roth accounts later for employer plans.

Code H is a rollover from a designated Roth to a Roth IRA or Roth SIMPLE IRA. Even if not taxable, the distribution must be reported on the taxpayer's return.

Remember, you don't have to memorize all these codes — they are all in your NTTC 4012.

Nonqualified Roth distributions

If the above Roth qualified distribution 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.

Note that 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.

Exercises (continued)

Question 2: Mary opened a Roth IRA three 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 that IRA. The entire distribution is excluded from her taxable income.

a. True
b. False

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.

Assume a withdrawal of $100,000 from an employer 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 employer qualified 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.

Transfers

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.

Rollovers

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 from a designated Roth employer plan to Roth IRA will most likely have code H on Form 1099-R box 7 “Roth IRA or Roth SIMPLE IRA distribution, exception applies”. The period that the rolled-over funds were in the designated Roth account does not count toward the 5-year test. However, the 5-year test is met if the taxpayer made a contribution to their Roth IRA more than 5 years prior.

An indirect 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. There is a limit of one distribution that is indirectly rolled over per twelve months — regardless of the number of accounts the taxpayer holds.

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.

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. 2020-46 (and its predecessor Rev. Proc. 2016-47) for more information and a sample self-certification letter. There is a link to the Rev. Proc. in your NTTC 4012.

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 Lesson 27, Other Taxes.

Conversions

A Roth conversion of a traditional IRA in which the taxpayer has basis requires Advanced certification and Basic certification if there is no basis.

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.

A required minimum distribution (discussed below) cannot be rolled over — not to a similar type of account (e.g. IRA to IRA) nor to a different type of account (e.g. IRA to Roth conversion).

Recharacterizations

A recharacterization is when the taxpayer changes the classification of a type of contribution made to a retirement account. An example would be changing a contribution to a traditional IRA to instead be to a Roth IRA or vice versa. This allows individuals to adjust their contributions based on changing financial circumstances or tax considerations, such as when a traditional IRA contribution is not fully deductible. Generally, a recharacterization must be completed by the due date of the return. While the recharacterization may have to be reported, it is not taxable and the IRA contribution is reported based on its final character.

Gil is covered by his employer’s retirement plan but also made a $6,000 contribution to his traditional IRA. While preparing Gil’s return, his income eliminates his IRA deduction — he has too much income. Gil has two options: a) leave the nondeductible contribution in his traditional IRA (Form 8606 is required to report his additional basis) or b) arrange with his trustee to recharacterize his contribution as to a Roth IRA (his income is not so high as to preclude a Roth contribution).

Refer to the IRA income limits in the Important Changes lesson.

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 receipt and acknowledgement of the contribution that is needed to claim a deduction for a charitable contribution (see Lesson 19, Deductions).

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 their 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 account trustee may (or may not) add distribution code Y on Form 1099-R to indicate that a QCD was made. The taxpayer will need to provide the amount.

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 by IRA deduction after age 70½

A taxpayer with taxable compensation can contribute to their traditional IRA and claim a deduction (subject to the regular IRA rules discussed in Lesson 17, Adjustments to Income). To prevent a taxpayer from a double benefit, a taxpayer cannot claim the full amount of 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 that make deductible IRA contributions need to calculate the excludible amount of their QCD. Each spouse must make their own calculation if married filing jointly. The Tax-Aide worksheet Reduced QCD by IRA Deduction contains instructions and an example that should be used for taxpayers who are affected by this provision. If the worksheet is used for a taxpayer, be sure to move it forward to the current year and update it as needed.

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.

Part II: Employer retirement plans

Advanced certification is required if the taxable amount is not shown on Form 1099-R Box 2a and Box 2b is checked.

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, discussed below.

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.*

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

Sara worked for a software development company for 20 years. She retired and began receiving pension income the same year. Sara 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, the taxable amount box is blank, 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, with an exception for taxpayers who started their retirement in the second half of 1986.

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.

The calculator will alert you to an important exception for taxpayers who started their retirement in the second half of 1986. They may continue the annual exclusion even after they have fully recovered their basis.

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.

Railroad retirement benefits

Railroad retirement benefits are paid to railroad employees working in jobs that are covered by the Railroad Retirement Act and administered by the Railroad Retirement Board (RRB). The railroad retirement benefits have two components: tier 1 (Social Security equivalent benefits) and tier 2 (treated as a qualified employer plan). The tier 1 benefits are discussed in Lesson 14, Income – Social Security benefits.

Railroad retirement pensions can be for the employee only or for both the employee and their spouse. Railroad pensions that start when both the retiree and the spouse are alive are always joint and survivor annuities. The taxable amount of the pension may have been already computed. If not, you will have to determine the taxable portion using the simplified method.

Do not use the simplified method if the pension qualifies as a disability pension treated as wages as discussed below.

The spouse of a railroad retiree receives a spouse annuity directly on a separate RRB-1099-R even though the spouse was not employed by the railroad. The simplified method does not apply to a spouse annuity while the retiree is alive.

After the death of the retiree, a survivor annuity is payable to the surviving spouse. From that point forward, the surviving spouse can use the simplified method using the retiree's unrecovered cost in their pension until the retiree's cost in the plan is fully recovered.

Designated Roth accounts

A qualified distribution from a designated Roth account, is not includible in gross income. This applies to both the employee's cost in the account and income earned on that account. The plan administrator is responsible for accurately reporting distributions, including the taxable amount, if any.

Qualified designated Roth distributions

When the distribution is qualified, the 1099-R will show code B and the taxable amount will be zero. A qualified distribution is generally a distribution that is:

- Made after a 5-tax-year period of participation; **and** made:
    - On or after the date the employee reaches age 591/2,
    - To a beneficiary of the employee or the employee's estate on or after the employee's death, or
    - Attributable to the employee being disabled.

EXAMPLE *Wilma had a designated Roth account with her old employer for more than 5 years. She started a new job with a new designated Roth account in her new employer's plan. The 5-year test starts anew for the new designated Roth account.*

Nonqualified designated Roth distributions

When the distribution is not qualified, the 1099-R will show code B and either code 1 or 2. The taxable amount will be shown. If the taxpayer is under 59 ½, the 10% early distribution tax will apply to the taxable amount unless an exception is met.

EXAMPLE *Andrea left her job after three years and withdrew the entire balance in her designated Roth account. Her 1099-R shows a total distribution of $6,150 and $150 as taxable. Since this is not a qualified distribution, $150 will be included in Andrea's income. If she is under 59 1/2 an early distribution tax will apply to the taxable amount unless she qualifies for an exception.*

Rollover to Roth IRA

A designated Roth distribution that is directly rolled over to another designated Roth account or rolled over to a Roth IRA on a timely basis is also tax-free. Note that code H is added for a rollover from a designated Roth to a Roth IRA and not taxable.

In-plan conversion to designated Roth

The IRS refers to these as in-plan rollovers; we will call them conversions as that is more descriptive.

An employee can convert a pre-tax account (such as a 401(k)) in their employer's plan to an after-tax designated Roth account. The 1099-R will show the taxable amount; but there is no early distribution tax.

Each in-plan Roth conversion or in-plan designated Roth rollover has its own 5-year rule for purposes of the addition to tax on early distributions. As noted above, the early distribution tax may apply to the taxable portion of the distribution if the qualification tests noted above are not met (unless an exception applies).

Roth nonelective contributions and matching contributions

Starting 2024, an employer retirement plan may provide for Roth nonelective or matching contributions. The contribution amount is taxable to the employee to make their contribution after tax. 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.

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 or a specified number of years. 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.

If the distribution on or after the annuity starting date is an amount that fully satisfies the payer's obligation under the contract (for example, the annuity is cashed in), the amount may be a refund of what was paid for the contract or for the complete surrender, redemption, or maturity of the contract. The payer will report the amount taxable on Form 1099-R, if any. Gross income includes the part of the distribution exceeds the remaining cost of the contract. See below for loss on termination of an annuity.

Nonqualified annuities

A nonqualified annuity is a financial product that can be purchased with after-tax dollars. It allows the investment to grow tax-deferred until the funds are withdrawn. Unlike qualified annuities, they do not have contribution limits or required minimum distributions, providing more flexibility in retirement planning.

A nonqualified annuity is signified by code D in box 7 (along with a numeric code) on Form 1099-R. The return is in scope only if Box 2a contains the taxable amount. If the taxable amount is not shown in box 2a, the simplified method cannot be used for the employee contribution amount (box 9b).

Additionally, 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 at 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.

The **minimum retirement age** is generally the earliest age at which the taxpayer 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 pension 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) and is 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 officer exclusion

For this discussion, 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 as discussed above), 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 (see *[Lesson 27, Other Taxes](#)*). *The latter includes more individuals.*

Part III: 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 (discussed in Lesson 27, Other Taxes). If an exception is met, the additional tax does not apply. 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 Lesson 27, Other Taxes.

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.

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. After the starting year for RMDs, taxpayers must receive the minimum distribution for each year by December 31 of that year.

For a traditional IRA: If the taxpayer reaches age 73 in 2025, their start year is 2025. The required start date for their first RMD is April 1, 2026. They must take their second RMD by December 31, 2026.

If the taxpayer had 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 Lesson 27, Other Taxes.

Peter turned 73 on August 20, 2024. His start year is 2024 for his traditional IRA. Peter can take his first RMD from his traditional IRA during 2024 or, at the latest, by April 1, 2025. His second RMD is due by December 31, 2025.

Ralph turned 73 on March 15, 2024 and retired on June 30, 2025.

For his traditional IRA, Ralph's start year is 2024 and the (latest) RMD start date April 1, 2025. His second RMD is due by December 31, 2025.

For his company's 401(k) plan, Ralph's start year is 2025 and the (latest) RMD start date is April 1, 2026. His second RMD is due by December 31, 2026.

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.

Required distribution – Roth IRAs

The RMD rules do not apply to Roth IRAs. However, the beneficiary must withdraw the entire balance of an inherited Roth IRA by the end of the tenth year.

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, together 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.

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. If the taxpayer is subject to an additional tax due to excess IRA contributions, their tax return is out of scope.

The withdrawn interest or other earnings associated with the excess contribution is no longer subject to the additional 10% tax on early distributions.

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 in 2025 of $1,000, which she withdrew by April 15, 2026, 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 2025 (the year in which the excess contribution was made). Maria doesn't have to report the excess contribution as income or pay the 6% additional tax because she withdrew the excess contribution by the due date of her return. Sometime in 2025 or early 2026, Maria will receive a Form 1099-R showing that the earnings are taxable for 2025. Since she has already reported the $50 of income on her 2025 return, no further action is needed.

Do not include a Form 1099-R that has the code for a prior year in the current year's return. If not already reported in the prior year, an amended return for the prior year may be appropriate and may be 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 and the total distribution box will be checked. 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, 2024. 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, 2024.
b. Take a distribution of $1,479 by December 31, 2024.
c. Take a distribution of $2,958 by December 31, 2024.
d. Take a distribution of $1,479 by April 1, 2025, and another $1,479 by December 31, 2025.

Question 9: Trevor turned 73 on February 14, 2024. He retired in 2025. 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

Loss on termination of annuity

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 the plan is otherwise terminated.

The taxpayer may claim a deduction for the unrecovered investment in the contract as an "other itemized deduction" as discussed in Lesson 19, Deductions.

Part IV: Special retirement distribution provisions

Certain distributions may be repaid or receive other tax-advantaged treatment. 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. 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.

Note that a 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.

The distributions described in this section may qualify for an exception to the additional tax on early distributions. See Lesson 27, Other Taxes.

Check the Tax-Aide Intake Booklet, to see if thetaxpayer indicated a contribution or repayment to a retirement account. You will need to confirm the provision that allows repayment.

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.

Self-support means the person is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or to be of long-continued and indefinite duration.

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 had 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.

Victim of domestic abuse

For 2025, domestic abuse victims may repay a distribution up to the lesser of $10,300 (subject to inflation adjustment) or 50% of the accrued benefit from an eligible retirement plan. Specific definitions and timing apply. See Pub 575. A qualified distribution may be repaid within 3-years starting the day after the distribution.

Emergency expenses

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, similar to the qualified birth or adoption provision above. Qualified emergency expense distributions are subject to three rules:

1. Not more than one distribution per calendar year is permitted to be treated as an emergency personal expense distribution by any individual.

2. The maximum amount that can be treated as an emergency personal expense distribution in any calendar year is $1,000 (or less if the balance in the account is less than $2,000).
3. A subsequent emergency personal expense distribution cannot be made for 3 calendar years unless the prior distribution was repaid in full or the taxpayer made contributions to the plan.

A qualified distribution may be repaid within 3-years starting the day after the 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 (repay) a qualified plan distribution. There are specific rules and the reporting of any repayment is different from the repayments discussed above. This is discussed in the Lesson 16, Income - Military Members.

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. 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.

During the interview with the taxpayer, use the NTTC Casualty Loss Screening Tool to determine whether you can assist the taxpayer – it's readily available from the Tax-Aide Links on your Tax-Aide computer.

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.

Situations that 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 subject to additional tax due to excess IRA contributions
- Roth IRA or designated Roth distributions that are not are not rolled over and 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, box 7 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 or if Form 8915-F is required to be filed
- Retirement income from a foreign country unless certified in International (other than German or Canadian social security – see Lesson 14, Income – Social Security Benefits)
- Foreign accounts or holdings requiring the filing of FINCEN114 or Form 8938

Where to find more information

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 for a missed rollover)

Pub 575, Pension and Annuity Income

Pub 560, Simplified Employee Pensions (SEPs)

Pub 721, Tax Guide to U.S. Civil Service Retirement Benefits

Pub 939, General Rule for Pensions and Annuities

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 2024, which is her required start year. She has until April 1 of the following year to take her distribution for 2024. Her next RMD is by the end of 2025.

Answer 9: d. Trevor retired in 2025, which was later than the year he turned 73. That makes 2025 his required start year. He can delay his first RMD until April 1, 2026. He must take his second RMD by December 31, 2026.

(A) Income – Sch K-1, Royalties, and Land Rents

Introduction

This is the fifth lesson covering items of taxable income. The three main topics in this lesson are not frequently seen and all three require Advanced certification. When a taxpayer does present Sch K-1, be sure to review it carefully as only a few items are in scope. Royalty income can be from a variety of sources and each is reported differently. Lastly, land rents are in scope for Tax-Aide.

This lesson does not apply to taxpayers who are in the business of renting properties. Residential rentals are in scope only for active military taxpayers renting their personal residences. Refer to the Lesson 16, Income – Military Members 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)
- Pub 17

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. 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. Any item 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).

During your interview with the taxpayer, carefully review any Sch K-1:

- For the right tax year
- For the taxpayer or spouse if MFJ
- To be sure it has in-scope items only

In-scope income or expense on a K-1

Amounts reported on Sch K-1 that are in scope and where the item will appear on the taxpayer's return include:

- Taxable interest income (Sch B, if required) and tax-exempt interest income (Form 1040 page 1)
- Dividend income, including (Sch B, if required)
  - Qualified dividends income (Form 1040 page 1 and Sch D tax calculation worksheet, if required)
  - Section 199A dividends (Form 8995)

- 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 (Sch D tax calculation worksheet, if required)
- Royalty income (Sch E)
- Foreign tax credits not requiring Form 1116

Interest and dividends were discussed in Lesson 8, Wages, Interest and Dividends. You may need additional information for state purposes that you may find on a state K-1, especially if there is tax-exempt interest reported on the K-1.

Capital gains and losses are covered in Lesson 10, Income – Capital Gain or Loss. The capital gain or loss from the K-1 is added to any other capital gains or losses the taxpayer has. Sch D will compute the overall net gain or loss situation.

Royalty income is discussed below. By entering the royalty income on the Sch K-1 input sheet, it will automatically go to Sch E.

Foreign tax credits are discussed in Lesson 23, Foreign Tax Credit. During the interview, be sure to include any foreign tax credit flowing from a K-1 with any Form 1099 that reports foreign tax credit. The limit on the simplified limitation election is $300 ($600 if MFJ) so that Form 1116 is not required. If the limit is exceeded, the only way to claim foreign tax credits is by completing Form 1116, which requires International certification. A taxpayer could alternatively claim an itemized deduction for the foreign taxes if they itemize as described in Lesson 19, Deductions.

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.

EXAMPLE

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 applicable K-1 input screen of the software. The software will carry the amounts to the appropriate form or schedule. Refer to your NTTC 4012, Tab D, for the type of K-1 received and which items are not in scope.

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. If there is a state Sch K-1, it may provide information for the necessary state return.

Exercise (Answers are at the end of this lesson.)

Question 1: Jack is not married. He received a K-1 from an investment partnership showing his share of foreign taxes paid was $75. Jack also has two brokerage accounts showing $130 and $115 of foreign taxes related to his interest and dividend income. He has enough income tax to use up all the foreign tax credits he can claim. You are certified at the Advanced level. How should you proceed (select all that apply)?

a. Explain to Jack that you are not trained to complete a full Form 1116 and that since his total foreign taxes are more than $300, that is the only way to claim a foreign tax credit.
b. Consult with your Coordinator to determine if other Counselors are available at your site to prepare and review Jack's return.
c. Use just $300 of the foreign taxes as a credit without completing Form 1116.
d. Tell Jack that he cannot claim the foreign taxes since he is not itemizing his deductions.

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 types of income, deductions, credits, etc., are in scope only 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. On a Sch K-1, royalties from a working interest would be reported as business income, which is out of scope.

Royalties from a taxpayer's work

Royalties from the taxpayer's own services are reported on Sch C if from a business. Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid for the right to use the taxpayer's work over a specified period of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold. See Lesson 9, Income – Business. If the royalty does not relate to the taxpayer's self-employment activity, it is reported on Sch E of the return.

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.

EXAMPLE *Ilene received two forms 1099-MISC: one reports royalties of $150 she inherited from her father (he was a composer) and another showing her own royalties of $2,300 from her own song writing business. Ilene will include the $2,300 as gross receipts on her Sch C and the $150 as other income on Sch 1.*

Exercise (Continued)

Question 2: Betty has been writing children's books for several years, about one per year. Some are printed and sold and some are self-published in digital form. She received $2,500 in royalties from books she wrote in prior years. How should Betty report her royalty income?

a. On Sch 1 as other income.
b. On Sch E as royalty income.
c. On Sch C as business income.

Land rents

Land rents meams the rental of vacant land, that is, land that has no depreciable improvements. If there are any improvements on the land that could be depreciated, the return is out of scope unless the taxpayer is in active military service (see Lesson 16, Income Military Members).

The taxpayer may or may not receive Form 1099-MISC for the rental income. 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 (Continued)

Question 3: 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 items covered in this lesson are in scope.

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. 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.

Situations that 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 or losses reported on a Sch K-1 (other than those listed in this lesson)
- Deductions, credits, and other items reported on a Sch K-1 (other than those listed in this lesson)
- Royalty income reported on Form 1099-MISC when there are associated expenses, except if includible on Sch C
- Royalty income from a mineral working interest (only nonworking interests are in scope)
- Taxpayers who filed or need to file Form(s) 1099

Where to find more information

Pub 17, Your Federal Income Tax

Exercise answers

Answer 1: a and b. The simplified foreign tax credit is not available to Jack and to claim the credit on Form 1116 requires International certification by both the preparer and reviewer.

Answer 2: c. Betty has a business of writing books and her business income includes the royalties from book sales.

Answer 3: 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 addresses several benefits that state or local governments provide to their residents. These payments may or may not be taxable for federal purposes.

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 assist a taxpayer who received:

- Unemployment compensation benefits
- Family leave benefits
- State or local income tax refunds
- 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 year 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 second item discussed — state or local income tax refunds. Your Instructor will guide you to the proper state tax treatment of items reported on Form 1099-G as state treatment likely differs from the federal treatment.

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. However, 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.

The amount shown on the 1099-G should be the correct taxable amount. If the taxpayer believes it is not, they should contact their unemployment office to get a corrected 1099-G.

The interview

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.

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. While it is best to wait for a corrected Form 1099-G, you can proceed with their return after warning the taxpayer that IRS may contact them if the corrected Form 1099-G is delayed.

Repaid 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).

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 on the federal return (state treatment may differ).

- And the amount of repayment is more than $3,000, the return is out of scope.

Taxpayers may be able to claim a refundable tax credit when they have repaid income of more than $3,000 that was previously taxed. Refer to Lesson 28, Payments and Miscellaneous Refundable Credits. The credit is out of scope and the taxpayer's return is out scope.

Exercises (Answers are at the end of this lesson.)

Question 1: Will received $12,000 of unemployment benefits during the year. However, his Form 1099-G shows that $14,400 was paid. Will contacted the state agency and they are investigating the matter. How should Will proceed?

a. Will must report the full $14,400 that is on Form 1099-G.
b. Will can disregard the erroneous Form 1099-G.
c. Will must wait until the agency finishes their investigation and issues a corrected Form 1099-G.
d. Will can file his return now reporting the actual amount of unemployment received ($12,000). He should continue to follow up with the agency to get a corrected 1099-G.

Family leave

Family leave reported on Form 1099-G is generally taxable. However, if taxpayers contribute to a governmental paid family leave program and the contributions are not deductible, amounts received under the program are not included as family leave benefits 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.

The amount shown on the 1099-G should be the correct taxable amount. If the taxpayer believes it is not, they should contact their state office to get a corrected 1099-G.

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 their deductions and received a federal income tax benefit for deducting their state or local income taxes are required to include their state/local income 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. They may not have to include some or all of their refund in their taxable income.

In many cases only a portion of a state or local income tax refund needs to be included in income. There is a worksheet in the tax software that can be used when the state tax refund situation is straightforward.

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. An often-seen situation is 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 year's return, there may have been no change in tax because nonrefundable credits could have been used. Thus, the taxpayer did not get any tax benefit and the recovery of that item is not taxable.

When computing the tax benefit received for an income tax deduction, remember that the taxpayer could have claimed the state sales tax deduction instead of the income tax deduction. You will need 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. The Colorado Resource Toolbox calculator has a handy link to the IRS sales tax calculator for this purpose.

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 (Continued)

Question 2: 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

Other amounts on Form 1099-G

Other income items require a thorough conversation with the taxpayer to determine the nature of the payment. Remember that you can ask assistance from more experienced Counselors or the Coordinator at your site if you are unsure.

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. These are also out of scope.

Taxes withheld

Be sure to enter the withholding from Form 1099-G, Box 4. This can be easily overlooked. The software will carry it to the appropriate line of Form 1040.

Exercises (Continued)

Question 3: Yakov has had his consulting business for several years and was adversely impacted by a local disaster (though he, himself, did not lose anything in the disaster). He applied for and received a small business grant of $3,000 from the state that is reported in box 6 of Form 1099-G. How should he report that grant?

a. Enter it as a state tax refund.
b. Enter it on Sch 1 as miscellaneous income.
c. Enter it on his Sch C as business income.
d. He does not need to include it on his tax return since it relates to a disaster.

Summary

This lesson explained the taxability of:

- Unemployment compensation
- State or local income tax refunds, which may or may not be taxable. If taxable, the refund may be only partially taxable.
- Other amounts shown on Form 1099-G.

Situations that 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 repaid during the current tax year more than $3,000 of unemployment benefits that were taxed in a prior tax year
- 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 received taxable grants that should be reported on Sch E, Sch F, or Form 4835
- Form 1099-G with an entry in boxes 7, 8, or 9

Where to find more information

Pub 17, Your Federal Income Tax

IRS information on Unemployment compensation

IRS information on incorrect or missing documents

Exercise Answer

Answer 1: d. Will is doing the right thing working with the agency to get a corrected Form 1099-G. He can file his return now and does not have to wait for the corrected form.

Answer 2: 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, you would use the state tax refund calculator to determine the portion of the refund that is taxable (it may be less than the full amount of the refund).

Answer3: c. The state has reported the grant as a taxable grant and there is no evidence that it is not taxable. Since the grant relates to his business, Yakov should add it to his Sch C business gross receipts.

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 benefits. Social Security benefits are paid as monthly retirement, survivor, and/or disability benefits. In some cases, individuals are 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.

Railroad retirement benefits

Railroad retirement benefits are paid to railroad employees working in jobs that are covered by the Railroad Retirement Act and administered by the Railroad Retirement Board (RRB). The railroad retirement benefits have two components: tier 1 (Social Security equivalent benefits) and tier 2 (treated as a qualified employer plan). The tier 2 benefits were discussed in Lesson 11, Income – Retirement.

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.

EXAMPLE

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.

Taxable Social Security benefits

Generally, if Social Security, including any Canadian, German, and railroad retirement tier 1 benefits (collectively referred to as "social security benefits") is the taxpayer's only source of income, the social security benefits are not taxable and the taxpayer may not be required to file a federal income tax return.

However, part of the taxpayer's social security benefits may be taxable — it depends on the taxpayer's filing status and other reportable income. 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. The taxable portion will not be more than 85% of the total benefits received.

If the taxpayer is filing MFS and lived with their spouse at any time during the year, 85% of the benefits is automatically taxable. This is an important issue that taxpayers wishing to file MFS should focus on before finalizing their return. A taxpayer filing MFS who did not live with their spouse uses the $25,000 threshold.

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%.

EXAMPLE

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 software will also complete the Social Security Benefits Worksheet (per the IRS instructions) to show the calculation. You can use that printed worksheet to show the taxpayer how the amount of taxable benefits is computed.

U.S. citizens who are residents of certain foreign treaty countries may be exempt from U.S. tax on their Social Security benefits. See Pub 915.

Exercises (Answers are at the end of this lesson.)

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 amount of Hank's benefits that could be taxable?

a. $31,896
b. $20,172
c. $11,724
d. $9,965

Form SSA-1099 or RRB-1099

Social security benefits are reported on Form SSA-1099 or Form RRB-1099. Box 5 of each form shows the amount of net benefits and is the amount generally entered into the software.

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.

Benefit reductions

The 1099 tax statement may show reductions for several items. Most of these reductions do not impact the amount of benefits reported in box 5 of the 1099, which is the amount that you will enter into the software.

Medicare premiums. The most frequently seen reduction is for Medicare premiums (Parts B, C, and/or D) for the current year. These Medicare premiums may be claimed as a self-employed health insurance (SEHI) deduction if the taxpayer or spouse is filing Sch C (see Lesson 17, Adjustments to Income), used for the public safety officer exclusion (see Lesson 11, Income - Retirement), or claimed as an itemized deduction on Sch A (See Lesson 19, Deductions). If Medicare charges in a prior year were insufficient, perhaps due to the income-based adjustment (IRMAA), the current year's Social Security benefits can be reduced — the prior year charges may or may not qualify for the SEHI.

Federal tax withheld. The second most frequently seen deduction is for federal income tax withholding.

Be careful when entering amounts from Form SSA-1099; it is too easy to transpose the Medicare charges and federal tax withholding amounts or to miss entering the federal tax withheld altogether.

Work income. Social Security can also be reduced for work income when the taxpayer has not reached their full retirement age. Box 5 will show the net amount to be reported on the return.

Prior year overpayments. Reductions can also be made for prior year overpayments of Social Security benefits or Supplement Security Income (SSI). While not often seen, it is possible that Form SSA-1099 shows a negative amount in Box 5. If the taxpayer is filing jointly with their spouse, they can reduce their spouse's Box 5 amount, if any, by the negative amount (but not below zero). If the (net) negative amount is over $3,000 and the Social Security benefit was taxed when it was originally received, a deduction or credit may be possible. See Lesson 28, Payments and Miscellaneous Refundable Credits for this out-of-scope situation.

Offsets. Other reductions include those for offsets or garnishments for some types of debt, such as taxes or court-ordered payments. You will use the amount reported in Box 5. See Lesson 19 – Deductions for a possible itemized deduction.

Exercises (continued)

Question 2: Greg's SSA-1099 shows box 5 benefits of $33,000 and that $2,500 of legal fees reduced the benefits he actually received. He had engaged a lawyer to get his benefits and the SSA paid the lawyer directly. What should Greg do on his federal return?

a. Reduce his box 5 benefits and report the net amount of $30,500 on his tax return
b. Claim an adjustment to income deduction for the $2,500
c. Claim an itemized deduction for the $2,500 if he itemizes
d. None of the above

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 Social Security Administration (SSA) and RRB pay to many of their beneficiaries ($250). No part of the lump-sum death benefit is subject to tax.

The whole amount of benefits received (box 5) is reported on the return. To compute 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, simply enter the total Social Security benefits as usual and the software will handle the computation.
- The **second option** is referred to as the lump-sum election method. Under this method, a computation is made to compute the amount of the retro benefits that would have been taxable had they been included in the earlier year's tax return. Any part that would have been taxable is then added to any taxable benefits for the current year 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.

The lump-sum method merely computes the amount of benefits received in the current year that is taxable in the current year. There is no need to amend the prior year's return.

The Social Security Fairness Act increases benefits for individuals receiving pensions from work not covered by Social Security, such as teachers and firefighters. Affected individuals may receive retroactive benefits to January 2024. That retro payment is eligible for the lump-sum option.

A taxpayer who is eligible for premium tax credits (see Lesson 26) will include the full amount of Social Security benefits received in their MAGI, including the retro amount. This may cause an unexpected excess advance premium tax credit that may need to be repaid.

How to proceed

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. If there is no increase in tax, skip the lump-sum method.

The software will use the lump-sum method if it is advantageous to do so, in which case, only the current year taxable income will be adjusted. You do not file amended returns for the earlier years.

When entering the prior year(s) information on the Social Security Lump-Sum Payment input screen, pay close attention to the amount entered for MAGI (modified adjusted gross income). This MAGI is different than other MAGI calculations you may have encountered. Use your NTTC 4012 to make the correct calculation.

Once the taxpayer elects the lump-sum method on their return, the election can only be revoked with the consent of the IRS.

It's a good idea to first see if the taxpayer will owe any tax. If so, the lump-sum method information should be entered into the software. If not, there is no need to do that.

Exercises (continued)

Question 3: Angie is a retired school teacher whose school pension previously denied her Social Security benefits. Due to the new law, she was awarded a retro payment of $14,600 in addition to the current year's Social Security of $14,965 for a total of $29,565. Her school pension is $46,000. She is worried that all of her Social Security will be taxed. Is she right?

a. Yes.
b. No.

Withholding tax

A taxpayer can choose to have federal income tax withheld from their Social Security benefits and/or their tier 1 railroad retirement benefits. The taxpayer can select withholding of 7%, 10%, 12%, or 22% of their monthly benefit payment. To do this, the taxpayer can:

- Mail in Form W-4V, Voluntary Withholding Request, to the Social Security Administration
- Start, stop, or change their withholding using their SSA.gov online account, or
- Call the Social Security Administration

Having federal tax withheld from Social Security benefits can be a good choice when the taxpayer will owe federal tax but not state tax.

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.

Only Canadian or German social security benefits are in scope and are treated the same as U.S. Social Security for federal tax purposes. Social security or other retirement from foreign sources are out of scope unless both the preparer and reviewer have been certified in International.

Form SSA-1099 or RRB-1099 reports the benefits and any reductions made. Some reductions, such as Medicare premiums, may be used as a deduction elsewhere on the return.

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.

Taxpayers can choose to have federal tax withheld from their Social Security benefits to reduce the amount of tax that might otherwise be owing.

Where to find more information

Pub 17, Your Federal Income Tax

Pub 915, Social Security and Equivalent Railroad Retirement Benefits

Exercise Answers

Answer 1: d. $9,965 or 85% of the net benefits is the maximum amount that could ever be taxable.

Answer 2: d. Greg must report the box 5 amount ($33,000) as his benefits received. Assuming none of his SS benefits is taxable, no deduction is possible. If a portion of his SS benefits is taxable, the answer is still no deduction because the 2% itemized miscellaneous deductions are permanently suspended for federal tax purposes.

Answer3: b, No. You will enter the information into the software so it can compute the portion of the retro payment that will be taxable using the lump-sum method. At most, only 85% of Angie's Social Security will be taxable, and possibly less based on the lump-sum calculation.

Income – Additional

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 Lesson 14, Income – Social Security Benefits.

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:

Part I: Other income

- Additional 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.

Part II: Worldwide 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. Sch 1 has many lines and they change from year to year. Several of the line items are out of scope as noted at the end of this Part I. In order to report the income on the proper line, use your NTTC 4012 — it will show you exactly how enter the particular income item.

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 you are still 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 their worldwide income.

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.

Additionally, if a divorce or separation instrument provides for alimony and child support and the payer spouse pays less than the total required, the payments are applied to child support first. Only the remaining amount is considered alimony.

Child support is never taxable or deductible. The taxability of alimony income depends on the date of the divorce or subsequent modification event.

Post-2018 divorces

Alimony and separate maintenance payments are not taxable to 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 as an adjustment to the MAGI. 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 the alimony or separate maintenance payments as income. The person paying alimony can claim a deduction as an adjustment to income as discussed in Lesson 17, Adjustments to Income. 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 taxable alimony income to make a deductible traditional IRA or nondeductible IRA or 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.

How to proceed

The taxpayer should indicate on the Tax-Aide Intake Booklet if they are divorced and the date of the final decree. Also, the taxpayer should have checked the Alimony box on page 2 of the Tax-Aide Intake Booklet. You can also review the prior year's tax return to see if alimony income was reported. A good interview with the taxpayer is needed to confirm the amount of alimony received and whether it is taxable.

State laws may differ.

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. The taxable amount is the winnings less the cost to win on an occurrence-by-occurrence basis. That is, for example, multiple entries for the same drawing are combined as the cost to win for that drawing event.

Fred buys one lotto ticket for $5 and wins $100. He does not get a W-2G. Report $95 as other income "gambling winnings."

Nikola buys 10 quick picks for the nightly lotto for $2 each and wins $1,000. He receives a W-2G for $1,000. Report the W-2G gross winnings ($1,000) and add a negative other income "cost of gambling winning ticket" for $20.

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.

Frequent (lucky) gamblers may receive several W-2G forms from the same payer. If so, it is acceptable to aggregate them into a single W-2G entry in the tax software.

In-kind winnings

If the prize or award is not made in money but is made in goods or services, the fair market value (FMV) of the goods or services is the amount to be included in income. FMV is defined as the amount a willing buyer would pay to a willing seller, both having knowledge of relevant facts. If the prize won is not money, the awarding entity may not have FMV information and may use the manufacturer's suggested retail price of the item or some other value amount, which may not be the true measure of FMV. Use a second negative other income entry to "reduce prize value to FMV" when the taxpayer has evidence of a lower FMV. The taxpayer should ask the payer to send a corrected W-2G or Form 1099-MISC for their (and the IRS's) records. Tax returns for taxpayers who dispute the value presented on a tax form without evidence should be declined.

Kiko buys 10 charity raffle tickets for $50 each and wins a vacation. She receives a 1099-MISC showing the retail value of the vacation at $15,000. A similar trip could have been purchased for $12,000 and Kiko has evidence of that value. Report the gross Form 1099-MISC amount of $15,000, add a negative other income entry for $3,000 "reduce prize value to FMV," and another negative other income entry for $500 "cost of winning prize ticket." Kiko should request a corrected Form 1099-MISC, though it is not necessary to hold the return.

Losses and expenses

A gambling loss is different than the cost to win. A loss occurs when the total waged for the discrete event does not win (e.g. six $5 losing lotto tickets for one drawing) or the amount won is less than the total amount wagered for that specific prize (e.g. buy a $10 lottery ticket and win $2). Gambling losses and gambling-related expenses may be claimed as a deduction if itemizing (limited to overall winnings). See Lesson 19, Deductions.

Scope limitation

Professional gamblers can use Sch C to report their gambling activities. Tax returns for taxpayers who wish to claim gambling activity as a business (Sch. C) are out of scope.

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 are out of scope.

Medical trial participation payments

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 Lesson 8, Income – Wages, Interest, and Dividends. The difference is that some states report these payments on a 1099 form instead of on a W-2.

As an alternative to expensive nursing home care, Medicaid may pay providers of home-based care for the elderly or disabled directly. Such payments are called Medicaid Waiver Payments (MWP) and may be excluded from gross income *if qualified*. When the care provider and the care recipient do not live together in the same home, the MWP is fully taxable and cannot be excluded. A care provider may not exclude MWP for the care of more than 10 individuals under age 19 or more than five individuals the age 19 or older.

A taxpayer may choose to include qualified Medicaid waiver payments in the calculation of earned income for the Earned Income Credit (EIC), Additional Child Tax Credit (ACTC), and the Child and Dependent Care Credit (CDCC) 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. Refer to the NTTC 4012 for software entries.

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 on Sch 1 and **not** treated as earned income.

Strike benefits

Strike pay or other lockout benefits come 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. There is a special place to enter strike benefits in the software.

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. Governmental payers should not be using a 1099 series form to report election worker pay. See the discussion in Lesson 8, Wages, Interest, and Dividends.

(A) 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.

(A) 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. The taxpayer will receive Form 1099-SA showing total distributions during the year. The taxpayer will need to advise you of the qualified medical expense that offset the distribution in order to avoid paying tax on it.

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. The medical expenses are cumulative from the date the HSA was set up. That is, a distribution can be for current year medical expenses or medical expenses in a prior year that were not otherwise reimbursed or deducted.

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).

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.

Josef's HSA has had self-only coverage for 7 years. He takes a distribution of $3,500 to cover his dentist ($1,500), his spouse's prescriptions ($750), and his child's doctor ($1,250). Even though he has self-only coverage, the medical expenses of his spouse and son are qualified for HSA purposes. His Form 8889 will show the distribution of $3,500 and qualified medical of $3,500.

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.

Withdrawal of excess HSA contribution

An excess contribution can be withdrawn to avoid paying the excise tax on the amount if:

• The excess contribution is withdrawn by the due date of the return, including extensions, and

• Any income earned on the withdrawn excess contribution is also withdrawn and included as "Other income" on Sch 1.

Failure to timely withdraw the excess contribution results in a 6% additional tax reportable on Form 5329, part VIII. If the additional tax applies, the tax return is out of scope.

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.

Vikki's used her HSA debit card to pay her doctor bill. She also took a $200 distribution to cover: $100 for a gym, $90 for menstrual products, $75 for allergy medicine, and $35 for personal protective equipment that she bought two years ago (gloves, sanitizer, masks) — none of the expenditures were reimbursed or previously deducted. The gym is not a medical expense. Vikki will show an HSA distribution of $200 and qualified medical expenses of $200 on her Form 8889.

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

Exercises (Answers are at the end of this lesson.)

Question 1: Ellen has had an HSA for several years and not taken a distribution before and has never itemized her deductions. This year she took a distribution of $4,575 to cover:

Dentist this year: $495

Dentist last year: $305

Doctor this year: $1,495

Doctor two years ago: $1,995

Menstrual and COVID protection products last year: $285

How much of Ellen's HSA distribution is taxable?

a. $2,585, the amount of prior year expenses
b. $285
c. $0

Achieving a Better Life Experience (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 Lesson 25, Miscellaneous Credits). A rollover from a 529 education plan may be possible with certain limits.

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.

Education benefits

Refer to Lesson 22, Education benefits for a discussion of the various benefits a student may receive and whether they are taxable.

If a scholarship or grant is taxable, remember that it is earned income for purposes of determining whether an individual is required to file a return and for computing the amount standard deduction to which a dependent is entitled. For all other purposes, the taxable scholarship or grant is not earned income.

(A) 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. Forms 1099-LTC showing reimbursements do not need to be entered in the software as they will never 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. The amount that could be taxable would be the benefit payment minus the greater of the allowed daily amount (see the Important Changes lesson for this year's daily amount) or the actual expenses incurred.

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 (available on the Tax-Aide Links menu on your Tax-Aide Chromebook).

Olympic, paralympic, and Olympic Committee 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 needed to subtract it with an adjustment to income on Sch 1. Refer to your NTTC 4012, Tab D.

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.

EXAMPLE *In 2025, Carla received a reimbursement from her health insurer of $500 for medical expenses she paid in the 2024. Carla did not itemize her deductions in 2024. None of the reimbursement is taxable.*

Rental income

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. This is a special provision that exempts the rental income so long as the unit is rented for less than 15 days during the year. Rental expenses are not allowed. However, a taxpayer can deduct allowable qualified home mortgage interest and property taxes on Sch A if itemizing. See Lesson 12, Income – Sch K-1, Royalties, and Land Rents or Lesson 16, Income – Military Members for rentals that are in scope.

(A) Cancelation of debt income (CODI)

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 cancelation or forgiveness of debt is a gift or bequest.

(A) CODI – nonbusiness credit card debt

Tax-Aide scope is limited to CODI from nonbusiness credit card debt. That is, if the credit card was used for business purchases, the tax return is out of scope. If the CODI is from any debt other than nonbusiness credit cards or qualified main home forgiveness (discussed below), the return is out of scope.

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.

Form 1099-C

Generally, if a taxpayer receives Form 1099-C for canceled credit card or other 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 cancelation of **nonbusiness** credit card debt income is in scope only, 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.

EXAMPLE *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.

Publication 4731, Screening Sheet for Nonbusiness Credit Card Debt Cancelation, located in the NTTC 4012, Tab D, Income, provides step-by-step guidance for you to determine if the cancelation of credit card debt is within scope.

Not cancelation of debt income

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.

The discharge of certain student loan debt is excluded from gross income. If excludible, the lender will not issue Form 1099-C. Advanced certification is not required when no Form 1099-C is issued for discharged student debt.

Insolvency

If a taxpayer had nonbusiness credit card debt canceled but the cancelation occurred during bankruptcy or the taxpayer was insolvent immediately before the cancelation, 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. Tax returns for taxpayers who were insolvent at the time the debt was canceled 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
Jewelry		Past-due mortgage interest, real estate taxes, utilities, and childcare costs	
Furniture	$2,000		
Clothes	$1,550		
Misc.		Student loans	
Other assets		Other liabilities	
Total Assets:	$199,550	Total Liabilities	$251,000

Assets (FMV)	Liabilities
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 (Continued)

Question 2: 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 3: 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

(A) CODI – principal residence

Cancelation of qualified debt on a taxpayer's main home is in scope. Cancelation of nonqualified debt or canceled debt on any other property are out of scope.

Usually, the amount of debt canceled is taxable income. This section discusses a special provision that allows a taxpayer to exclude the cancelation of debt income (CODI) if certain criteria are met.

State tax laws may differ.

During your interview with a taxpayer who presents a 1099 form for canceled mortgage debt, be sure to refer to Pub 4731-A, Screening Sheet for Foreclosures/Abandonments and Cancelation of Mortgage Debt, to ensure that the tax return 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 cancelation 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.

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 cancelation of indebtedness. This amount must be included in gross income unless it qualifies for an exception or exclusion.
- In addition to this cancelation 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 cancelation 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 cancelation-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 cancelation-of-debt income. He will report the disposition of his home with the selling price of $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.

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.

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 (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 with 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, Cancelation of Debt. If foreclosure/abandonment and debt cancelation 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 cancelation 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.

Scope limitations

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; that is, 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)

EXAMPLE *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.*

EXAMPLE *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 cancelation 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. 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?

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 main home as previously discussed in Lesson 10, Income – Capital Gain or Loss.

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 cancelation of debt.

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 cancelation 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.

EXAMPLE

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 $145,000 and the principal balance of the mortgage was $165,000. 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 cancelation ($20,000 as the excess of mortgage canceled over the FMV of the home) from income.

EXAMPLE

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 $165,000 to $155,000. The lender issued Frank a Form 1099-C showing $10,000 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 first?

a. Ask the questions on the screening sheet, Pub 4731-A (available in the NTTC 4012).
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 2019 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 of the property at the time of foreclosure was $130,000 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 $45,000 on Sch D.
c. Report the disposition on Form 8949 and report $20,000 debt canceled on Form 982.
d. Include the debt cancelation 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 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 cancelation amount in ordinary income.

Question 9: Gene bought his home in 2019. 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 of the home 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 cancelation on Form 982, line 10b
b. Report the $40,000 debt cancelation on Form 982, line 2, only
c. Report the $40,000 debt cancelation on Form 982, line 2, and the foreclosure on Form 8949 and Sch D
d. Report the $40,000 debt cancelation on Form 1040

Part I: Other income summary

Taxable income from all sources is entered on Form 1040. There can be many, many types of other income that are taxable. Remember that all income is taxable unless there is a provision in the law that excludes or exempts it. This lesson discussed various types of other income that may be seen at your site. It did not cover all the possible types of other income. Be sure to check the Tax-Aide Scope Manual if you are unsure whether a particular item is in scope or out of scope.

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.

Additional income includes any taxable income for which there is not a specific line identified on Form 1040. Form 1040, Sch 1, Line 8, has lines for various types of other income and also a write-in "other" line. The NTTC 4012 guides you to the appropriate input screen so that the income is reported on the proper line.

Gambling winnings are reported on Sch 1. Gambling losses and expenses may be deductible if the taxpayer is itemizing their deductions.

Form 1099-K may include proceeds that are not reportable or taxable, such as a reimbursement from a friend. To account for the full amount reported on the 1099-K, Sch 1 provides a place to identify these nontaxable proceeds

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.

Olympic prizes and medals that are reported on a 1099 form must be shown on the return. Generally, these can be removed from taxable income with an adjustment to gross income entry in Part II of Sch 1.

A taxpayer may have taxable income when they receive a recovery of an expense that they previously claimed as a tax deduction. The amount to include in income is limited to the amount that yielded a tax benefit when deducted.

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 cancelation of debt income. The amount reported as proceeds on a disposition of the home depends on whether the debt was recourse or nonrecourse.

Situations that 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.

- Alimony related to divorce agreements executed before 1985
- Form 1099-SA for Archer (Archer MSA) or Medicare Advantage (MA MSA) Medical Savings Accounts
- An HSA distribution due to the death of an HSA holder if the spouse is not the designated beneficiary
- Distributions from an ABLE account in which the funds were not fully used for qualified disability expenses
- Distributions from a QTP or Coverdell ESA which were more than the amount of the qualified expenses
- Cancelation of debt and the taxpayer filed bankruptcy or was insolvent immediately before the debt was canceled
- Cancelation of debt other than nonbusiness credit card or qualified principal residence debt
- Cancelation of debt on a residence other than a qualified principal residence
- Cancelation of debt for a principal residence that was used in a business or as rental property
- Cancelation of debt when Form 1099-C for cancelation of residential debt includes an amount for interest

- Other types of income for which no training has been provided or as listed in the Tax-Aide Scope Manual

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

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 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 is covered in Lesson 23, Foreign Tax Credit.

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.

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 make their returns 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. $300
c. $22,000
d. $22,300

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

Converting 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:

$$\frac{\text{Amount of foreign currency}}{\text{Exchange rate of foreign currency to one U.S. dollar}} = \text{Amount in U.S. dollars}$$

$$\frac{\text{3,000 Euros}}{0.74855} = \$4{,}007.75$$

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. $377.57
b. $264.85
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 to 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 exclusion and housing exclusion/deductions

Certain taxpayers can exclude income earned in, and while living in, foreign countries. In addition to the foreign earned income exclusion, an exclusion or a deduction from gross income can also be claimed for the housing amount.

The maximum amounts of the exclusions and deduction are indexed to inflation annually. The current year foreign earned income exclusion amount can be found in the Important Changes lesson in this publication. The base housing amount is 16 percent of the maximum foreign earned income exclusion amount (computed on a daily basis), and the maximum housing expenses generally equal 30 percent of the maximum foreign earned income exclusion amount (computed on a daily basis). However, higher maximum amounts are available for housing in certain countries according to Notice 2025-16.

Eligibility

To claim the foreign earned income exclusion, the foreign housing exclusion, and/or the foreign housing deduction 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.

Choosing the 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) or an amended return. 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 (Lesson 23, Foreign Tax Credit).

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.

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 software will use the Foreign Earned Income Tax Worksheet to calculate the taxpayer's tax when the foreign earned income exclusion is claimed.

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.

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

The tax home test

To claim the foreign earned income exclusion, the taxpayer's tax home must be in a foreign country.

"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.

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.

"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.

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.

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.

EXAMPLE *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

Determining 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.

EXAMPLE

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

Bona fide residence or physical presence test

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

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

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.

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.

Exception to the bona fide residence or physical presence test

The minimum time requirements for bona fide residence and physical presence can be waived if the taxpayer must leave a foreign country because of war, civil unrest, or similar adverse conditions in that country. See Pub 54 for full details.

Qualified earned income

To qualify for the foreign earned income exclusion, income must be earned income for services 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.

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.

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.

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.

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.

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.

Volunteer Says…	Hope Responds…
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 in Germany, you meet the tax home test. Now, what was your address while you were living in Germany?	1567 Albion Street, Munich.
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 or foreign housing or claim the foreign housing deduction, 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. The housing deduction will be entered as an adjustment to gross income on Sch 1.

Where to find more information

Pub 17, Your Federal Income Tax

IRS: taxability of long-term benefits

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

Exercise answers

Answer 1: c. Ellen can use all qualifying medical expenses that have not been reimbursed or deducted to offset her distribution so long as the expense was incurred after she set up her HSA.

Answer 2: 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 3: Yes. Kay was solvent and not in bankruptcy.

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-A, 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 cancelation 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 cancelation 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.

Answer 10: d. 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: b. 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.

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, Armed Forces Tax Guide

Optional:

- Pub 525, Taxable and Non-taxable income
- Pub 527, Residential Rental Property
- Pub 925, Passive Activity and At-Risk Rules
- Form 8582 and instructions (passive activity limitations)
- Pub 555, Community Property

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

Military pay

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. Also, refer to the state issues discussed later in this lesson.

For federal tax purposes, the U.S. Armed Forces includes commissioned officers, warrant officers, and enlisted personnel in all regular and reserve units under control of the Secretaries of the Defense, Army, Navy, and Air Force. The U.S. Armed Forces also includes the Coast Guard and Space Force. The Public Health Service and the National Oceanic and Atmospheric Administration can also receive many of the same tax benefits. The U.S. Armed Forces doesn't include the U.S. Merchant Marine or the American Red Cross.

All taxable 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.

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. 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.

Refer to the Armed Forces Gross Income charts in the NTTC 4012, Tab D for included (taxable) and excluded (nontaxable) pay. The following highlight a few of these.

Basic allowance for housing (BAH)

BAH is excluded from income; however, the qualified home mortgage interest and real estate taxes paid with a BAH can still be deducted on Sch A if itemizing.

Disability severance pay

U.S. Armed Forces members discharged from military service due to medical disability may receive a severance payment that is generally taxable as wages. The member may later be awarded Veteran's Affairs (VA) disability benefits in which case 100% of the disability severance benefit is not taxable. 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. The member will need to attach a copy of the letter of determination to an amended return to claim refunds for any years in which his disability benefits were taxed.

There is a special simplified refund procedure for VA determinations that affect tax years 1991 through 2020. Refer to Pub 3 for details.

Disability payments after the VA determination are not taxable and not reported on Form W-2, Form 1099-R, nor any other document.

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.

Exercises (Answers are at the end of this lesson.)

Use the Armed Forces Gross Income charts in the NTTC 4012, Tab D, to answer these questions.

Question 1: Because Joey received a basic allowance for housing (BAH) that was excluded from his W-2 wages, he cannot use the qualified mortgage interest or property taxes on his Sch A if he itemizes.

a. True
b. False

Question 2: 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

Combat pay

Gross income doesn't include compensation received for active service in the Armed Forces for any month during any part of which the service was in a combat zone or qualified hazardous duty area (even one day). Military pay earned while hospitalized due to wounds, disease, or injury incurred in the combat zone can also be excluded. The military member's Form W-2 shows the amount of combat pay with a code Q in box 12.

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.

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. 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.

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 (Lesson 21) purposes.
- Be able to contribute to an IRA with extended time within which to make the contribution – see Lesson 18, Military Adjustments to Income.
- Have additional time within which to file their returns – see Lesson 32, Military Finishing and Filing the Return.

EXAMPLE *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.*

Exercises (continued)

Question 3: Javier served in the U.S. Army in a combat zone from January 1 until April 4. His W-2 will show code Q in box 12 with the amount of pay he received for:

a. The whole year
b. January through March
c. January through April

State bonus payments

A state bonus payment is a bonus payment made to the taxpayer or to their dependent(s) by a state (or a political subdivision of a state). A state bonus payment will be treated as combat zone pay and may not be taxable if it is made because of current or former service in a combat zone.

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 "The five-year test period suspension (military and others)" in Lesson 10, Income – Capital Gain or Loss.

Qualified plan repayments by reservists

A servicemember may take a distribution from their retirement account; later, they may be able to and wanting to put the money back into their retirement account. A reservist who was ordered or called to active duty after September 11, 2001 may be able to contribute (repay) amounts to an IRA. The amount repaid is not deductible and is instead treated as basis in the IRA. The funds can thus accumulate tax-deferred. See traditional IRAs in Lesson 11, Income – Retirement.

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.

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
- 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 of a regular IRA contribution or the amount of that contribution that can be deducted as an adjustment to gross income.

Because the repayment cannot be deducted, it is instead treated as basis in the IRA. The repayment amount is included with nondeductible contributions on line 1 of Form 8606.

EXAMPLE

Charlie is on active duty and contributed the maximum to his traditional IRA ($7,000) for 2025. 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 by the end of 2025. 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.

A member of a reserve component of the Armed Forces (a “reservist”) includes a person in:

• The Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve;

• The Army National Guard of the United States;

• The Air National Guard of the United States; or

• The Ready Reserve Corps of the Public Health Service.

A distribution that meets the requirement above and eligible to be repaid is not subject to the early distribution additional tax – whether or not it is eventually repaid.

Residential rental

Members of the military may rent out their home for a profit while they are away at a permanent duty station. A home or dwelling unit means a house, apartment, condominium, co-op, mobile home, boat, vacation home, or similar property. These situations are in scope with some caveats and special rules.

Special attention is needed for a year during which the taxpayer uses the dwelling unit as their home or residence (that is, for more than 14 days). This is usually the first year and the last year of their deployment.

A word of caution: the rules related to rentals can be very complex when the facts are not simple and straightforward. If there are co-owners or if there is personal use that is not use by the taxpayer as a main home pre- or post-deployment, check with your Coordinator whether the return should be prepared at your site.

Scope limitations

- Residential rentals are in scope with Military certification when the taxpayer is active military only.
- When the residential rental qualifies as a business for qualified business income deduction (QBID) (discussed in Lesson 19, Deductions), the Sch E net profit from the rental can be used for the QBID. If the taxpayer wants to claim that their Sch E rental is a business for QBID purposes, the return is out of scope.
- Short-term rentals are treated as hotel-type establishments if substantial services are included and are not treated as dwellings. The income and expenses are reported as a business on Sch C. A tax return with a short-term rental is out of scope.

Ian rents a room in his home that is always available for short-term occupancy by paying customers. He includes daily cleaning and towel services. Ian doesn't use the room himself and only paying customers are allowed to use the room. This room is used solely as a hotel, motel, inn, or similar establishment and isn't a dwelling unit.

- Renting personal property, such as equipment or vehicles, is out of scope.
- The sale or other disposition of a dwelling unit that was rented out 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. This is a special provision that exempts the rental income so long as the unit was used as a home and is rented for less than 15 days during the year. Rental expenses are not allowed. However, a taxpayer can deduct allowable qualified home mortgage interest and property taxes on Sch A if itemizing.

When the rental is located in a state that is not the taxpayer's resident state, a second state tax return may be required. Tax-Aide volunteers in states that participate in the State Tax Assistance Program (STAP) may be able to complete the required returns with the other state's STAP assistance.

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.

Rental expenses

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 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 subject to possible limitations discussed below. The following highlights a few commonly-seen rental expenses.

Mortgage interest

Mortgage interest or points on a loan used to buy or improve the rental 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. Note that the qualified home mortgage rules and limitations for Sch A deduction purposes do not apply to rentals.

Rental-related points paid for the use of money are interest and deductible over the life of the loan, that is, they are amortized over the applicable time period. Similarly, loan origination cost can also be amortized over the life of the loan. As with deprecation (discussed below), the taxpayer needs to provide the deductible amortization 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).

EXAMPLE

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. Paul decides to prorate on a monthly basis and will 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 4: 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 is deductible as a rental expense for the time the unit 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 taxpayer owned the vehicle and used the standard mileage rate method the first year the vehicle was placed into service or
- The taxpayer leases the vehicle and uses the standard mileage rate method for the life of the lease.

In-town 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 maintains 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 Lesson 9, Income – Business, 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 annual 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.

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; taxpayers should keep them in their records for future reference.

If the taxpayer made depreciable improvements or additions to the rental property during the tax year, Form 4562, Depreciation and Amortization, is required to be filed. Form 4562 is out of scope, which means that tax returns for the first year of the rental or for years in which new depreciable assets are added are out of scope. Form 4562 is not required for a year in which no depreciable property is first placed in service — the amount of depreciation is simply entered on Sch E.

Other deductible rental expenses

In addition to the items discussed above, deductible rental property expenses include the various items listed on Sch E or that the taxpayer decides are expenses that relate to the rental.

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 5: 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 6: 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

Limits on rental expenses

There are several instances where an allocation of expenses is needed or where not all of the rental expenses can be claimed during the tax year. Generally, a day that a dwelling unit is held out and available for rent counts as a rented day. However, if the dwelling unit is used for personal purposes, any day that the unit is available for rent but not actually rented isn't a day of rental use.

Property Changed to Rental Use

Changing the character of property from personal to rental or vice-versa is an exception to the personal use limitations discussed below. Changing a home or other property (or a part of it) to rental use at any time other than the beginning of the tax year, requires that yearly expenses, such as taxes and insurance, be divided between rental use and personal use. The rental deduction is limited to the part of the expense that is for the part of the year the property was used or held for rental purposes. Expenses for the part of the year the property was held for personal use are not rental expenses.

Renting a part of a property

When part of the property is rented, certain expenses must be divided between the part of the property used for rental purposes and the part of the property used for personal purposes, as though there were actually two separate pieces of property. A deduction is allowed for the expenses related to the part of the property used for rental purposes and are shown as rental expenses on Sch E.

Personal use of a dwelling unit

If the dwelling unit was used as a residence and was also used as rental property for any part of the year, the taxpayer must allocate their expenses between the personal use period and the rental use period. See the personal use discussion below where not all rental expenses may be allowed.

Dividing expenses

Expenses that apply to only the rental use 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 is deductible as a rental expense. However, the taxpayer cannot deduct any part of the cost of installing 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. The taxpayer can choose any reasonable method to allocate the expenses. For example, the 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).

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 reports 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*

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 7: For taxpayers who lived in a dwelling unit and rented it for part of the year, 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

Limitations for personal use

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. There is an ordering rule for the allowable rental expenses and a carryover for some of the disallowed expenses.

Personal use test

The personal use test is met (and the taxpayer is deemed to have used the dwelling unit as a home) if the taxpayer rented out the unit for 15 days or more and also 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.

Gary used his home for 10 days in December after returning from deployment. Previously, the home was rented at fair value. Gary is not treated as using his home as a residence and can claim all his expenses against his rental income on Sch E.

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.

Amy and Betty are co-owners of a condominium at the beach. Last year, the unit was rented to vacationers whenever possible. The unit wasn’t used as a main home by anyone. Betty used the unit for 2 weeks last year; Amy didn’t use it at all.

Because Betty has an interest in the unit, both Amy and Betty are considered to have used the unit for personal purposes during those 2 weeks.

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.

Limit on expenses

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 some of the unused expense amounts.

Rental losses

Deducting all rental expenses, depreciation, and amortization 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 and passive activity rules. These are applied after any allocation is made between personal use and rental use as discussed above.

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. The at-risk rules would not apply to a normal rental situation where the taxpayer owns the property.

The **passive activity rules** state that passive activity losses can be deducted only from passive activity income. Passive income does not include wage, self-employment income, interest, dividends, annuities, and some royalty 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. An example would be renting vacant land that requires no involvement by the owner or their agent.
- Active participation for a taxpayer who owns at least 10% of the rental property 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 that allows a loss

Residential 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). The deductible loss amount is reduced if the taxpayer's modified adjusted gross income (MAGI) exceeds certain limits ($100,000, ($50,000 if MFS)). Several items are not taken into account in computing MAGI for this purpose. See F8582 instructions for details.

Exercises (continued)

Question 8: A rental loss of $33,000 can be claimed so long as the taxpayer is considered to actively participate in the rental activity.

a. True
b. False

Reporting passive rental losses

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. Also, if there was a unallowed loss in a prior year that carries into the current year, the return is out of scope.

State issues

Military members are often serving in a state that is not their home state. This can present state tax filing complications. Under federal law, a member of the military who is domiciled (a legal resident) in a state is not subject to tax as a resident of a different state, even if he or she maintains an abode in that state. However, this provision does not apply to income from state sources other than military pay.

State-sourced income is income received from labor performed in the state (other than military service), business done in the state, or property located in the state, including income from rental of real estate property. It generally does not include personal savings account interest or dividends from an individual's investments.

***Domicile** means the permanent legal home intended to be used for an indefinite or unlimited period, and to which, when absent, the person intends to return. It is not always where the person presently lives.*

Joany's state of domicile is X. She is currently stationed in state Y and has been there all year. State Y may not treat Joany as a resident for tax purposes with respect to her military pay. That protection would change if Joany changes her residency to state Y.

The civilian spouse of an active-duty U.S. military servicemember can elect to have the same domicile or residence as the servicemember. When the spouse's domicile or residence is the same as the servicemember's, the spouse may be able to keep the prior domicile or residence for tax purposes when accompanying the servicemember who relocated to a new duty station. This special provision does not extend to a servicemember's dependents.

The taxpayer, and spouse if MFJ, will decide their state of domicile and tax residency.

When the servicemember is stationed in a state that is not the taxpayer's resident state, a second state tax return may be required. Tax-Aide volunteers in states that participate in the State Tax Assistance Program (STAP) may be able to complete the required returns with the other state's STAP assistance.

Community property

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. They have to figure community income and separate income under state law. Whether military income 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.
- State community property laws *may* apply to Armed Forces retired or retainer payments.

The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. The states of Alaska, Tennessee, and South Dakota permit elective community property treatment.

The determination of what is or is not income subject to community property laws can be a difficult legal issue. Check with your Coordinator whether the tax returns for married taxpayers who choose to file separately should be prepared.

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:

- Basic allowance for housing (BAH)
- Disability severance pay
- Pay while in a combat zone
- 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.

Situations that 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.

- 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 if no property is first placed in service during the year)
- Taxpayers who filed or need to file Form(s) 1099

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

Exercise answers

Answer 1: b, False.

Answer 2: 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 or 1099.

Answer 3: c. The full month's pay is combat pay if any part of a single day was served in a combat zone.

Answer 4: 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 5: 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 6: c. The fencing adds value to the property and would have to be capitalized and depreciated.

Answer 7: c. The rental portions of utilities and home insurance 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 between both Sch A and Sch E.

Answer 8: b, False. A rental loss cannot be more than $25,000 and may be less if married filing separately or if MAGI is high enough.

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. 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. Those and other adjustments are not covered in this publication and are out of scope.

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.

To be eligible, the taxpayer or spouse must be:

1. a teacher, instructor, counselor, principal, or aide in a school (cannot be a home school)
2. at a school that provides elementary or secondary education (grades K-12)

3. and employed for at least 900 hours during the school year

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 school year, she cannot deduct her educator expenses.

Qualified educator expenses

Expenses that qualify include:

- The educator's own professional development expenses
- Books, supplies, equipment (including computer equipment, software, and services), and other materials used in the classroom
- Athletic supplies for courses in health or physical education
- 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 school year. She spent $262 on supplies for her students during the tax year. 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.

Reimbursements that reduce the amount of educator expenses include:

- A reimbursement that is not included as income on Form W-2
- Redeemed U.S. Series EE or I Savings Bonds where the interest would be tax-free, such as redeeming savings bonds to pay educator expenses (would require Form 8815, which is out of scope)
- Receive a nontaxable distribution from a qualified tuition program (QTP) or a distribution of nontaxable earnings from a Coverdell education savings account (ESA) applied toward the educator expenses

(A) 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 Lesson 27 – Other Taxes.

The self-employment tax is automatically calculated on Sch SE by the software and the deductible portion is automatically carried to the adjustments to income section of Form 1040, Sch 1.

(A) 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.

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 (LTC) insurance contract for any month in which they were eligible to participate in an employer-subsidized long-term care insurance plan. LTC is tested separately from health care insurance.

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, Connor, 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. Connor's prior employer is not a current employer so its COBRA coverage does not count for the test. She is not eligible for any other subsidized employer coverage. Yvette can use her premiums to determine her self-employed health insurance deduction.

Qualified health coverage

For an in-scope return, the health insurance policy must 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).

For SEHI 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. For SEHI purposes, a child includes a son, daughter, stepchild, adopted child, or foster child.

Estelle's grandchild, Betsy, has lived with Estelle for some years and she provides all of Betsy's support, including health insurance. The premiums paid for Betsy's coverage can be included in Estelle's SEHI because Betsy is Estelle's dependent.

Qualified health coverage includes Medicare, retiree, or any private insurance for medical, vision, dental, or special policies (such as cancer supplemental health insurance). The spouse's Medicare premiums qualify for the deduction when filing MFJ even though paid from the spouse's benefits. Be sure to include all health, dental, vision, supplemental, or limited coverage that was paid by the taxpayer (or spouse if MFJ). Also include long-term care (LTC) premiums limited to the deduction cap for Sch A based on age.

Income replacement policies are not health insurance and do not qualify.

In all cases, the premiums must have been paid on an after-tax basis by the sole proprietor, or the spouse if filing MFJ. 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 (no double dipping).

Some taxpayers may receive reimbursements from their employers, prior employers, or insurance companies. Only unreimbursed costs qualify for the deduction.

Calculating the SEHI

The self-employed health insurance deduction is limited to the net earnings from self-employment (profit shown on Sch C reduced by the deduction for one-half of the self-employment tax). The software will apply this limitation.

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 Carson's net self-employment earnings.

It is not required that the taxpayer ran the business in a month in order to claim the SEHI for that month. The monthly test is simply the one mentioned above for subsidized employer coverage.

Wilford was a stay-at-home dad until September when he started his own business. For the whole year, he was not eligible for subsidized coverage and paid $300 for his own health coverage each month. Wilford can claim all his health insurance premiums of $3,600 for the SEHI, limited to his net earnings from self-employment.

When the total health insurance costs exceed the SEHI deduction limit, a taxpayer can include any remaining premiums as an itemized medical expense deduction on Sch A (automatically done by the software).

SEHI vs. itemized deduction for medical

The SEHI deduction will result in the lowest federal AGI for a taxpayer who does not itemize deductions. However, claiming all health premiums as an itemized deduction may be more beneficial than the SEHI in some circumstances. If the taxpayer does itemize their deductions, you should compare the results for the federal and state returns with the SEHI deduction (and fewer Schedule A medical expenses) against the return without the SEHI deduction (and all medical expenses on Schedule A). Caution: be careful to not double count or omit medical expenses when changing from one scenario to the other. Make this comparison after all other sections of the federal return are complete (but review other aspects of the return to confirm that no further analysis or change is needed). State tax law may impact the overall decision on these deductions and Counselors should compare the federal plus state impacts to determine which is better.

Scope limitation

The SEHI deduction is out of scope for health insurance purchased through the Marketplace if the taxpayer is entitled to premium tax credits (PTC) with respect to premiums that would be used for SEHI. This scope limitation is due to the circular calculations typically required to settle on the AGI and PTC.

The return remains in scope if the business owner can use other health insurance (such as premiums for coverage not eligible for PTC: optional vision/dental coverages, long-term care, or Medicare) that is equal to or greater than the allowable SEHI deduction.

EXAMPLE *Omar's net earnings from self-employment are $500. He had marketplace coverage and was eligible for PTC through June. Starting in July, he has Medicare coverage and his total Medicare premiums are more than $500. He can use his Medicare premiums for SEHI and his return remains in scope.*

Do not simply ignore the SEHI — that could result in a significant disadvantage and tax cost for the taxpayer since the AGI impacts so many other aspects of the tax return.

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.

EXAMPLE *Gloria withdrew $5,000 early from a one-year, deferred-interest certificate of deposit. She had to forfeit three months' interest. She can claim this penalty amount as an adjustment to income.*

Alimony paid

Alimony is a payment to a spouse or former spouse under a divorce or legal separation instrument. The taxpayer cannot reside with the spouse or former spouse and is not filing jointly. 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 stops upon the death of the recipient and 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. The taxpayer needs to provide 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 this 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. $600
b. $11,400
c. $12,000
d. $23,400

IRA contribution deduction

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 an IRA that is not a Roth or SIMPLE IRA (contributions to SIMPLE IRAs are out of scope).

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). See this year’s limits in the Important Changes lesson.
- 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.

Distinguishing IRAs:

Traditional IRA: may get a tax deduction now and pay tax later when distributed. Tax will not be paid later for the amount of contributions not allowed as deductions.

Roth IRA: no deduction now and no tax when distributed if rules are followed.

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.

Repayment of a prior distribution that is allowed to be repaid is not an IRA contribution. Refer to *Lesson 11, Income - Retirement Income*.

There are two criteria for traditional IRA contributions: the limitation on the amount of contribution and the limitation on the amount of the contribution that can be deducted. For Roth IRAs, the only limit is on the amount of contribution allowed.

Eligibility requirements for an IRA contribution

In order to make an IRA contribution to either a traditional or Roth IRA, the taxpayer, and the taxpayer’s spouse if applicable, must meet these eligibility requirements:

- Age: there is no age limit for either traditional or Roth IRA contributions.
- Compensation: individuals must have taxable compensation (with some exceptions).
- 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; that is, the April 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 was covered in *Lesson 11, Income – Retirement**.*

Type of IRA

Although a person may have traditional IRA accounts with several different financial institutions, the tax law treats all of their traditional IRA accounts as one single IRA. As an aside comment, an IRA trustee will keep an IRA that was rolled in from an employer plan in a separate (rollover) IRA account and generally the taxpayer cannot make a contribution to that rollover account; they'll need to use a different IRA for contributions.

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.

Each inherited IRA is treated separately. A taxpayer cannot make a contribution to an IRA they inherited from someone other than a spouse. A surviving spouse who transfers an IRA inherited from their spouse to their own IRA can make contributions to the transferred IRA.

A self-employed taxpayer can contribute to two other types of IRAs: SIMPLE and SEP. The limitations on contributions, and deduction for those contributions, to these plans are substantially higher than the traditional IRA limitation. Both SIMPLE and SEP IRAs are out of scope for contributions and deduction purposes. See Lesson 11, Income – Retirement for distributions.

The compensation requirement and limitation

Taxpayers cannot make an IRA contribution that is greater than their compensation for the year. Compensation is generally the income a taxpayer has earned from working. W-2 wages, salaries, tips, etc. received as an employee are compensation. Compensation also includes net earnings from self-employment (Sch C profit less the deduction for ½ of the self-employment tax), taxable alimony, and taxable non-tuition fellowship and stipend payment 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 (even though not reported on Form W-2).

Eddy has net earnings from his business of $2,500 (Sch C profit less his self-employment tax deduction). He has health insurance premiums of $2,000 that he can use for the SEHI (discussed above). He also wants to make a deductible contribution to his traditional IRA. The limit on his IRA, assuming Eddy has no other compensation, is $2,500. Compensation for IRA purposes is not reduced by the SEHI deduction nor vice versa.

Compensation does not have the same definition as earned income.

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.

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 allowable 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.

Generally, income that is excluded from gross income is not treated as compensation for IRA purposes. There are two exceptions. Excluded Medicaid waiver payment (MWP) income can be treated as compensation, but only for nondeductible IRA contributions. Combat pay is the other exception as noted below.

Becky earned $15,000 taking care of her disabled mother. The $15,000 is properly classified as Medicaid waiver payment (MWP) income and Becky elects to exclude it from her gross income. She can consider the $15,000 as compensation for contribution to her traditional or Roth IRA. If to her traditional IRA, it will be wholly nondeductible and added to her basis in the IRA on Form 8606.

Items that are not compensation

The following are **not** considered compensation:

- Earnings and profits from property, such as rental income, interest income, and dividend income
- Pension or annuity income
- Deferred compensation received (compensation payments postponed from a past year)
- Income from a partnership for which you don't provide services that are a material income-producing factor
- Conservation Reserve Program (CRP) payments reported on Schedule SE (Form 1040), line 1b
- Taxable scholarship or grant income that is not reported on Form W-2.
- Any amounts (other than combat pay and qualified Medicaid waiver payments) you exclude from income, such as foreign earned income and housing costs

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.*

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 a joint return, the maximum that Bob can contribute to his IRA is $2,000.

a. True
b. False

Special rules for members of the military

Combat pay that is excluded for income tax purposes can be treated as compensation for IRA contribution purposes. And, members of the military may have more time to make their contribution and be able to repay certain qualified plan distributions. These topics are discussed in Lesson 18, Military Adjustments to Income.

IRA deduction limits

After confirming that the taxpayer (or spouse if MFJ) is eligible for an IRA deduction, the deduction limit is the lesser of:

- The contributions to the traditional IRA for the year, or
- The general limit reduced by Roth IRA contributions made for the same tax year
  - The general limit for a taxpayer age 50 or older is increased by the $1,000 catch-up amount

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 participates in a retirement plan at work. The phase-out income levels are adjusted for inflation. See the Important Changes lesson for this year's levels.

If the taxpayer or spouse is an active participant in an employer's retirement plan, the retirement box (box 13 on their W-2) will be checked. For IRA deduction purposes, the software will compute the MAGI limit and print the IRS worksheet.

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. Form 8606 requires basis information in IRAs from prior years and is in scope for Tax-Aide.

If taxpayers do not report nondeductible contributions, all of the contributions to a traditional IRA will be treated as having been deducted by the IRS. This means all distributions will be taxed when withdrawn unless the taxpayer can show, with satisfactory evidence, that nondeductible contributions were made.

A taxpayer who made an allowable contribution to their traditional IRA that 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 (assuming the taxpayer is allowed a Roth contribution). A Roth contribution can also be recharacterized as a traditional IRA contribution.

Recharacterizing a Roth conversion is not allowed. Recharacterizing a contribution is allowed when done by the due date of the return, including an extension.

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 (including the $1,000 catch-up amount if age 50 or older)

The taxpayer may not know that a contribution is excessive until the tax return is completed (e.g., the taxpayer's only compensation is from their self-employment and they don't know the profit 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 and the tax return is out of scope. This additional tax is covered in Lesson 27, Other Taxes.

When the taxpayer has modest compensation and traditional or Roth IRA contributions, you need to confirm that the limit has not been exceeded. The software may not alert you to an excess contribution.

The taxpayer must report the earnings distributed with the excess contribution 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 to report, if any.

If the taxpayer made an excess traditional IRA contribution in a prior year, they can deduct that excess in the current year if it is within this year's limitations. That serves to "cure" the excess situation. Similarly, an excess contribution to a Roth IRA can be cured by contributing less than the maximum permitted in a subsequent year.

See Lesson 11, Income – Retirement for withdrawing such excess to avoid the additional tax.

Undoing an IRA contribution A contribution can be withdrawn tax free by the due date of the return, including extensions. 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.

(A) Health savings accounts (HSA) contributions

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. Often, employers establish HSAs for their employees. After-tax 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
  - If the other person is not required to file a return or files only to get a refund of taxes paid in or withheld, then the individual is not a dependent and can have 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 for an individual, the individual, family members, or any other person may contribute on behalf of the 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. Form W-2, Box 12 using code W will include:

- Employer contributions that are excluded from an employee's income
- An employee's contributions through a salary-reduction cafeteria plan
  - These are treated as an employer contribution

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.

EXAMPLE

Maria's employer contributed $1,000 to her HSA and she put in an additional $360 through the company's salary-reduction program. The maximum additional contribution that Maria can make to her HSA is reduced by $1,360. Because the contributions of $1,360 were made on a pre-tax basis, no further deduction is available for such contributions.

Limits on HSA contributions

The total amount that can be contributed 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.

EXAMPLE *Arnold has a high-deductible health plan with an HSA with his company. His mother contributed $400 to his HSA as a gift on his 40th birthday. The $400 is part of Arnold's allowable contributions and a deduction for Arnold assuming he does not exceed the maximum limit.*

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:

a. 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 for the type of coverage in that month (self-only or family).

OR

b. 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 is 13 months and runs from December 1 of the current year through December 31 of the following year (for calendar taxpayers).

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 as income the excess contribution in the following year when it is clear that the testing period has failed (and subject to an additional 10% tax on Form 8889, Part III).

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.

EXAMPLE *Stephan started the year with self-only HDHP with his employer. In July, he got married and changed to family coverage. Using the worksheet, the maximum amount that can be contributed to Stephan's HSA is 6 months at the self-only monthly maximum plus 6 months at the family monthly maximum.*

EXAMPLE *Jamal had self-only coverage with a HDHP plan through May. In June, he started a new job and he is covered by his new company's regular health plan (not an HDHP) starting in June. The contribution limit for Jamal is 5/12 of the self-only annual maximum because he did not have HDHP coverage June through December.*

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 as discussed in Lesson 15, Other Income.

If the taxpayer made an excess contribution in a prior year, they can deduct that excess in the current year if it is within this year's limitations. That serves to "cure" the excess situation.

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.

EXAMPLE *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.*

Scope Limitation

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 can't make contributions to an HSA. There are exceptions for limited-purpose health FSA or HRA, suspended HRA, post-deductible health FSA or HRA, or retirement HRA. Situations where the HSA contribution could be limited due to FSA or HRA participation are out of scope.

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.

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.

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.

EXAMPLE *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.*

EXAMPLE *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.*

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.

Eligible taxpayer

Generally, a taxpayer can claim the student loan interest deduction if all the following are true:

- The taxpayer is not using the MFS 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 with after-tax money
  - Interest paid with tax-free employer education benefits cannot be deducted

Conduct a probing interview to verify that the taxpayer meets all these tests for the deduction.

Qualified student loans

The student loan must have been used for qualified higher education expenses for certain individuals. 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.

Dependent definition modified for student loan interest deduction

When the loan is for the taxpayer's dependent's schooling, the general definition of a dependent applies except:

- An individual can be your dependent even if you are the dependent of another taxpayer.
- An individual can be your dependent even if the individual files a joint return with a spouse.
- An individual can be your dependent even if the individual had gross income for the year that was equal to or more than the exemption amount for the year — see the Important Changes lesson for this year's amount.

Qualified higher education expenses for student loan interest deduction

Qualified higher education expenses include the costs for an eligible student to attend an eligible educational institution: 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
- 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 received for educational expenses (other than gifts, bequests, inheritances, or emergency financial grants)

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.

EXAMPLE *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.*

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.

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) to the extent the earnings are treated as tax free because they were used to pay student loan interest.
- Paid with tax-free funds. Employers can provide tax-free education benefits to their employees up to $5,250 per year. That benefit can be used to pay down the student loan or to pay the interest on the student loan. The taxpayer cannot claim a deduction for interest paid with tax-free funds.

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.

Volunteer Says…	Brenda Responds…
Did you receive any educational assistance during the tax year, 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 during the tax year, 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.]	

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 nursing 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

Jury duty turned over to the employer

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 even though they are not at their jobs so the employee must turn their jury duty pay over to their employers. The taxpayer can claim an adjustment to gross income for the amount of jury duty pay that they turned over to their employer.

Nontaxable Olympic, paralympic, and Olympic Committee prizes

As discussed in Lesson 15, Income – Additional, 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.

W-2 box 12 code H

This is informational since you don't need to do anything with a code H. Code H reflects a contribution to a Sec. 501l(18)(D) pension plan that has not reduced taxable wages. The amount carries automatically to Sch 1 as an adjustment to income. If you see code H on a W-2, you now know what it is.

Adjusted gross income

The taxpayer's adjusted gross income (AGI) is the amount that is used to compute various limitations, such as the medical and dental deduction on Sch A and the credit for child and dependent care expenses. The software does all the calculations based on your entries. Briefly, the taxpayer's AGI is gross taxable income less the adjustments discussed in this lesson. Adjustments not discussed in this lesson are out of scope.

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.
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.	

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
- Nontaxable Olympic, paralympic, and Olympic Committee prizes

You also learned what code H on a W-2 is.

If you believe a taxpayer could benefit from an adjustment that is out of scope, discuss the situation with your Coordinator. It may be appropriate to decline the return.

Situations that 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:

- 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 plan contributions other than IRAs
- Certain business expenses of performing artists
- Other adjustments to gross income not covered in this training guide
- Excess contribution to an IRA or HSA that is not withdrawn timely
- Form 8889, Health Savings Accounts, Part III
- Participants in an FSA or HRA who also make a contribution to their HSA
- Qualified HSA funding distribution from an IRA

See Form 1040, Sch 1, page 2 for a complete list of other adjustments to gross income.

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

Exercise answers

Answer 1: d. 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: b, False. By filing jointly, Bob and Carol can consider their combined compensation and he can contribute up to the annual maximum plus the catch-up $1,000 since he is over age 50.

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 employee business expenses or moving expenses. Special IRA rules may apply to members of the military. 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
- Pub 3, Armed Forces' Tax Guide
- 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 reservist expenses that can be deducted
- Determine if a move qualifies as a permanent change of station (PCS)
- Identify deductible moving expenses and when the moving expense deduction can be claimed
- Determine eligibility for special IRA provisions for the Military

Armed Forces 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 as an adjustment to gross income using Form 2106. This applies:

- If the military reservist must travel more than 100 miles away from home and stay overnight to attend a drill or reserve meeting
- As long as the duty occurred under competent orders and
- Whether or not the reservist was compensated

***Reservists** include commissioned officers, warrant officers, and enlisted personnel 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. It does not include members of the Merchant Marines or the American Red Cross.*

Expenses are deductible only if the reservist pays 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.

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

EXAMPLE

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.

The Department of Defense sets per-diem rates for Alaska, Hawaii, and U.S. associated territories. See https://www.travel.dod.mil/Travel-Transportation-Rates/Per-Diem/Per-Diem-Rate-Lookup/. The State Department sets foreign rates. See aoprals.state.gov/web920/per_diem.asp.

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. A list of possible taxable and excludible allowances or reimbursements can be found in the NTTC 4012, Tab D.

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.

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 this lesson.)

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

Allowable moving expenses

Qualifying military moving expenses fall into the following two categories, the cost of:

- Moving household goods and personal effects
  - Includes the cost of storing and insuring household goods and personal effects within any period of 30 consecutive days after the day these goods and effects are moved from the former home and before they are delivered to the new home.
- Reasonable travel and lodging expenses
  - Only the standard mileage rate method is in scope for moving miles using an owned vehicle.
  - Does not include meals.
  - Only miles traveled from the old home to the new home is included in the calculations.

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.

In the event of a move to or from a foreign country, moving expenses include:

- Moving household goods and personal effects to and from storage, and
- Storing these items for part or all of the time the new job location remains the main job location. The new job location must be outside the United States.

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.

Personally procured move (PPM)

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 (the excess of the 95% incentive payment over the actual expenses incurred) is taxable and is reported on a separate Form W-2.

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). His separate Form W-2 for the move 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.

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 will Sgt. Bishop's W-2 include for these allowances?

a. $1,500
b. $1,000
c. $300
d. $200

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 1,050 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.
Instead of detailing the actual costs of your car, we can use the standard mileage rate for a military move. We'll use your allowable miles of 1,050 and the software will compute the deduction.	Okay

Volunteer Says…	Mrs. Fannin Responds…
Lodging costs are allowed, but not food. So, your total allowable expenses include $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.]	

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.
The allowance is not taxable so it was 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.	

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 the 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.

In which 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

Special IRA provisions

Excluded combat pay for IRA purposes

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 a designated combat zone, or have qualifying service outside of a combat zone (as described in Lesson 16, Income-Military Members), 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.

The taxpayer's combat pay can be found on Form W-2 in box 12 with the code letter Q. Refer to Lesson 17, Adjustments to Income for overall IRA limitations.

Qualified reservist repayments

The repayment of qualified reservists' distributions is not deductible and, instead, increases the taxpayer's basis in their IRA as reported on Form 8606. The repayment does not affect the current year's deductible contribution to a traditional IRA. Refer to Lesson 16, Income – Military Members for qualified plan repayments.

Summary

This lesson focused on two types of deductions that members of the Armed Forces can claim as an adjustment to income: reservists' unreimbursed expenses and moving expenses for members of the military. Members of the military, active or retired, may use the special IRA provisions for combat pay, additional time to make IRA contributions, and the ability to repay certain qualified plan distributions.

Situations that 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 2106 for other than reservists' travel expenses

Where to find more information

Pub 3, Armed Forces' Tax Guide

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 on Form W-2. However, nontaxable allowances such as dislocation allowances, temporary lodging allowances and mileage allowances provided by the Armed Forces should not be added 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

In addition to the deductions covered in Lesson 17, Adjustments to Income, there are deductions that are subtractions from a taxpayer's adjusted gross income. This lesson discusses deductions that a taxpayer may claim to arrive at taxable income.

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)
- Form 1040, Sch 1-A (additional deductions)
- Form 1098-VLI (vehicle loan interest)

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
- Determine the amount of qualified tips income deduction
- Determine the amount of qualified overtime income deduction
- Determine the amount of new passenger vehicle loan interest deduction
- Determine if the taxpayer qualifies for the enhanced deduction for seniors

Standard deduction or itemized deductions

Many, if not most, taxpayers will claim the standard deduction. A few will have enough to itemize their deductions. After you enter all the information, the software uses the most advantageous method. 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.

Keep in mind that the standard deduction for your state may be lower than the federal standard deduction. If a taxpayer's deductible expenses exceed the state standard deduction, enter them in the software even when the taxpayer is using the standard deduction on their federal return.

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.

EXAMPLE

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.

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.

Extra standard deduction if 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.

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.

The standard deduction for decedents is the same as if they had lived the entire year; however, if a taxpayer dies 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.

Be sure to enter the correct birthdates and date of death (if deceased) for the taxpayer or spouse.

Extra standard deduction if blind

Taxpayers are entitled to a higher standard deduction if they are considered blind on the last day of the year. 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.

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.

Special rule for married taxpayers age 65 or older and/or blind

A married taxpayer can take the higher standard deduction if one spouse is 65 or older, or is 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.

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 (Answers are at the end of this lesson.)

Question 1: Roderick is 64 and blind. Can he claim an extra standard deduction?

a. Yes
b. No

Question 2: Leticia died in May just before reaching her 65th birthday that would have been June 5. Does she qualify as age 65?

a. Yes
b. No

Standard deduction for those who can be claimed as dependents

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.

The standard deduction is generally lower for an individual who can be claimed as a dependent by another taxpayer. A dependent's standard deduction will be automatically calculated by the tax software, as long as the box indicating they can be claimed as a dependent by another taxpayer has been checked. Briefly, it is:

- $450 plus earned income
- Minimum: $1,350
- 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.

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 as $450 plus her earned income (if any) or the minimum $1,350 if higher, but not more than the regular standard deduction for a person using the single filing status.

(A) Itemized deductions

Itemized deductions allow taxpayers to reduce their taxable income for specific personal expenses. If the taxpayer's 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 with pre-tax dollars, it also cannot be claimed as a deduction. An employer-sponsored salary reduction plan is the most commonly seen pre-tax situation.

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 and the software will complete Sch A. The tax software will automatically select the larger of itemized deductions or the applicable 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
- Other deductions

Even when the standard deduction will be better for a taxpayer on their federal return, that may not be true for state tax purposes. If you think the taxpayer's allowable expenses may be more than the state standard deduction, 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.

(A) Medical and dental expenses

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 (or spouse if MFJ) 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
- The taxpayer's child when the taxpayer is divorced or separated and the other parent is claiming the child as a dependent.

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.

Amy supports her mother's (Janice) by paying for her care in an assisted living facility. Janice has a small pension that is more than the allowed exemption amount so Amy cannot claim Janice as her dependent. Amy can claim the medical expenses that she pays for her mother, even though Janice is not her dependent.

Use your Qualifying Child or Relative Resource Tool to help you confirm whose medical expenses can be claimed by the taxpayer.

Medical or dental expenses

Generally, medical or dental 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 (the amount is limited based on the age of the insured — see the Important Changes lesson)

- Transportation or travel to get medical care including
  - Only the standard mileage rate allowed for a car used for medical reasons is in scope — see the Important Changes lesson for this year's rate
  - Parking and tolls can be added to the standard mileage rate
  - Actual medical-related transportation (ambulance, taxi, bus, etc.)
  - Lodging expense for out-of-town medical care is limited to $50 per person per night.
- Home improvements needed for mobility or medical care
- A child's doctor-recommended tutoring by a teacher who is specially trained and qualified to work with children who have learning disabilities caused by mental or physical impairments, including nervous system disorders
- The cost (tuition, meals, and lodging) of attending a school that furnishes special education to help a child to overcome learning disabilities

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.

Medical expenses that are paid by credit card are deemed to have been paid when charged to the card, not when paid to the credit card company. Medical expenses for a taxpayer that are paid within one year after the date of death are generally treated as paid when incurred.

What's not a medical expense

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 to exclude part of their retirement plan distribution from income (no double dipping)
- Health or long-term care premiums used 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 a 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 your 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) Use the Schedule A – Medical Expenses chart in Tab F of your NTTC 4012 to answer this question.

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.

Jennifer purchased health insurance through the Marketplace. The policy premium was $1,250 a month and APTC of $750 a month was paid directly to the health insurance company. She paid the remaining $500 each month ($500 x 12 = $6,000 for the year). Her tax return show that she owes $200 repayment of her APTC. Jennifer can claim a total of $6,200 for her medical insurance expense.

(A) Taxes

Taxpayers can deduct certain taxes if they itemize. To be deductible, the tax must have been imposed on the taxpayer or spouse if MFJ and paid by the taxpayer (or spouse if MFJ) 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 review the MAGI the software has in the Sales Tax Worksheet. You may need to add various tax-exempt sources of funds, such as nontaxable alimony, 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 information for 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 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 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. During the interview, 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 are based on value alone and are imposed on a yearly basis.
- Foreign income taxes as discussed below.

Nondeductible taxes

Not all taxes are deductible and some items aren't actually classified as taxes. Some examples include foreign real estate taxes, homeowner association fees, Social Security taxes, federal income taxes, and license fees.

State and local tax deduction cap

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 $40,000 ($20,000 if MFS). There is also a phaseout if AGI is over $500,000 ($250,000 if MFS) but the phaseout cannot reduce the deductible tax amount below $10,000 ($5,000 if MFS). The $40,000/$20,000 deduction cap and the phaseout AGI are scheduled to increase by 1% per year through 2029.

Any state and local taxes paid above the $40,000 ($20,000) 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 (reported on Sch C) or for the production of income (reported on Sch E income or on Line 6 of Sch A).

Foreign income taxes

Generally, income taxes that are 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 (unless certified in International). To be eligible for this election, qualified foreign taxes must be $300 ($600 if MFJ) or less. More information will be provided in Lesson 23, Foreign Tax Credit.

When claimed as an itemized deduction, foreign income taxes can be deducted in full and are not subject to the state and local tax deduction cap noted above.

Exercises (continued)

Question 4: Which of the following taxes are deductible on Sch A?

a. Federal income tax
b. State income tax, local real estate tax, and foreign income 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

Interest expense

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 or if itemizing deductions would be beneficial assuming all the investment interest was deductible.

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 home can be a house, cooperative apartment, condominium, mobile home, house trailer, or houseboat that has sleeping, cooking, and toilet facilities.
- 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 second home is rented out for 14 days or less, the taxpayer must have used the home for more than 14 days in order to treat it as a second home. Otherwise, it is treated as rental property.
  - If there is more than one second home, the taxpayer can choose the qualified second home for home mortgage deduction purposes.
- 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.

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.

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 Lesson 16, Income – Military Members.

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. The taxpayer must be legally liable for the mortgage and must have paid the interest during the tax year.

Interest paid on a mortgage on a personal residence that is not the main home or the designated second home is not deductible.

Limits on mortgage amount

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.

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): interest is deductible on up to $1 million ($500,000 if MFS) of these mortgages plus any grandfathered debt combined. The debt limit is applied 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): interest is deductible on up to $750,000 ($375,000 if MFS) of all mortgages including any grandfathered debt combined. The debt limit is applied throughout the tax year.

The Interview Tips – Itemized Deductions in the NTTC 4012, Tab F, 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.

Mortgage interest statement

Generally, the total amount of home mortgage interest paid by a taxpayer is shown on Form 1098. 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.

Mortgage loan points

Points are the charges paid by a borrower and/or seller to a lender to secure a loan or to reduce the stated rate of the 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 as described in Pub 936.

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.

Types of interest not deductible on Sch A

Interest that cannot be deducted on Sch A includes:

- Interest on car loans, including the personal portion of a vehicle used for business as discussed in Lesson 9, Income - Business
- 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
- Private mortgage insurance (PMI)

A new temporary deduction for qualified car loan interest is discussed later in this lesson.

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 their new boat	$2,000	
Total	$6,080	

(A) Charitable contributions

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 and all congressionally-chartered Veterans Services Organizations (VSOs)
- 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. The link is also available in "Useful Tax Prep Links" on your Tax-Aide computer.

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.

A taxpayer who cannot reduce the taxable amount of their retirement distribution for their qualified charitable contribution because they made deductible IRA contribution can add the contribution amount to their itemized deductions. This was discussed in Lesson 11, Income – Retirement.

Contributions that 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 race 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.

Limits on 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.

While this training guide addresses TY2025, a TY2026 provision of OBBBA is worth noting and highlighting to taxpayers who make charitable donations but do not itemize their deductions.

In TY2026, taxpayers will be allowed a deduction for cash contributions in addition to their standard deduction of up to $1,000 ($2,000 if MFJ). You may wish to alert taxpayers to this provision and the recordkeeping requirements that follow so that they will be prepared when they return for preparation of their TY2026 tax return.

Recordkeeping

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.

EXAMPLE

Joe donated some IBM shares that had gone up in value to the Red Cross. The Red Cross gladly accepted the donation and immediately sold the shares. Joe would be able to deduct the fair market value of the share; however, because the donation is of appreciated capital gain property, Joe's tax return is out of scope.

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 charitable 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.

(A) Other itemized deductions

Federal tax law allows certain other itemized deductions. Three are in scope:

Gambling losses and expenses

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). See Lesson 15, Income – Additional for a discussion of gambling winnings. Gambling losses and expenses (up to the amount of winnings) can be claimed as an itemized other deduction.

Jolene takes the gambling bus to the local casino for the day (about 50 miles away). The bus costs $20. She plays bingo all day spending $45 on cards. She doesn't win a thing. Separately, Jolene wins $1,000 in her state lotto for which she spent $10 on tickets for that drawing. She receives a W-2G for $1,000.

Jolene will report the gross winnings of $1,000 and a separate negative other income entry for $10 "cost of winning ticket." If Jolene itemizes her deductions, she can claim the $65 of gambling losses and expenses ($45 lost on bingo + $20 bus ride). That is, her bingo losses and expenses allowed in full because they are less than her overall gambling winnings (no tracing needed). She should have evidence of her losses and expenses, which is her responsibility.

As with other areas of a tax return, the taxpayer is responsible for maintaining adequate records in the event the IRS should inquire. Records of wins and losses in a log is ideal, especially when supplemented with ATM or other sources of gambling funds transaction receipts and receipts for expenses.

While this training guide addresses TY2025, a TY2026 provision of OBBBA is worth noting and highlighting to taxpayers with significant gambling activity.

Under OBBBA, starting with TY2026 only 90% of a taxpayer's gambling losses/expenses will be allowed as an itemized deduction. You may wish to alert taxpayers to this provision. They should consider the per-session method (out of scope) since it will effectively sidestep the 90% limit for win sessions. It is not your responsibility to train taxpayers on the per-session method. Taxpayers should find their own guidance (online or elsewhere) and are responsible for their gambling recordkeeping. If they adopt the per-session method, their tax return is out of scope for that year.

(The per-session method is briefly described in Lesson 15, Income – Additional.)

Unrecovered cost in an annuity

Upon the death of the last annuitant, the unrecovered cost in annuity can be claimed as an "other itemized deduction" on line 16 of Sch A. This is the annuitant's payments for the annuity reduced by any basis recovered through the simplified method discussed in Lesson 11, Income – Retirement.

If the annuity was terminated for reasons other than death of the annuitant, the loss would have been subject to the old 2% of AGI floor for which no federal deduction is available (there may be a possible state tax deduction).

Work-related expenses of impaired individuals

These are expenses that enable the employee to work, such as attendant care services at their workplace. Individuals qualified to claim this deduction are those who have:

- A physical or mental disability (for example, blindness or deafness) that functionally limits employment, or

- physical or mental impairment (for example, a sight or hearing impairment) that substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, or working

Note that transportation expenses would require Form 2106 and that form is out of scope, except for Military.

Other deductions that are out of scope are listed here for your information. They include:

- Casualty – use 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
  - Generally, a personal casualty loss attributable to a qualified disaster is reduced by $500 per incident and can be added to the standard deduction.
  - Personal casualty losses attributable to declared disasters which are not qualified must be itemized and reduced by $100 per incident and then by 10% of AGI.
- Theft losses arising from transactions entered into for profit, including investment scams, may be deductible as a casualty but are out of scope
  - Theft losses, such as various extortion scams, are not entered into for profit and not treated as a casualty for federal purposes. An example would be romance scam.
- Federal estate tax on income in respect of a decedent
- Repayment of income over $3,000 – see Lesson 28, Payments and Miscellaneous Refundable Credits
- Certain unrecovered cost in a pension that does not qualify for the unrecovered cost in an annuity above
- Certain bond premium amortization on bonds acquired prior to 1987
- Contingent-payment or inflation-indexed debt instrument losses

Itemized deductions previously subject to the 2% of AGI limitation

These miscellaneous (old 2%) deductions are not allowed for federal tax purposes. The following was federal law prior to 2018 and is provided in case your state tax laws still follow the old federal rules. The old 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 charged by the card processor incurred when paying income tax
- 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

Qualified business income (QBI) deduction

The law provides a deduction with respect to "pass through" business income that can be claimed in addition to the standard deduction or itemized deductions. For Tax-Aide scope, only two elements of QBI are in scope: Sch C businesses and REIT dividends (called §199A dividends).

(A) *Advanced certification is required if the tax return has business income (Sch C). Basic certification applies if the only QBI is from REIT (§199A) dividends on Form 1099-DIV.*

These are the key points of the QBI deduction:

- A sole proprietor can take up to 20% of QBI as a deduction on the tax return.
  - The calculations on Sch C and Sch SE are not affected by the deduction.
- The taxpayer can take up to 20% of REIT dividends (Sec. 199A dividends) as a deduction on the tax return.
- Taxable income is not reduced below zero by the 20% deduction.
- The 20% deduction is limited for higher incomes. These QBI threshold amounts are in the Important Changes lesson.
  - The deduction is limited for specified service trades or businesses when the applicable threshold is exceeded.
- The QBID can be claimed with any filing status.

Calculating the QBID

For taxable income that does not exceed the applicable threshold amount, the QBI deduction is the **lesser** of:

- 20% of qualified business income (for in-scope returns, it is the net profit reported on a Sch C only) plus 20% of qualified REIT (Sec. 199A) dividends
  - The taxpayer's Sch C profit is reduced by:
    - The deductible part of the self-employment tax,
    - The self-employment health insurance deduction,
    - Contributions to certain qualified retirement plans (such as SIMPLE OR SEP — both out of scope; does not include traditional or Roth IRA contributions), and
    - The new qualified tips deduction (discussed below).
- 20% of taxable income before the QBID and before net capital gains and qualified dividends. Stated another way: 20% of (AGI
  - (Minus the standard or itemized deductions,
  - (Minus the new tips deductions on Sch 1-A that relates to the business, and

- (Minus net capital gains and qualified dividends that are included in AGI).

A tips deduction arising from a W-2 job would not reduce QBI.

Jackie computes his QBI as his Sch C profit $5,500 less his self-employment tax deduction $389 for a net total of $5,111. His QBI deduction is 20% of $5,111 or $1,022 assuming his QBI deduction is not limited by his taxable income.

Based on the taxpayer's entries, the tax software automatically computes the QBI deduction and completes Form 8995, Qualified Business Income Deduction Simplified Computation.

Your responsibility is to make sure that the taxpayer's return is in scope. During an interview with a taxpayer who has relatively high income, review the taxpayer's gross income and possible deductions to make a preliminary estimate of income for QBID. You should also review the previous year's return to see if there is a loss carryover or if the taxpayer had to use Form 8995-A (required when the income threshold is exceeded).

Scope limitations

Tax returns are out of scope for taxpayers with:

- Pass-through business income from an entity on a Sch K-1 — this was discussed in Lesson 12, Income – Sch K-1, Royalties, and Land Rents, or
- Income over the threshold amount, or
- Who require Form 8995-A, Qualified Business Income Deduction, or
- Who have a carryover loss — this will appear on the Form 8995 in the previous year's return for a carryover loss on Lines 3 or 7.

Exercises (continued)

Question 8: Philip is filing separately from his spouse. His Sch C business shows a profit and his taxable income is more than his business profit but below the threshold amount. Will Philip's return be able to claim a QBI deduction?

a. Yes
b. No

Qualified tips deduction

A new temporary provision allows a deduction for qualified tip income that can be claimed in addition to the standard deduction or itemized deductions.

Who is eligible

- Employees
- Self-employed taxpayers
  - The tips deduction reduces QBI for the QBI deduction discussed above.
- The tip earner must have a valid Social Security number.
- The taxpayer must have earned the tips in a qualified occupation as specified by the IRS as customarily and regularly receiving tips. IRS groups the occupations into eight main categories:
  - 100s – Beverage and food service
  - 200s – Entertainment and events
  - 300s – Hospitality and guest services
  - 400s – Home services
  - 500s – Personal services
  - 600s – Personal appearance and wellness
  - 700s – Recreation and instruction
  - 800s – Transportation and delivery

Who is not eligible

- A married taxpayer using the MFS filing status (HOH is ok).
- Self-employed individuals in a specified service trade or business (SSTB) under section 199A.
- Employees whose employer is in an SSTB.

An SSTB is any trade or business providing services in the fields of:

- Health
- Law
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial services
- Brokerage services
- Investing and investment management Trading or dealing in securities, partnership interests, commodities
- Any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners, as demonstrated by:
    - Receiving fees, compensation, or other income for endorsing products or services
    - Licensing or receiving fees, compensation or other income for the use of taxpayer's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity
    - Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

What qualifies

- Tips that are voluntary cash (or equivalent medium) tips received from customers or through customary tip sharing
- The tips must have been reported on a Form W-2, 1099-NEC, 1099-K, or 4137 (unreported tip income), or self-reported on Sch C

What does not qualify

- Any amount received for an illegal activity, prostitution services, or pornographic activity
- Qualified tips do not include compulsory service charges.

EXAMPLE

Luigi's Restaurant imposes an automatic 18% service charge for large parties and distributes that amount to waiters, bussers, and kitchen staff. Because the service charge is added with no option for the customer to disregard or modify it, the amounts distributed to the workers from the compulsory service charge are not qualified tips.

If the customer is allowed to disregard or modify the amount, the tips would qualify. (This may be subject to local law.)

The limits

- Maximum deduction is $25,000
- Qualified tips from Sch C cannot be more than the net profit from the trade or business on which the tips were earned. This limitation is the net profit shown on Sch C 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).
- The deduction phases out starting at MAGI over $150,000 ($300,000 for MJF).
    - The phase out is at a rate of $100 per $1,000 (or portion thereof) above the MAGI threshold.

- MAGI is AGI increased for certain excluded foreign income.

Reporting

Employers and other payors must file information returns with the IRS (or SSA) and furnish statements to taxpayers showing certain cash tips received and the occupation of the tip recipient. IRS intends to issue guidance for payers for tax year 2025 to allow them to estimate the amount of tips. At the time of this writing, that guidance has not been issued.

EXAMPLE

Omar's Sch C for his delivery service shows a profit of $7,500, including tip income of $750. His self-employment tax is $1,060 making his net profit $6, 970 ($7,500 less ½ of the s-e tax of $530). He can deduct all his tips of $750.

Omar thus computes his QBI as his Sch C profit $7,500, less his self-employment tax deduction $530, and less tips deduction $750 for a net total of $6,220. His QBI deduction is 20% of $6,220 or $1,244 assuming his QBI deduction is not limited by his taxable income.

Qualified overtime deduction

A new temporary provision allows a deduction for qualified overtime income that can be claimed in addition to the standard deduction or itemized deductions.

Who is eligible

- The overtime earner must have a valid Social Security number.

Who is not eligible

- A married taxpayer using the MFS filing status (HOH is ok).

What qualifies

- Qualified overtime income
  - Defined as pay that exceeds the regular rate of pay that is required by the Fair Labor Standards Act (FLSA)

EXAMPLE

Jerry was paid time and a half for his overtime that was reported on his W-2. His employer provided a letter showing that Jerry's total overtime was $15,000 and the amount in excess of regular pay was $5,000. Jerry can claim a qualified overtime deduction for $5,000.

- The overtime pay amount must be reported on W-2, Form 1099, or other specified statement (not yet defined).

What does not qualify

- Tips that qualify for the qualified tips deduction cannot be used for the overtime deduction.

The limits

- The maximum deduction is $12,500 ($25,000 if MFJ)
- The deduction phases out starting at MAGI over $150,000 ($300,000 for MFJ).
  - The phase out is at a rate of $100 per $1,000 (or portion thereof) above the MAGI threshold.
  - MAGI is AGI increased for certain excluded foreign income.

Reporting

Employers and other payers are required to file information returns with the IRS (or SSA) and furnish statements to taxpayers showing the total amount of qualified overtime compensation paid during the year. IRS intends to issue guidance for payers for tax year 2025 to allow them to estimate the amount of qualified overtime pay. At the time of this writing, that guidance has not been issued.

Qualified passenger vehicle loan interest deduction

A new temporary provision allows a deduction for qualified vehicle loan interest paid that can be claimed in addition to the standard deduction or itemized deductions.

Who is eligible

- A taxpayer who pays interest on a loan for a new vehicle purchased for personal use during the year.
- The taxpayer must include the vehicle identification number (VIN) of the vehicle(s) on their tax return.

Note: there is no valid SSN requirement for this deduction.

Who is not eligible

- Taxpayers who cannot provide the VIN.

What qualifies

Interest paid on a loan used to purchase a **new** passenger motor vehicle (a used vehicle does not qualify).

- The vehicle loan originated after December 31, 2024.
  - There is no limit on the number of vehicles.
- A "vehicle" includes a car, minivan, van, sport utility vehicle, pickup truck, or motor cycle.
  - The vehicle must have at least two wheels.
- The gross vehicle weight rating must be less than 14,000 pounds.
- Final assembly of the vehicle must have been in the US.
  - The VIN Decoder website for the National Highway Traffic Safety Administration (NHTSA) provides plant of manufacture information.
- The loan must be secured by a lien on the vehicle.
- If a qualifying vehicle loan is later refinanced, interest paid on the refinanced amount is generally eligible for the deduction.

What does not qualify

- Interest paid on a loan for a used vehicle.
- Interest paid on fleet, commercial, or leased vehicle loans.
- Interest paid on a loan to finance the purchase of a vehicle intended to be used for scrap or parts.
- Interest paid to a related person.
  - Brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants are related for this purpose.
  - Related entities (not likely to be encountered at Tax-Aide sites).

The limits

- Maximum annual deduction is $10,000, regardless of the number of qualifying vehicle loans
- The deduction phases out starting at MAGI of $100,000 ($200,000 for MFJ).
  - The phase out is at a rate of $200 per $1,000 (or portion thereof) above the MAGI threshold.
  - MAGI is AGI increased for certain excluded foreign income.

Reporting

Lenders or other recipients of qualified interest must file information returns with the IRS and furnish statements to taxpayers showing the total amount of interest received during the taxable year if the amount is $600 or more using new Form 1098-VLI (eff for TY2026). For TY2025, lenders are allowed to mail (or make otherwise available to the borrower) a statement showing the total interest paid during the year.

Enhanced deduction for seniors

A new temporary provision allows a senior taxpayer to claim an additional deduction in addition to the taxpayer's standard or itemized deductions to arrive at taxable income. You may see this new deduction described as a senior exemption deduction or, as the IRS calls it, an enhanced deduction for seniors.

Who is eligible

- A taxpayer (or spouse if MFJ) who has attained the age of 65 by the end of the tax year.

Remember, a taxpayer's age is based on the date before their birthday, for example if born on January 1, the taxpayer is a year older as of the day before (December 31).

- The taxpayer (or spouse) must have a valid Social Security number.

Who is not eligible

- A married taxpayer using the MFS filing status (HOH is ok).

The limits

- The maximum deduction is $6,000 per eligible individual (taxpayer or spouse, if MFJ)
- The deduction phases out starting with modified adjusted gross income (MAGI) over $75,000 ($150,000 if MFJ)
    - The phase out is at a rate of 6% of the MAGI over the threshold.
    - MAGI for this purpose is adjusted gross income plus certain excluded foreign income.
    - On an MFJ return where both spouses qualify, the MAGI reduction is first applied with respect to the taxpayer. The spouse's deduction is the same amount as the deduction allowed to the taxpayer.

Sally and Barry are both over age 65 and filing jointly. Their MAGI is $200,000. Their return will show that Sally gets a deduction of $3,000 ($6,000 less 6% of $50,000 (that is, MAGI $200,000 less the phaseout threshold of $150,000). Barry's deduction is also $3,000. Their total enhanced senior deduction shown on Sch 1-A is thus $6,000.

Exercises (continued)

Question 9: Harry turned 65 on January 1, 2026. He misses out on the senior deduction for 2025 because he is not yet 65.

a. True
b. False

Question 10: La Donna is not married, has a valid SSN, is over the age of 65, and her adjusted gross income for the year is $70,000 from her pension and savings. Is she allowed a senior deduction?

a. Yes
b. No

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
- Other deductions

In addition to the standard or itemized deductions, taxpayers may be eligible to claim:

- The qualified business income deduction
- The qualified tips deduction
- The qualified overtime deduction
- The qualified vehicle loan interest deduction
- Enhanced deduction for seniors

Situations that 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.

- Casualty and theft losses
- Mortgage credit certificates
- Investment interest if itemizing deductions, or if itemizing deductions would be beneficial assuming all the investment interest was deductible
- Form 1098-C, Contributions of Motor Vehicles, Boats and Airplanes with a value over $500
- Tax returns affected by limits on charitable deductions
- Noncash contributions of more than $5,000 in total
- Donations of property that was previously depreciated
- Donations of capital gain property, such as appreciated securities or artwork
- Repayments of previously-taxed income over $3,000. See Lesson 28, Payments and Miscellaneous Refundable Credits.
- 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

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](#) (Rev. December 2020)

[Pub 530, Tax Information for Homeowners](#)

[Pub 561, Determining the Value of Donated Property](#)

[Pub 463, Travel, Gift, and Car Expenses](#)

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.

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: b, Yes. The QBI deduction is allowed even if the filing status is MFS.

Answer 9: b, false. An individual born on the first day of the year is considered to be that age as of the last day of the previous year. Harry is allowed to claim the enhanced senior deduction because he is deemed to be age 65, subject to other requirements for the deduction.

Answer 10: a, yes. La Donna's income is below the phase-out threshold so she will get the full $6,000 enhanced senior deduction in addition to her standard or itemized deductions

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
- Understand how the tax has been computed on a return

Taxable income determined

Taxable income is determined by subtracting these allowable deductions from adjusted gross income (AGI):

- Standard or itemized deductions
- The qualified business income deduction
- The qualified tip income deduction
- The qualified overtime income deduction
- The qualified interest on a vehicle loan deduction
- The enhanced senior deduction

The tax calculation

Most taxpayers will compute their tax using the tax tables. Taxpayers with higher incomes will use the appropriate tax rate schedule. Both the tax table and tax schedules are found in the Form 1040 Instructions. The software handles the actual calculation.

Special tax calculations

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 a 0% tax rate on their qualified dividend income. The rate increases to 15% and then 20% for higher-income taxpayers.

EXAMPLE *Alicia files as single and her return includes qualified dividends of $400 and taxable income of $25,000. The software will complete the Qualified Dividends and Capital Gain Tax Worksheet. The worksheet will show that her dividends are taxed at 0%. The tax on the rest of her taxable income will be based on the tax tables.*

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.

Other tax computations or worksheets are listed in the instructions to Form 1040, such as the alternative minimum tax. They are not discussed here because they are all out of scope.

Exercises (The answers appear at the end of the lesson.)

Question 1: IRS has all the information they need to compute a person's tax so that a person doesn't have to file a return if they don't want to.

a. True
b. False

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.

(A) *Forms 8615 and 8814 are in scope for Native Americans receiving per capita payments and Alaska residents receiving permanent fund dividends if training has been provided. Both forms require Advanced certification.*

Form 8615, Tax for Children Who Have Unearned Income and Form 8814, Parent's Election to Report Child's Interest and Dividends, are 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 threshold amount. Refer to the Important Changes lesson for this year's threshold amount.
2. The child is required to file a return for the tax year.
3. The child:
   - Was under age 18 at the end of the year, or
   - 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.
4. At least one of the child's parents was alive at the end of the tax year.
5. The child does not file a joint return for the tax year.

For item 3 above, it is not required that the child actually used the income for their support; just the fact that they had enough earned income is sufficient.

You don't have to memorize these criteria; they are in Tab H of your NTTC 4012 and the tax software will generate Form 8615 when it applies based on your entries. Your responsibility is to identify the possible application of the kiddie tax during the interview. Refer to your NTTC 4012 during the interview if a taxpayer under the age of 24 presents with unearned income close to or over the ceiling amount.

It's important to highlight the kiddie tax issue that can arise when a student has a taxable scholarship or grant and/or elects to treat some or all of their unrestricted scholarship or grant as taxable. The taxable scholarship or grant is unearned income for the kiddie tax and could trigger the kiddie tax. Fortunately, the taxable scholarship or grant is earned income for purposes of determining if the student has to file a tax return (item 2 above). If the student is not required to file a return, the kiddie tax does not apply.

Ralph is a 20-year-old full-time student and a dependent of his parents. He earned $12,000 from a summer job which is less than the cost of half of his support. He also has a $3,000 Pell grant that he wants to make taxable so his parents can maximize the American opportunity credit.

Ralph's total income is $15,000 and his standard deduction is $15,450 (his earned income $12,000 + $3,000 plus $450). He is not required to file a tax return so the kiddie tax cannot apply.

In the above example, if Ralph had $3,000 of investment income (unearned) instead of scholarship income, the answer would be different. His standard deduction would be $12,450 and he would be required to file a return. Additionally, his unearned income is over the kiddie tax ceiling amount. Assuming he is not filing a joint return, he would be subject to the kiddie tax and his return is out of scope.

The Education Benefits Calculator on the Tax-Aide Colorado Resource Toolbox will alert you to the kiddie tax issue and help to maximize the benefits to taxpayers that wish to claim an education benefit. Taxable and nontaxable scholarships or grants are discussed in Lesson 22, Education Benefits.

Exercises (continued)

Question 2: Letty is age 20, a full-time student, and dependent of her parents. She received interest ($800) and dividends ($500) from the trust set up by her grandparents. In addition, there was a capital gain (gross proceeds $5,000 and gain of $1,000). Is she subject to the kiddie tax?

a. Yes, her unearned income will be taxed at her parents' tax rate.
b. Yes, she satisfies the age requirement of the kiddie tax and her parents are alive.
c. No, she doesn't have to consider her trust income since it was her grandparents that set it up, not her parents.
d. No. She has to file a return (her $2,300 of income exceeds her standard deduction); but, she is not liable for the kiddie tax as her income is less than the ceiling amount.

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.

Tax returns eligible to use the Foreign Earned Income Tax Worksheet require International certification.

The kiddie tax is in scope in limited situations as noted above. 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.

The tax may be further reduced by tax credits to be covered in upcoming lessons.

Situations that 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

Where to find more information

Pub 17, Your Federal Income Tax

Exercise answers

Answer 1: b, False. While IRS receives much information from payers and payees, the taxpayer must file a return each year if they meet the filing requirements.

Answer 2: d. Letty’s total unearned income is less than the ceiling amount and she does not have to file the kiddie tax form.

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
- Qualifying Child or Relative Resource Tool
- 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

Refundable versus nonrefundable tax credits

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.

Child and dependent care credit (CDCC)

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. 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.

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 QC/R Tool to help determine if the taxpayer has a qualifying person and if the taxpayer is eligible for the credit.

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.
- A spouse who is physically or mentally unable to care for themselves and lived with the taxpayer more than half the year.

A person cannot care for themselves if they can't dress, clean, or feed themselves because of physical or mental problems. Also, persons who must have constant attention to prevent them from injuring themselves or others are considered not able to care for themselves.

Note that this meaning is not the same as "permanently and totally disabled." See the helpful definitions section of your Qualifying Child or Relative Resource Tool (QC/R Tool).

The software may use the term disabled when it really means incapable of self-care

- Someone who is 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

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.

The qualifying person must have an SSN, ITIN, or ATIN and be a U.S. citizen, national, or resident or a resident of Canada or Mexico.

Birth or death of otherwise qualifying person.

In determining whether a person is a qualifying person, a person who was born or died during the tax year is treated as having lived with the taxpayer for more than half of the year if the taxpayer's home was the person's home more than half the time he or she was alive during the year.

Person qualifying for part of year

A person's qualifying status is determined each day. For example, for a child for whom child and dependent care expenses are paid turns 13 years old and no longer qualifies on September 16, count only those expenses through September 15.

Exercises (Answers are at the end of this lesson.)

Question 1: Henri turned 13 on July 16 of the tax year. His parents paid the school an extra $200 each month for after-school care all year because they both work. How much can Henri's parents claim for the CDCC?

a. $2,000
b. $1,300
c. $1,000
d. Nothing, Henri is too old as of December 31

Question 2: If Henri in Question 1 was incapable of self-care, would the answer change?

a. Yes
b. No

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 (Sch C profit 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
- Election worker compensation
- 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 what is and what is not earned income.

Rule for student-spouse or spouse not able to care for self

A taxpayer or a spouse is treated as having earned income for any month they are a full-time student or physically or mentally incapable of self-care. The nonworking 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 full-time student is defined as enrolled and attending a school for the number of hours or classes the school considers full time. The nonworking spouse must be a full-time student for some part of five calendar months during the year. The term “school” includes high schools, colleges, universities, and technical, trade, and mechanical schools. A school doesn't include an on-the-job training course, correspondence school, or school offering courses only through the Internet.

If, in the same month, both the taxpayer and the 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.

Taxpayer interview and tax law application

Here’s how a volunteer could help Dorothy determine if she and her husband satisfy the earned income test for CDCC:

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 and he began working full time 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 of $250 for each of those months.	

Special rule for surviving spouse

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.

John’s wife, Maggie, died in a car accident in January so he will file a joint return with her. John paid $3,500 for after-school care for his young son so he could work. Maggi had earned income of $1,500 before she died. Without the special rule, John and Maggie’s qualifying CDCC expenses would be limited to Maggie’s earned income. The special rule allows John to disregard Maggie’s income. Thus, he can use just his earned income and it is more than $3,000 so he can claim the maximum CDCC (based on his on his AGI).

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 this purpose, unpaid volunteer work or work for a nominal salary is not considered working.

For married taxpayers filing jointly, 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 as discussed above.

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 the qualifying persons and it is possible that all the expense is for one qualifying person and none for the other.

Work for part of year

If the taxpayer or spouse works or actively looks for work during only part of the period covered by the expenses, then work-related expenses are figured for each day.

Don works all year and pays care expenses of $250 a month ($3,000 for the year), all the expenses are work related. However, if Don works or looks for work for only 2 months and 15 days during the year and pays expenses of $250 a month, Don's work-related expenses are limited to $625 (21/2 months × $250).

Temporary absence from work

A taxpayer doesn't have to figure their expenses for each day during a short, temporary absence from work, such as for vacation or a minor illness, if they pay for care anyway. Instead, the credit can include the expenses paid for the period of absence. An absence of 2 weeks or less is a short, temporary absence. An absence of more than 2 weeks may be considered a short, temporary absence, depending on the circumstances.

Part-time work

If the taxpayer works part-time, generally figure the expenses for each day. However, if payment is required for care weekly, monthly, or in another way that includes both days worked and days not worked, figure the credit including the expenses paid for days you didn't work. Any day when work was at least 1 hour is a day of work.

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.

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.

Household employees

Expenses paid for household services meet the work-related expense test if they are at least partly for the well-being and protection of a qualifying person. 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.

Nonqualified expenses

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

EXAMPLE *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.*

EXAMPLE *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.*

Payments to relatives

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

Taxpayer interview and tax law application

Continuing the conversation with Dorothy:

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.	

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.

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.
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.	

Exercises (continued)

Use the screening sheet in the NTTC 4012, Tab G, Nonrefundable Credits, to answer the following questions.

Question 3: 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 4: Why don't Audrey and her husband qualify for the credit (select all 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

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 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.

At this point while preparing a tax return, you will have already determined the filing status and can rely on that to determine if the taxpayer passes the joint return test.

Special rules

There is a 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.

Harold remarried in the same year that his first wife, Jean, died. Harold will file jointly with his new wife. Jean's status on her final return will be MFS and she can claim the CDCC for the care that was paid so that Harold could work while she was incapable of self-care and unable to work.

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 (such as a church or school).

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.

Employee's 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.

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 can be no more than $1,200 ($6,000 – $4,800).

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.

Expense and earned income limits

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.

Prior year expenses

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.

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 amounts to be taken into account 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 limit will be the smaller of actual qualifying expenses or the taxpayer's earned income (the earned income of the spouse with the lower amount of earned income is used if MFJ). The limit is reduced by employer-provided care benefits.

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

As a nonrefundable credit, the amount of CDCC 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.

Situations that 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

Where to find more information

Pub 503, Child and Dependent Care Expenses

Pub 926, Household Employer's Tax Guide

Exercise answers

Answer 1: b, $1,300 (6½ months). Once Henri turned 13, he is no longer a qualified person for CDCC.

Answer 2: a, Yes. Because Henri cannot take care of himself, he remains a qualified person for CDCC for the entire year.

Answer 3: b, No. They do not qualify.

Answer 4: 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 Benefits

Introduction

This lesson covers various tax benefits available to taxpayers to help offset education costs. During the interview, look for distributions from qualified education accounts, Forms 1098-T, and dependent children of college age.

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 whether any portion of a number of different educational assistance payments is taxable, including education savings accounts
- Consider where a deductible education expense can be claimed
- Determine who qualifies for either education credit

Introduction – education benefits

Education expenses can be used in any of several areas on the tax return. The several education benefits listed below use terms that may have similar or different definitions depending on the type of benefit. This lesson presents an overview of these various benefits. During the filing season, you can refer to the detailed charts in NTTC 4012 Tab J to confirm the applicable requirements or limitations.

A taxpayer who is a student may be eligible for a variety of educational assistance benefits:

- Scholarships, fellowships, or grants including Pell and other Title IV needs-based grants
- Veterans' benefits
- Education savings accounts:
    - Coverdell savings accounts
    - Qualified tuition programs (called QTPs or 529 plans)
- Employer-provided educational assistance
- Student loan forgiveness

A taxpayer may also be eligible for tax benefits associated with their own education or the education of their dependent:

- Making an education assistance benefit nontaxable
- Exclusion of interest income from certain U.S. savings bonds
- Business income deduction (Schedule C)
- Educator adjustment to gross income (discussed in Lesson 17, Adjustments to Income)
- American opportunity credit (AOC)
- Lifetime learning credit (LLC)

Education benefits received are not taxable if they are offset by qualified education expenses. The type of expenses that qualify depends on the type of benefit received. If an educational expense is used to make a benefit tax-free, that expense cannot be used again to make another benefit tax-free, to claim a deduction, or to claim one of the two credits.

However, education expenses may reduce the amount of an early distribution from a qualified retirement account that is subject to an additional tax even if the educational expense is used for one of the benefits listed above. This is discussed in Lesson 27, Other Taxes.

Scholarships, fellowships, or grants

The school will report the total of scholarships or grants received on Form 1098-T. Details of the scholarships or fellowship grants can be found in the student's school financial account, which shows the school's charges for tuition, fees, etc., and the payments made for those expenses. A scholarship or grant is "restricted" if it must be used for certain expenses, such as tuition, books, and required fees. A scholarship or grant is unrestricted if, essentially, the student can withdraw the funds for other uses.

A scholarship or fellowship grant is not taxable if the student is a degree candidate and then only to the extent it does not exceed qualified education expenses. If the scholarship or fellowship grant must be or is actually used for other purposes (such as living expenses), it is taxable. Qualified expenses for this purpose include tuition and fees required to enroll at or attend the school plus course-related expenses, such as fees, books, supplies, and equipment. Use Worksheet 1-1 in NTTC 4012, Tab J, to determine if any portion of the scholarship or grant is taxable.

There can be a timing issue when the scholarship or grant is received either before or after the tax year. It is best to match the grants to the respective session for which it was granted (semester, trimester, or quarter).

Thomas is a half-time college student who started his first semester in January 2026. He prepaid $5,500 in December 2025 for qualified tuition for the spring semester beginning in January 2026. In February 2026, he received a grant of $4,000 that had to be used for tuition. None of his grant is taxable and his adjusted qualified education expenses for 2025 is $1,500 ($5,500 - $4,000).

In 2026, he will not include the February 2026 grant in his calculations since it has already been offset by qualified education expenses.

Veterans' benefits

Veterans' benefits are never taxable. The part of the benefit payments that must be used for education expenses reduces the education expenses; only the education expenses that remain after the reduction can be used to make another benefit tax-free or to claim a deduction or credit.

Qualified tuition program (QTP or 529 plans) and Coverdell educational savings account (ESA)

The following is a high-level summary of key provisions for a QTP or Coverdell ESA. The taxpayer is responsible for accounting for any QTP or Coverdell ESA they fund or for which they are the account owner or otherwise responsible. You are not expected to memorize all these criteria. While much is in NTTC 4012, please refer to Pub 970 for complete details.

State treatment of QTPs and Coverdell ESAs may differ, including what is a qualified education expense for state purposes.

Contributions

QTPs and ESAs are set up by taxpayers to fund a designated beneficiary's expenses at a higher education or a qualified elementary or secondary public, private or religious school. While contributions to a QTP or Coverdell ESA are limited and not deductible, the earnings in the account can be distributed tax-free if for qualifying education expenses (QEE).

Excess contributions

The beneficiary may owe a 6% excise tax each year on excess contributions that are in a Coverdell ESA at the end of the year and not distributed timely. See Lesson 27 – Other Taxes for possible additional taxes on excess contributions.

Distributions

Form 1099-Q reports gross distribution from QTPs and Coverdell ESAs. Form 1099-Q is generally issued in the name/SSN of the beneficiary for distributions paid to them or paid directly to a school; otherwise, Form 1099-Q is generally issued in the name/SSN of the account owner.

Distributions can be tax free to the extent of adjusted qualified education expenses (AQEE) incurred at an eligible elementary, secondary, or postsecondary school during the tax year. AQEE are the qualified education expenses remaining after being reduced by other tax-free education assistance or by expenses used to claim a different benefit (such as AOC or LLC). This prevents double-dipping.

Generally, qualifying postsecondary education expenses include:

- Tuition, fees, books, supplies, and equipment that are required by the school
- Special needs services
- Room and board if the student is at least half-time
- Computers and related services

For elementary and secondary schools, these are also QEE for a Coverdell ESA:

- Academic tutoring
- Uniforms
- Transportation
- Supplementary items and services (including extended day programs)

QEE for a QTP include:

- Qualified elementary and secondary school expenses
  - Tuition
  - Materials, tutoring, various fees, and therapists for disabled students (added by OBBA for distributions made after July 4, 2025)
- Postsecondary credentialling expenses (added by OBBA for distributions after July 4, 2025)
  - The credentialing program can be a vocational, a registered apprenticeship, a recognized license, or a program leading to a recognized employment credential
- Principal or interest on student loans of the beneficiary or the beneficiary's sibling

Refer to the charts in NTTC 4012, Tab J, Education Benefits and Pub 970 when a taxpayer presents a Form 1099-Q to assure a correct calculation of AQEE.

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.

Rollovers

Tax-free distributions also include rollovers to another qualified education program or to an ABLE account within 60 days (limited to one per 12 months and may be limited in amount).

Excess distributions

For QTPs or Coverdell ESAs, a part of excess distributions (distributions exceed AQEE) can be taxable to the taxpayer (the earnings in the account that are distributed would be taxable). The return is out of scope if any part of a distribution is taxable. Additional taxes on excess distributions may also apply — see Lesson 27 – Other Taxes.

Janna got $3,000 from her 529 plan to help with her college tuition. She incurred $6,000 for tuition and fees. She was also awarded a scholarship to be used for tuition and fees of $4,000. Her adjusted qualified education expenses (AQEE) are therefore $2,000 ($6,000 less the scholarship of $4,000). The 529 distribution exceeds her AQEE and the 1099-Q shows positive earnings, so some portion of the excess distribution will be taxable and her return is out of scope.

Note that Janna will not be liable for the additional tax on an excess distribution because it was her tax-free scholarship that caused the excess [Pub 970].

If Janna is at least a half-time student, she can consider her room and board as AQEE for 529 plan purposes, even if she lived at home, and then there would likely be no excess.

Termination of account

A loss on a QTP or ESA **cannot** be claimed because the 2% miscellaneous deductions have been permanently repealed. State tax treatment may differ. A loss occurs when all amounts from that account have been distributed and the total distributions are less than the unrecovered basis. Basis is the total amount of contributions to that QTP or ESA.

Employer provided education benefits

Employers can use educational assistance programs to help employees with undergraduate or graduate-level student loan debt and other education expenses on a tax-free basis. The maximum amount of benefit is $5,250 per year and is tax-free to the employee.

Qualified expenses include:

- Books, equipment, and supplies
- Tuition and other fees
- Qualified education loans (principal and interest)

Qualified expenses used to make the employer-provided benefit tax-free cannot be used again for an education deduction or credit.

Instead of applying employer benefits to education expenses or deductible interest on the student loan, tax-free employer benefits can be applied toward principal payments of a student loan. That maximizes qualified education expenses that are still available for one of the credits or the interest will be deductible as an adjustment to gross income. Determining what is paid by the employer benefit is something the taxpayer needs to work out with their employer.

Educational assistance benefits do not include payments for the following items:

- Meals, lodging or transportation
- Tools or supplies other than textbooks that the student can keep after completing the course of instruction
  - For example, educational assistance doesn't include payments for a computer or laptop that the taxpayer can keep
- Courses involving sports, games or hobbies unless they:
  - Have a reasonable relationship to the business of the employer, or
  - Are required as part of a degree program

Determining what is paid by the employer benefit is something the taxpayer needs to work out with their employer.

Student loan forgiveness

Normally, forgiveness of debt can result in taxable income as discussed in Lesson 15, Income - Additional. However, discharged loan amounts resulting from certain student loan forgiveness and repayment assistance programs are tax-free. Tax-free forgiveness includes:

- Teacher loan forgiveness
- Law School repayment assistance
- National Health Service Corps Loan Repayment Program
- Student loan forgiveness through the end of 2025 under the American Rescue Plan of 2021

The student should not receive a Form 1099-C for student loan forgiveness that is tax-free.

(A) Deduction for work-related education

A self-employed taxpayer may find that claiming a business expense for education expenses has several advantages:

- Reduces Sch C profit and AGI
- Reduces self-employment tax
- Can be for a single course or seminar
- Does not have to be from a qualified educational institution, such as a college or university

The requirements for a Sch C education expense were discussed in Lesson 9, Business Income.

Unreimbursed expenses of an employee are deductible by:

- Armed forces reservists – see Lesson 18, Military Adjustments to Income
- An individual with disabilities claiming impairment-related education expenses on Sch A (if itemizing) – see Lesson 19, Deductions
- Qualified performing artists – out of scope
- Fee-based state or local government officials – out of scope

Exclusion of interest income from certain U.S. savings bonds (out of scope)

A qualified U.S. savings bond is a series EE bond issued after 1989 or a series I bond. Taxpayers can exclude the otherwise-taxable interest to the extent of adjusted qualified education expenses (tuition, fees, and contributions to a QTP or Coverdell ESA reduced by other tax-free benefits) paid for themselves, their spouse, or a dependent. Income limits apply.

Education credits

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. Following is a discussion of the general rules for each credit. Refer to the charts in NTTC 4012, Tab J for more detailed information.

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.

Taxpayers can take education credits for themselves, their spouse, and/or dependents 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.

Eligible taxpayers

To claim an education credit, the taxpayer

- Cannot be claimed as a dependent on someone else's tax return
  - If that other person does not have a filing requirement or files only to get a refund of taxes paid or withheld, the individual is not a dependent.
- Is not filing as married filing separately
- Has 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)
- Was not a nonresident alien for any part of the tax year, or if they were, they elected to be treated as resident aliens
- Has a valid identification number (SSN or ITIN) by the due date of the tax return (including extensions)
- Has the valid identification number (SSN, ITIN, or ATIN) by the due date (including extensions) for the dependent student claimed for the credit

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.

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.

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.

Qualifying expenses

Most students should receive Form 1098-T from the educational institution. The form should show the total amount the student paid for tuition and related expenses, the amount and source of scholarships and grants received, 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. The transcript should also show the source of payments, such as a scholarship, a grant, or a cash payment.

In addition to payments for the current tax year's classes, 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.

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.

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.

These are **not** qualifying expenses:

- 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.

- Expenses that have been refunded. If paid and refunded in the same year, they cancel each other out.

  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.
- Tuition or other education expenses that have been used to make educational assistance received tax-free (such as scholarships, grants, etc. discussed above).

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 federal 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 Lesson 20, Taxable Income and Tax Calculation.

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 an education credit would be $8,000 ($9,500 - $1,500).

American opportunity credit

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. Such students can claim the nonrefundable part of AOC only. Refer to NTTC 4012, Tab J, Education Benefits, Student Under Age 24 Claiming American Opportunity Credit, for details.

Additional AOC requirements

Requirements for the American opportunity credit for a student in addition to the requirements noted above:

- As of the **beginning** of the tax year, the student had not completed the first four years of postsecondary education (generally, the student did not complete a bachelor's degree).
  - 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, the AOC (or its predecessor the Hope credit) been not been claimed for this student for four years.
  - If the parents claimed the credit using the student's expenses for 2 years and the student claimed the credit for 2 years, the student in not eligible for the AOC.
- The student must be enrolled in a program that leads to a degree, certificate, or other credential.
- The student was 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.
  - The school determines half-time or full-time status and will check the box on Form 1098-T if at least half-time.
- The student cannot have been convicted of a felony for possessing or distributing a controlled substance as of yearend.
  - This determination is made as of **December 31** of the tax year.
- The taxpayer and student must have the required TIN by the **due date of the return** (including extensions).

Max finished his bachelor's degree in the spring of 2025 and started his graduate studies in the fall of 2025. Assuming that he is otherwise eligible for AOC (not having claimed the AOC in 4 prior years), Max can include all the qualified education expenses paid in 2025 – both for the undergraduate and graduate work.

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.

Qualifying education expenses for AOC

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.

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.

Juan, a student, earned $12,000 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 = $12,000, 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 $12,000 + $2,000 = $14,000. 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, 40% of which is a refundable credit.

Note that scholarship income is treated as earned income for standard deduction and filing requirement purposes.

Scenario 3: Juan chooses to include the entire grant as income on his return. Juan's gross income is $12,000 + $4,000 = $16,000. 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.

Note that Juan's scholarship income is treated as unearned income for kiddie tax (and all other purposes) only after Juan has a filing requirement.

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.

Expenses that don't qualify for AOC

Amounts paid for insurance, medical expenses (including student health fees), room and board, transportation, and living or family expenses do not qualify.

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 other education benefits, such as the lifetime learning credit if the requirements are met.

Lifetime learning credit (LLC)

The LLC is a non-refundable credit that cannot exceed $2,000 per tax return (20% of up to $10,000 in eligible expenses) regardless of the number of students on the return. As a general rule, the AOC will provide better tax results for the taxpayer than the LLC provides. A taxpayer who cannot claim AOC can usually claim the LLC because LLC:

- Is available for an unlimited number of tax years.
- Is available for all years of postsecondary education, including post-graduate study.
- Is available for courses to acquire or improve job skills.
- Does not have a minimum amount of course workload required, such as half-time.

Qualifying education expenses for LLC:

Qualified expenses include tuition and required enrollment fees. 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

EXAMPLE *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.*

EXAMPLE *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.*

Note that the LLC differs from the AOC in important ways:

- The student doesn't need to be pursuing a program leading to a degree or other recognized education credential.
- The education for LLC must be job related.
- A felony drug conviction doesn't make the student ineligible.
- The school must require that books, equipment, etc. be purchased from the school.

Exercises

Use the NTTC 4012, Tab J, Education Benefits to answer the following questions. (Answers are at the end of this lesson.)

Question 1: Bob was a full-time student and a fifth-year senior. He has 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

Choosing an education benefit

Taxpayers have several options for using education expenses to reduce taxes as discussed above. These are the ones most frequently seen at a Tax-Aide site:

- Make an unrestricted scholarship or grant tax free
- Make a 529 plan or other education program distribution tax free
- Business expenses on Sch C if the expenses qualify or as an educator's adjustment to gross income
- American opportunity credit
- Lifetime learning credit

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 benefits for the same education expense.

Common errors

The definition of a qualifying expense varies among the 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 use 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 to make an education assistance payment tax-free, 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

Summary

When you get to this section of the interview using the Tax-Aide Intake Booklet, ask probing questions based on the taxpayer's information and on the rules for claiming education benefits. The benefits include:

- Making education financial assistance tax-free
- Claiming a business deduction (Sch C or educator)
- Claiming either tax credit
    - American opportunity credit
    - Lifetime learning credit

These are some key points to remember for education 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 can be refundable (up to $1,000)
- The AOC is available for up to four years per student
- Students that include tax-free scholarships or grants in income in order to free up education expenses for the AOC 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
- LLC can be claimed for an unlimited number of years
- LLC is a non-refundable credit of up to $2,000 per return (20% of up to $10,000 in expenses)

Situations that 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.

- ESA or QTP distributions that are not offset by qualified education expenses.
- Adjustments on Form 1098-T indicating that a prior year's education credit is subject to repayment (recapture).
- Excess ESA or QTP contributions not distributed timely to avoid an additional tax
- Tax returns where the taxpayer is subject to the kiddie tax.

Where to find more information

Pub 970, Tax Benefits for Education

Exercise answers

Question 1: a, Yes. Bob qualifies for the American opportunity credit because he claimed the credit in three previous tax years only; he is allowed up to four tax years.

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. Add up the 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, including Advanced, 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

Foreign tax credits

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. The foreign tax credit was created to help taxpayers avoid the 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 nonrefundable credit on their U.S. taxes. Determining which taxes paid to a foreign government on foreign-sourced income can be used in the computation of the credit can be very difficult because there are exceptions and special rules as detailed in Pub 514, Foreign Tax Credit for Individuals. Fortunately, most of our taxpayers will have foreign taxes that are eligible for the simplified limitation election discussed in Part I.

As a general rule, taxpayers must choose to take either a credit or an itemized deduction for **all** qualified foreign taxes. If the taxpayer is not eligible for the simplified limitation election, they must complete Form 1116. Taxpayers may change their choices each year:

- whether to take the credit or a deduction
- whether to use the simplified foreign tax credit election or the full Form 1116.

To be creditable, a foreign tax must:

1. Be an income tax
2. Be imposed on the taxpayer
3. Be a legal and actual foreign tax liability, and
4. Have been paid or accrued during the tax year

Some foreign taxes, such as foreign real property tax, are not income taxes.

This lesson is broken down into two parts:

[Part I: Simplified foreign tax credit election]

[Part II: Foreign tax credit using Form 1116]

A U.S. 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 and 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. (These are the questions on Sch B.)

Form 8938, Statement of Specified Foreign Financial Assets may be required for various foreign assets. The determination of what is or is not a specified foreign asset can be complex. Generally, accounts with a financial institution (such as a bank or brokerage) or an investment account (including some retirement accounts) are foreign financial assets. The filing thresholds for Form 8938 depend on the filing status of the taxpayer and whether they live in the U.S. or outside the U.S. Form 8938 is out of scope.

A tax return is out of scope if the taxpayer cannot answer "no" to the digital asset question on Form 1040.

Part I: Simplified foreign tax credit election

Taxpayers who receive certain types of income that are reported to the IRS on a tax form 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:
    - Form 1099-INT,
    - Form 1099-DIV, and/or
    - Form K-1

  Other tax forms, other types of income, or income that is not reported on one of these forms cannot be used for the simplified foreign tax credit.
- If the tax relates to dividend income from shares of stock, those shares must have been held for at least 16 days.
- The total foreign taxes shown on all the forms is not more than $300 ($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.

When the simplified foreign tax credit election is made, foreign tax credits that cannot be used in the current year are lost. There is no carry over or carry back from or to a year where the simplified limitation election was used. Counselors should alert taxpayers to this restriction if it applies; the taxpayer may wish to preserve their carryover by filing a full Form 1116.

If the total for all foreign taxes exceeds the $300 ($600 if MFJ) limit, the taxpayer is **not allowed** to use the simplified foreign tax credit method. They will need to complete the full Form 1116 to claim a foreign tax credit. The taxpayer may alternatively choose to claim their foreign income taxes as an itemized deduction on Sch A line 6, not subject to the state and local tax (SALT) cap. Foreign income taxes cannot be split between the credit and an itemized deduction; it's either/or.

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.

EXAMPLE *Ryan, who is single, received a 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.*

EXAMPLE *Rachel's brokerage statement shows $289 of foreign taxes paid. However, her foreign tax credit is limited to her tax (less nonrefundable credits with higher priority) of $199. If she uses the simplified foreign tax credit election method, her foreign tax credit is $199. She loses the $90 foreign taxes not credited (total $289 les $199 allowed). She may or may have a more favorable result if she completes Form 1116.*

EXAMPLE *Ricardo is also single. His brokerage tax statement shows $450 of foreign taxes paid to various countries. Ricardo cannot use the simplified foreign tax credit election and would need to complete Form 1116 if he wants to claim the foreign taxes as a credit. Alternatively, he can add the foreign taxes to his itemized deduction.*

Exercises (Answers are at the end of this 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

Question 4: Chris's brokerage statement shows $189 of foreign tax credits related to her dividend income. Chris's tax on his tax return is only $115. Assuming Chris files his return claiming a foreign tax credit without using Form 1116, what can Chris do with the unused $74 of foreign tax credits?

a. Chris can claim a refund for the $74.
b. Chris can carryback the $74 to the prior year, assuming he had a tax liability in that year.
c. Chris can carry the $74 over to future years until the credit is used up.
d. Chris loses the possible $74 foreign tax credit. He needs to file a full Form 1116 if he wants to preserve the carryback or carryover.
e. Claim an itemized deduction for the $74, assuming he itemizes.

If you are pursuing International Certification, continue with the rest of this lesson. Otherwise skip to the Summary below.

Part II: Foreign tax credit using Form 1116

Filing Form 1116 must be completed to claim a foreign tax credit:

- If the foreign tax paid is more than $300 ($600 for married filing jointly).
- The taxpayer has or will have excess foreign tax credits and they want to use the carryback or carryover provisions.
- The taxpayer does not meet the other conditions to make the election to claim the foreign tax credit (FTC) without filing Form 1116.

The foreign earned income exclusion discussed in Lesson 15, Income – Additional, differs from the foreign tax credit although both attempt to eliminate the double taxation that can occur with foreign income. 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).*

An amount denominated in a foreign currency will need to be converted to U.S. dollars. See the discussion in the Lesson 15, Income – Additional, Part II, for instructions on converting foreign currency amounts.

Qualified for the foreign tax credit

To qualify for the foreign tax credit, the following requirements must be met by the taxpayer:

- Had income from a foreign country
- Paid taxes on that income to the same foreign country
- Is not claiming the foreign earned income exclusion on the same income (see the foreign earned income exclusion section of the Lesson 15, Income – Additional)

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

In-scope foreign taxes that qualify for the foreign tax credit generally include taxes on:

- Wages
- Dividends
- Interest
- Royalties
- Annuities

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.

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.

Exercises (continued)

Question 5: 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. Can Anne can claim a foreign tax credit without completing Form 1116?

a. Yes
b. No

Not Qualified for the foreign tax credit

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
- Taxes paid to a country that has been designated by the Secretary of State as repeatedly providing support for acts of international terrorism
- Taxes paid to a country with which the U.S. has severed or does not conduct diplomatic relations
- Taxes paid to a country 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

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.

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 for the $2,500 in income taxes paid to Hong Kong.

Exercises (continued)

Question 6: 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 for the inheritance tax she paid in Spain?

a. Yes
b. No

Question 7: 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 claim a foreign tax credit for taxes paid to the sanctioned country?

a. Yes
b. No

Question 8: Assume the taxpayer is a U.S. citizen or resident living in a non-sanctioned foreign country and that the tax is being paid to a foreign government on income from that country. 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).

a. Q or NQ Dividend taxes
b. Q or NQ Foreign oil related income tax
c. Q or NQ Interest income tax
d. Q or NQ Real estate taxes
e. Q or NQ Income tax on wages from a foreign country, assuming the taxpayer does not take the foreign earned income exclusion
f. Q or NQ Taxes paid that are returned to the taxpayer in the form of a subsidy

Foreign or U.S. source income

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 based on the payer's status:
  - U.S. source if the payer a U.S. financial institution; foreign source if the payer is a foreign financial institution
  - If the payer is an individual: U.S. source if the payer's residence is in the U.S.; foreign source if the payer's residence is abroad
- Dividends are sourced the same as the payer's status: U.S. source if the payer is a U.S. corporation; foreign source if the payer is 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.

No "economic benefit"

As mentioned earlier, if the foreign tax paid provides a specific economic benefit for the taxpayer, it cannot 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
- Discharge 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 an additional tax on their profits*

The second tier entitles business owners to certain reduced fees and other benefits, such as the 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.

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 category 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 including:

- Dividends
- Interest
- Royalties
- Rents
- Annuities
- Net gain from the sale of property that produces such income, or non-income-producing investment property

Extra diligence may be required to determine the amount of interest or dividends that are sourced to a foreign country. Brokerages and mutual fund companies often provide foreign tax and foreign source income supplemental information that is available on their website only. A proper Form 1116 cannot be completed without that information.

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 below.

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.

Special rules apply to foreign taxes on a lump-sum distribution from a pension. This would involve using Form 4972, which is out of scope.

General category income

General category income includes earned income and other types of income that don't fit one of the other categories.

Income earned in a foreign country that an individual does not exclude is in the general category. This includes the portion of earned income that exceeds the exclusion limitation. Earned income includes:

- Wages and salaries

- Income earned in the active conduct of a trade or business
    - Including profit from the resale of goods
- High-taxed income (see below)

Exercises (continued)

Question 9: Erin 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. How many Forms 1116 will she need?

a. 3
b. 2
c. 1
d. 0

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. The exclusion was discussed in Lesson 15, Income – Additional. For purposes of the foreign tax credit, it is important to recall whether a taxpayer can switch between those two options:

- The taxpayer can always elect the foreign tax credit in year 1 and the foreign earned income exclusion in year 2.
- 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 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

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 income taxes paid to Spain.

High-taxed income

Some passive-category income, such as dividends or interest, must be included in the general category. If the income is taxed by a foreign government at a rate higher than the highest U.S. income tax rate, it is high-taxed income. Refer to the tax rate schedules in the Form 1040 instructions for the current highest U.S. income tax rate.

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 on her Form 1116 for general category income because the tax rate paid on this passive income is higher than the highest U.S. income tax rate.

Exercises (continued)

Question 10: 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 interest Income be classified? How should the dividend income be classified?

a. Passive category income
b. General category income

Question 11: 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

Key points for 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. Tax-Aide Counselors should refer to Form 1116 and its instructions for specific guidance on allocation of deductions and losses. Most deductions are prorated based on gross income — but not all. Extra care should be taken depending on the items of income or deduction on the taxpayer's return.

These items or situations are complicated and are out of scope:

- Expenses directly related to the foreign income
- Investment interest expense (out of scope always)
- 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

Taxpayers have the option of claiming foreign income taxes as a credit or as an itemized deduction (not subject to the cap on state taxes). This is an annual election that applies to all foreign income taxes paid during the year – see Lesson 19, Deductions.

Part I of this lesson covered taxpayers who paid taxes to a foreign country or U.S. possession and who may be able to take a nonrefundable foreign tax credit without filing Form 1116 if they meet certain conditions. Claiming the foreign tax credit in this circumstance is in scope for Tax-Aide Counselors with Advanced Certification.

Part II of this lesson 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, their income, and the taxes they paid must all meet specific requirements.
- 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:
  - Can elect the foreign tax credit in year 1 and the foreign earned income exclusion in year 2.
  - 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

Situations that 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.

- Completing Form 1116 unless the preparer and reviewer have International certifications
- Deductible foreign income taxes that are not allowable as a credit
- Certain expenses deducted to reduce foreign gross income on Form 1116 as listed above
- Tax returns that must report a carryback or carryover of foreign tax credits on Form 1116
- Tax returns for which a separate Form 1116 is 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
- Either question on Sch B is answered "yes," that is, Form FINCEN 114 is required to be filed or the taxpayer received a distribution from, or was the grantor of, or transferor to, a foreign trust

Where to find more information

Pub 514, Foreign Tax Credit for Individuals

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. Alternatively, Clyde can elect to deduct his foreign taxes if he is itemizing his deductions. Clyde's return with Form 1116 is out of scope unless the preparer and reviewer have International certification.

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: d, by using the simplified limitation election method for foreign tax credits, Chris gives up the ability to carry back or carry over any unused credits.

Answer 5: b, No. Anne cannot elect the simplified foreign tax credit because her Japanese wages do not qualify. Also, she probably did not receive a U.S. 1099 tax form for her Japanese interest and dividends, so they don't qualify either.

Answer 6: 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 7: b, No. Taxes paid to a sanctioned country cannot be claimed as a credit and will be reported on a separate Form 1116. However, this income is taxable in the U.S. since she is a U.S. citizen.

Answer 8:

a. Q – Dividend taxes
b. NQ – Foreign oil–related income tax
c. Q – Interest income tax
d. NQ – Real estate taxes
e. Q – Income tax on wages from a foreign country, assuming the taxpayer does not take the foreign earned income exclusion
f. NQ – Taxes paid that are returned to the taxpayer in the form of a subsidy.

Answer 9: b, 2. Erin will need to file two Forms 1116: one for the passive income category for her Japanese interest and dividend income and a second Form 1116 for her Japanese wages.

Answer 10: Regina's interest Income is in the passive category income basket. But, her dividend income is treated as general category income because it is high taxed income.

Answer 11: a. Since 17% (the Barbados tax rate Bernard paid) is not more than the highest U.S. income tax rate, Bernard's income is in the passive category income.

Child Tax Credit and 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 that was discussed in Lesson 21!

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
- Form 8862 (claiming credits after disallowance)

Objectives

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

- Determine the taxpayer's and dependent's eligibility for the credit(s)
- Determine which taxpayer can claim the credits

Child tax credit (CTC) and additional child tax credit (ACTC)

The child tax credit is a **nonrefundable** credit that allows taxpayers to claim a tax credit 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.

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).

Eligibility for 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. Starting with tax year 2025, the taxpayer claiming CTC or ACTC must have a valid Social Security number by the due date of the return. If filing MFJ, at least one of the spouses must have the valid Social Security number.

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
    - If the taxpayer is a U.S. citizen or U.S. national, an adopted child who lived with the taxpayer all year as a member of the household meets the citizen test.
- Has a valid Social Security number

Tax-Aide Counselors can use the [QC/R Tool] to determine whether the child and taxpayer qualify for CTC and ACTC.

A child age 17 or older may remain a qualifying child for dependency purposes but will not be an eligible qualifying child for CTC or ACTC. An example is when the child is permanently and totally disabled.

Harriet's adult child, Marvin, is permanently and totally disabled. He lives with Harriet and does not provide more than one-half of his support. Because Marvin is over the age of 16, Harriet cannot claim the CTC or ACTC for him. Harriet can claim other benefits with a qualifying child, such as the earned income credit, because Marvin's age is disregarded for qualifying child purposes.

Taxpayers that exceed the MAGI limits for the CTC or ACTC will not get the full amount of the credit.

Taxpayers claiming the child tax credit must have a valid Social Security number (at least one spouse if MFJ) 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 and his son both have valid Social Security numbers (SSN). Jeff, turned 17 on December 30. According to the QC/R Tool, 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 this lesson.)

Question 1: Jose and Yolanda 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

CTC limitations

The amount of CTC 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:
  - $400,000 for MFJ,
  - $200,000 for all other filing statuses
- 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 CTC. Stan's MAGI is $54,000 and his tax liability is $4,680. Stan is eligible to take a CTC of up to $4,680 to offset his tax liability. Stan cannot claim the full amount of the CTC because it is limited to his tax liability of $4,680. Stan may be eligible for the additional child tax credit.

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.

ACTC

The refundable ACTC is for certain individuals who get less than the full amount of the CTC. The criteria for a child to be a qualifying child for the ACTC are the same as the criteria for the CTC listed above.

For taxpayers with earned income over $2,500, the ACTC 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)

Taxpayers electing to exclude foreign earned income from tax can claim CTC only; the ACTC is not refundable for them.

The refund for taxpayers claiming the ACTC will not be issued prior to February 15.

Earned income for ACTC

Earned income for the ACTC is the same as for the earned income credit. See Lesson 29, Earned Income Credit.

ACTC calculation

Sch 8812 is used to calculate the ACTC and the software completes it automatically. If you have a question about the amount that appears as CTC or ACTC, the software's Child Tax Credit Worksheet may help you understand the calculation.

There is an alternate method to compute the additional child tax credit for taxpayers with three or more qualifying children. Taxpayers may benefit from this alternate method 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 ACTC using the regular method

In the alternate calculation, the MAGI limitation (discussed below) does not apply.

Credit for other dependents (ODC)

There is a $500 nonrefundable credit for dependents who do not qualify for the higher CTC. The dependent must be a U.S citizen, U.S. national, or resident of the U.S. The taxpayer (or spouse if MFJ) and the dependent must have a valid identification number (SSN, ITIN, or ATIN).

Taxpayers cannot claim the ODC 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.

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.

EXAMPLE

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.

Children of divorced or separated parents or parents who live apart

The rules for children of more than one person, including divorced or separated parents are incorporated into the QC/R Tool. These rules are also discussed in Lesson 6, Dependents.

The noncustodial parent may be entitled to claim the CTC, ACTC, or ODC 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.

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. If Mary does release the child's exemption, Mary can still claim the earned income credit, head of household, and child and dependent care credit for Amy assuming she qualifies for them.

These rules and the Form 8332 requirement for divorced or separated parents apply until the child is emancipated under local law. Generally, emancipation is at age 18, but that can vary. A child may also seek emancipation in a court of law.

MAGI for CTC, ACTC, and ODC

The taxpayers' MAGI is the same as their AGI from Form 1040 increased for excluded amounts of foreign, Puerto Rico, or American Samoa income.

As noted above, if MAGI is more than $400,000 for MFJ taxpayers or $200,000 for all other filing statuses, the tentative total CTC, ACTC, and ODC is reduced (or eliminated).

Exercises (Continued)

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 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 $90,000 and a tax liability of $8,000
d. Julie, who is married filing jointly with a MAGI of $422,000

Credits were 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 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, but not below zero. If a taxpayer is not able to benefit from the maximum CTC, the taxpayer may be eligible for the ACTC, which is a refundable tax credit up to a set amount. The taxpayer must have earned income to claim the ACTC.

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 or ACTC must have a valid Social Security number by the due date of the return, including extensions — at least one spouse if filing MFJ. For the CTC and the ACTC, the qualifying child must also have a valid SSN by the due date of the return including extensions.

To claim the ODC, 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.

The total of all three credits is reduced, maybe down to zero, for MAGI over certain levels. This limitation does not apply to taxpayers with three or more qualifying children for CTC/ACTC who use the alternate method.

If taxpayers claim the CTC, ACTC, or ODC 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

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. Laura will need to show Jack's SSN on her return.

Answer 3: c. Nick may be able to take the full 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 $9,000 is more than the maximum amount of the credit for two qualifying children.

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 in addition to 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.

Nonrefundable credits

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 but cannot result in a refund. 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.

Eligible taxpayer

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

Eligible contributions

To be eligible for the credit, taxpayers' contributions must be elective or voluntary.

An employee contribution is voluntary as long as it is not:

- Required as a condition of employment,
- Required to participate in the employer's retirement plan, or
- Required 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 an employed designated beneficiary of an ABLE savings account to their ABLE account (extended permanently by OBBBA) if they:
  - Are at least 18 years old at the close of the taxable year,
  - Are not a dependent or a full-time student, and
  - Meet the income requirements.

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.

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.

Reductions to an eligible contribution

Only the net contributions are eligible for the savings 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 amount of the credit

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.

Married taxpayers

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) of $1,500 from her former employer. In the current tax year, Joe contributed $2,500 and Mary contributed $3,000 to their respective IRAs. Joe and Mary 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: Joe's net contribution for the credit is $1,000 and Mary's is $1,500.

Exercises (Answers are at the end of this lesson.)

Question 1: All of these taxpayers contributed to their employers' 401(k) plans. 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!

(A) 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

Residential clean energy credit (out of scope)

The residential clean energy credit, available for expenditures before January 1, 2026, 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

The residential clean energy credit is not refundable, but unused credits may be carried forward to subsequent years. Be sure to review the taxpayer's return for the prior year to see if Form 5695 Part I indicates there is a carryforward to 2025. If so, the 2025 tax return is out of scope.

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. The credit is available for qualifying property placed in service on or before December 31, 2025. 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

The Qualified Manufacturer Identification Number is required for exterior doors, windows, and residential energy property claimed for the credit. 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.

EXAMPLE

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.

Energy efficiency requirements

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.

Eligibility

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.

Reporting

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.	

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.

Situations that 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)
- Carryover of residential clean energy credits to the current tax year
- Qualified electric vehicle credits (Form 8834)
- New or used clean vehicle credit (Form 8936)
- Mortgage interest credit
- Other credits listed on Sch 3 not included in this or a prior lesson.

Where to find more information

[IRS.gov for retirement savings credit]

[IRS.gov for residential energy credit FAQs]

[IRS.gov for energy efficiency requirements]

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.

(A) Premium Tax Credit

Introduction

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1095-A (health insurance Marketplace statement)
- Form 8962 & Instructions (premium tax credit)

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) and the mechanics of how the credit works.

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.

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

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. That is, a taxpayer must reconcile their APTC with the final amount of PTC allowable.

Form 1095-A

While conducting an interview with taxpayers using the Tax-Aide Intake Booklet, ask whether they 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 of APTC that was paid.

The deadline for the Marketplace 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.

Review all Forms 1095-A that the taxpayer received. An individual may be listed as insured that is not on the taxpayer's return. For example, a child age 25 could stay on the parents' policy even though the child is not a dependent. That may be a shared policy (discussed below) and out of scope.

Additionally, determine whether the taxpayer is self-employed. The tax return could be out of scope if marketplace policy premiums (eligible for PTC) would need to be used for the SEHI (discussed in *Lesson 17, Adjustments to Income**)*

Eligibility

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. Disqualifying MEC includes:
  - 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) for one or more months.
  - There is an exception in the Form 8962 instructions for policies that remained in force with partial payment.
- The taxpayer cannot be claimed as a dependent by another taxpayer.
- 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 taxpayer was determined eligible for APTC by the Marketplace and received the benefit of APTC for one or more months of coverage of a tax family member.
  - 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.
- If married, the taxpayer files a joint return with their spouse. **Exceptions**:
  - Even though married, the taxpayer is considered unmarried for head of household filing status.
  - Even though married and filing MFS, the taxpayer is a victim of domestic abuse or spousal abandonment.

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 a taxpayer was 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, the taxpayer 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, the employee has a marketplace policy, and the employee 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 with ICHRA coverage 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 ineligible 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 and granted APTC. Therefore, Adele is treated as not eligible for Medicaid for the year and is eligible for the PTC.

Finalizing PTC

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 the cost of optional coverages 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.

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 PTC tax 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 excess APTC they must repay, they should contact the Marketplace now to adjust their APTC to avoid another repayment.

Household income

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 who are 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. As noted above, the taxpayer would need reconcile the APTC paid for the now-unclaimed dependent, so there would not be a shared policy.

Lee and Gayle are married filing jointly. Their only child, Mary, is a full-time 21-year-old student who earned $35,000 during the year that she saved. Mary would be the qualifying child dependent of Lee and Gayle. However, if Lee and Gayle include Mary's MAGI in their MAGI, they will have to repay a lot of APTC. Lee and Gayle may decide to not claim Mary as a dependent. That leaves their tax family size at 2 (Mary is no longer in the tax family for PTC). Lee and Gayle will include all the APTC that was paid for Mary on their Form 8962 because they were the ones who told the marketplace that Mary would be part of their family when they enrolled Mary in marketplace coverage.

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 MFS or qualifies to file as HOH.

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 this 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.

An unclaimed dependent on Form 1095-A

When APTC has been paid for an individual and that individual does not appear on any tax return, special attention is needed. First, determine why that individual is not on a tax return:

1. The individual could be claimed as a dependent by a taxpayer
2. The individual cannot be claimed as a dependent by any taxpayer

The tax treatment of APTC and the requirement to reconcile APTC differs, according to IRS guidance.

In 1., the individual could be claimed by a taxpayer (that is, the individual is a dependent but no one is actually claiming them). 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 reconcile the APTC paid for that individual's coverage. This taxpayer may or may not be the one who could claim the individual. Since the taxpayer is not claiming the individual, the PTC calculation will be made on a smaller tax family size resulting in a smaller amount of PTC allowed.

Marcy is 25 years old, earned $3,500 during the year and her parents continue to support her. Her parents have their own coverage and took out a separate policy for Marcy for which APTC was granted. The parents decide to not claim Marcy as their dependent for personal reasons. Because

APTC was paid for her and she can be claimed as a dependent, the person who enrolled Marcy (her parents) are required to reconcile the APTC that was paid for Marcy.

In 2., the individual could not be claimed by any taxpayer but the 1095-A shows that APTC was paid for them. The individual now has a filing requirement irrespective of their income and must reconcile the APTC. The individual would compute their own PTC on Form 8962 using the information from Form 1095-A. If the Form 1095-A includes anyone else, it would be a shared policy and out of scope.

Monica is 25 years old, not disabled, and had investment income of $7,500 during the year. She lives with her parents who support her. Monica is too old to be a qualifying child dependent and has too much gross income to be a qualifying relative dependent.

Her parents have their own coverage and took out a separate policy for Monica for which APTC was granted. Except for the APTC, Monica is not required to file a tax return. Because APTC was paid for her and she cannot be claimed as a dependent, Monica is now required to file a tax return and reconcile the APTC that was paid on her behalf.

Returns for Alaska residents

Alaska residents may use Form 8814 to include their child's interest and dividends on their returns. In this case, refer to the Form 8962 instructions for the household income amount to include for the child's income.

Shared policy (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

Chuck and Camille cover their son Willie (age 25) on their marketplace policy. At the end of the year, it turns out that Willie's income is $7,000 and he is still fully supported by Chuck and Camille. Willie is too old to be a qualifying child and makes too much to be a qualifying relative so he cannot be claimed as a dependent.

The Form 1095-A shows all three individuals as covered and is a shared policy. The tax returns for all three are out of scope.

Because APTC was paid on the policy that covers Willie, Willie is required to file a tax return to include the PTC Form 8962 whether or not he is allocated any APTC.

The Tax-Aide Intake Booklet asks about marketplace coverage. When you review this with the taxpayer, ask them if they have health coverage and what that is. They may not have received a Form 1095-A even though they are covered by a marketplace policy, such as Willie in the example, where the Form 1095-A was sent to his parents. Willie's tax return (which is out of scope) will reject if Form 8962 is not included.

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.

Alternate calculation (out of scope)

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.

EXAMPLE

Andrea and Andi married during the year. Andi had marketplace coverage and received APTC throughout the year. They are filing a joint tax return that initially shows there is excess APTC that will have to be repaid. Andrea and Andi are eligible for the alternate calculation and their joint tax return is out of scope.

Another option is for Andrea and Andi to file separately. All APTC would be excess PTC but the repayment cap limits the amount of repayment. The required repayment may be less than the alternate calculation. Still, the return is still out of scope since we cannot know what the repayment would be under the alternate calculation.

Cap on excess APTC repayment

When the taxpayer received more APTC than the final PTC amount based on the taxpayer's actual facts and 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.

EXAMPLE

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 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).

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 medical 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. See Lesson 19, Deductions.

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. See Lesson 17, Adjustments to Income.

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 slightly above 400 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

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.

This lesson does not cover all the situations you may encounter. If you are unsure about a situation, check with a more experienced Counselor or your Coordinator to determine if the return can be prepared at your site.

Situations that 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

Where to find more information

Pub 974, Premium Tax Credit (PTC)

Healthcare.gov

IRS FAQs on PTC basics

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. 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 that the taxpayer can claim as a dependent but does not actually claim as a dependent on their tax return.

*You should **never** change the tax family size in the software.*

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 their 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.

Other Taxes

Introduction

This lesson covers several Other Taxes reported on the return that are in scope. The taxes in this lesson cannot be offset by nonrefundable credits. Instead, there must be refundable credits or other payments to cover these taxes. Double check to make sure that any of these taxes apply and that there is not an exception for it.

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

Other or additional 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 taxes on education and ABLE accounts
- Additional tax on taxable HSA distributions

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 out of 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 Lesson 26, Premium Tax Credit, for information on the repayment of the advanced premium tax credit that is added to the tax liability before nonrefundable credits.

(A) Self-employment tax

Self-employment (S-E) tax represents Social Security and Medicare taxes collected primarily from individuals who work for themselves, which are often referred to a FICA taxes (Federal Insurance Contribution Act). S-E tax is the counterpart 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.

The self-employment tax rate on net earnings is 15.3% (12.4% Social Security tax plus 2.9% Medicare tax). There is an annual cap on the earnings subject to the Social Security tax, but no cap for the Medicare tax.

Who pays 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 member of the clergy.
- The taxpayer has net profit from self-employment income in the amount of $400 or more.

Generally, taxpayers who are independent contractors or sole proprietors must file Form 1040 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. Refer to Lesson 30, Refund and Amount of Tax Owed, for a discussion of estimated tax payments.

S-E tax applies no matter how old the taxpayer is and even if they are already getting Social Security or Medicare benefits.

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 based on your entries.

Who does not pay self-employment tax

Some professions have an exemption from 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 (Form W-2) and do not have to pay the self-employment tax even though they report their income and expenses on Sch C.
- Children under the age of 18 performing services in the employ of their father or mother.
- Children under the age of 18 performing services in the delivery or distribution of newspapers or shopping news.
- Individuals who buy and sell newspapers or magazines to consumers where the sales price is fixed.

(A) Taxes on unreported tip income

All tip income is subject to federal income tax. It's a different story whether the tips are subject to FICA taxes. Tips of less than $20 per month that are not reported to the employer are not subject to Social Security and Medicare taxes (but they are still taxable for income tax purposes).

Self-employed taxpayers who receive tips should include the tips in gross receipts on Sch C.

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 and withholds Social Security, Medicare taxes, and federal income tax on that income.

EXAMPLE

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.

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.

Jacob is a so-so server at Max's Restaurant. He reports his cash tips to his employer but, combined with credit card tips, Jacob's overall tips fall short of the applicable 8% for allocated tips. His employer reports $6,255 of allocated tips on Jacob's W-2. Jacob keeps a detailed log of his tips and says his total tips were just $4,866. Jacob can report tips of $4,866 on his tax return. (Refer to your NTTC 4012 for the software entries.)

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 this 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.

How much of her 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

(A) Additional 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 two parts of Form 5329 are in scope:

- Part I to claim an exception to the additional tax on part or all of the early distributions from IRAs or qualified pension plans,
- Part IX to request a waiver of the additional tax for failure to take an RMD

The other parts of Form 5329 are out of scope.

Refer to the Tax-Aide Intake Booklet for the question regarding retirement income or payments from pensions, annuities, and/or IRA. Also review any Form 1099-R that reports these payments. Discuss the additional tax with the taxpayer to determine if the taxpayer is subject to the additional tax or if they qualify for an exception.

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.

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 a complete list of exceptions.

If an exception to the penalty applies, complete Form 5329 Additional Taxes on Qualified Plans (Including IRAs) and Other Tax Favored Accounts. Exceptions to the early distribution additional tax 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 retirement income lesson for withdrawing such excess.

Victims of domestic abuse

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

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 aren't subject to the additional tax on early distributions if they separated from service in or after the year they attained age 50 or reached 25 years of service, if earlier. Qualified public safety employees include those who were or provided:

- 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

Note that more employees qualify for this exception than are eligible for the public safety officer exclusion discussed in Lesson 11, Income – Retirement.

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 for self, spouse, child, or grandchild
  - Tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution
  - Expenses for special needs services incurred by or for special needs students in connection with their enrollment or attendance
  - If the student is at least a half-time student, room and board
- Total and permanent disability
- Terminal illness – see NTTC 4012 for the physician's certification requirement
- Qualified long-term care distributions made after December 29, 2025 (up to $2,600)
- 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)

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.

EXAMPLE

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 will 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 some of the expenses to reduce the additional tax.

Late distributions (failing to take the required minimum distribution)

An owner of a traditional IRA must generally start receiving distributions from their IRA when they reach their required start year as discussed in Lesson 11, Income - Retirement.

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.

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 retirement income lesson for withdrawing such excess to avoid the additional tax.

(A) Additional taxes on education and ABLE accounts

Excess distributions

A portion of distributions from a qualified tuition program account (often called a 529 plan) or from a Coverdell education account that exceed the beneficiary's qualified education expenses for the year may be taxable and subject to an additional tax of 10%. There are several exceptions to the additional tax. See Pub 970.

Similarly, if ABLE account distributions exceed qualified expenses, an additional tax of 10% may apply.

If any part of a distribution from a QTP (529), a Coverdell ESA, or an ABLE account is taxable on Form 5329, the return is out of scope [Form 5329, Part II].

Excess contributions

Even though the contribution is not deductible, there is a limit on how much can be contributed to a Coverdell ESA each year. There are a few exceptions detailed in Pub 970. The maximum is $2,000 per designated beneficiary, or less if MAGI exceeds $95,000 ($190,000 if MFJ). There is an addition tax of 6% if the maximum is exceeded. The additional tax doesn't apply if the excess contribution is withdrawn timely.

Similarly, there is a limit on contributions to an ABLE account (the annual gift tax exclusion amount). There are a few exceptions detailed in the instructions to Form 5329. There is an addition tax of 6% if the maximum is exceeded. The additional tax doesn't apply if the excess contribution is withdrawn timely.

If an excess contribution is not withdrawn timely per the instructions and the additional tax applies, the return is out of scope [Form 5329, Part V and Part VIII].

(A) Additional taxes on an HSA

Excess 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 Lesson 15, Income – Additional. Furthermore, 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

Use Form 8889, Part II, for the additional tax or if one of these exceptions applies.

An HSA distribution that is rolled over to another HSA is not taxable and not subject to the additional 20% tax.

Excess contributions

Excess contributions to an HSA are subject to a 6% additional tax (Form 5329, Part VII) each year until cured. The excess must be withdrawn by the April due date of the return to avoid the additional tax in the first year (the year the excess contribution was made) as discussed in Lesson 15, Income – Additional. In subsequent years, the excess can be applied toward the annual maximum contribution or withdrawn to cure the excess situation. If the additional tax applies, the return is out of scope.

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 taxes on education and ABLE accounts
- Additional tax on HSAs

Situations that 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 subject to additional taxes on education or ABLE accounts
- Additional tax on an excess HSA contribution that are not withdrawn timely such that the additional tax applies
- 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 Lesson 26, Premium Tax 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

Pub 970, Tax Benefits for Education

IRS on ABLE accounts

IRS on emergency expense and domestic abuse exceptions

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

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
- Reported tips
- Taxable fringe benefits
- Taxable sick pay
- Pensions and annuities
- Retirement plan and IRA distributions
- Gambling winnings
- Unemployment compensation
- Certain federal payments such as Social Security benefits

What do I need?

- Tax-Aide Intake Booklet
- NTTC 4012

Optional:

- Form 1040-ES
- Form 4868 (extension form)

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 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.

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 consolidated tax 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.

If a paper return must be filed, attach all Forms W-2 and any Forms W-2G and Forms 1099 if federal 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 are at the end of this lesson.)

Question 1: Federal income tax is always withheld from all types of income a taxpayer receives.

a. True
b. False

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 Lesson 30, Refund and Amount of Tax Owed 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 the tax return.

The interview

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. Also review the prior year's return to see whether there was a significant balance due. 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

Prior year overpayment

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 reviewing the prior year's return and confirm with the taxpayer:

- The last year's return showed an overpayment
- Some or all was applied tax year
- Whether the IRS sent a notice that they made an adjustment to the prior year's return

Be sure to use the final amount of an overpayment that was applied to the current year.

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.

EXAMPLE

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.

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.

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) in 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 an “other 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, Part II, Other Payments and Refundable Credits (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.

Situations that 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)

Where to find more information

Pub 505, Tax Withholding and Estimated Tax

Pub 17, Your Federal Income Tax

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

The earned income credit (EIC) is a tax credit for eligible individuals who work and have earned income under certain levels based on their filing status and number of qualifying children. EIC is a refundable credit — it can reduce the amount of tax owed and may also result in a refund.

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)

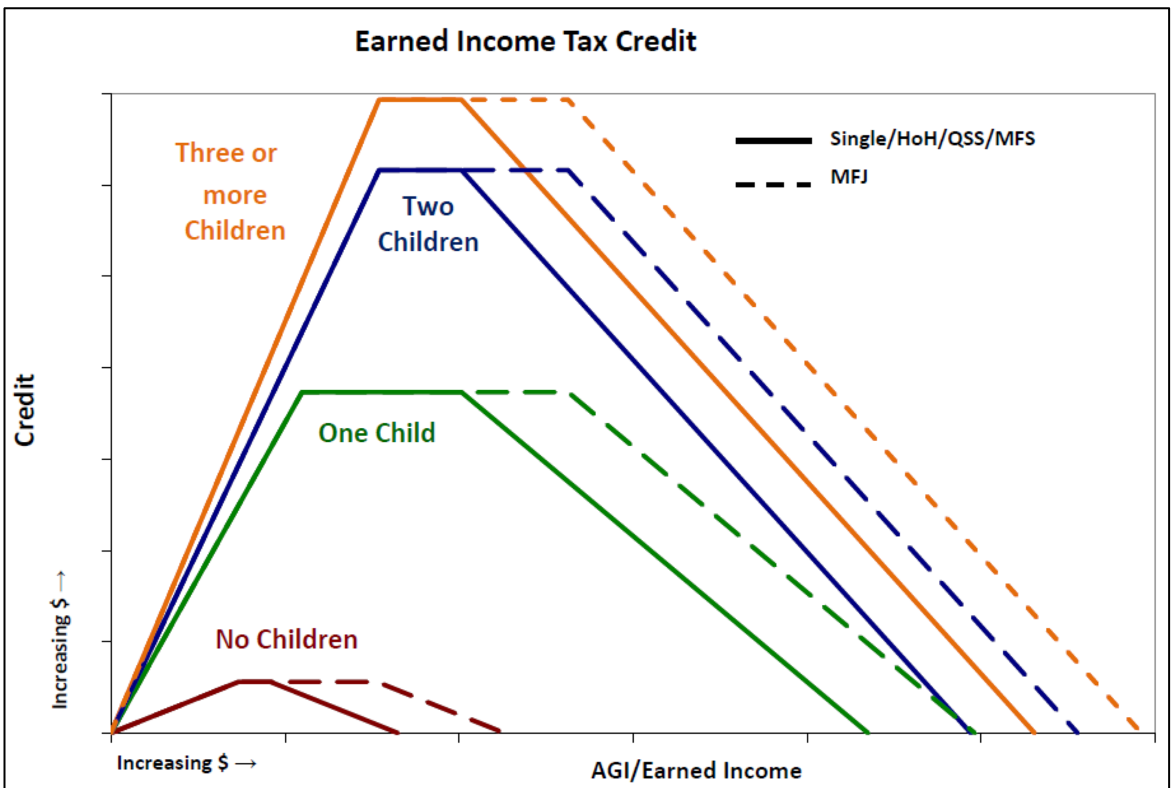
Objectives

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
- Determine the appropriate rules to apply
- Identify when a taxpayer is not eligible for EIC

EIC at a glance

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. Taxpayers with three qualifying children will receive a greater EIC and have higher income limits than taxpayers with only one qualifying child. A taxpayer with no qualifying children can receive a modest EIC.



The purpose of this chart is to show how the earned income credit changes with AGI/Earned income, number of children and filing status. It is not intended as a scalable reference document.

As a fraud prevention measure, a refund for taxpayers claiming the EIC will not be issued prior to February 15.

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

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.

Rules for 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 all these requirements:

- Must have earned income,
- 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, and
  - 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.
- 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 of separation and was not a member of the same household with the taxpayer's spouse by the end of the year.

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).

EXAMPLE

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.

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.

Combat pay

Although combat pay is not 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 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.

(A) ***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 on Sch C 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.

EXAMPLE *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.*

Disability pension

Long-term disability benefits treated as wages as described in Lesson 8, Income – Wages, Interest, and Dividends.

Household employee income

As described in Lesson 8, Income – Wages, Interest, and Dividends.

Medicaid waiver payments

Certain Medicaid waiver payments (MWP) as described in Lesson 8, Wages, Interest, and Dividends for details if your state normally reports MWP on a W-2. If your state normally reports MWP on a 1099, see the discussion in Lesson 15, Income – Additional. 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 or to not include their MWP income as earned income for EIC purposes.

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 Lesson 15, Income – Additional .

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 Lesson 15, Income – Additional.

Earned income not qualifying 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. Two items bear repeating:

- Work performed while an inmate in a penal institution is reported on Form W-2 but does not qualify as earned income for EIC purposes. 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.

Exercises

Use the Summary of EIC Eligibility Requirements Chart in the NTTC 4012, Tab I, Earned Income Credit, to answer the following questions. Answers are at the end of this lesson.

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

In addition to the rules above for all taxpayers, a taxpayer can file Form 1040 claiming the EIC with a qualifying child if the child meets the relationship, age, residency, and joint return tests as detailed in Lesson 6, Dependents. 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 household costs about evenly. Marco was a full-time student 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.

Rules for a qualifying child of divorced or separated parents

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 claim the child 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.

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, Mary, all year. All three have valid Social Security numbers.

Using the QC/R Tool, start with Chart 1 to determine whether Robyn can claim Aiden. You will get to Box 16 and have to consider that Mary could possibly claim Aiden. However, in Box 17, Robyn would win the tiebreaker because she is Aiden's parent. You'll end up in box 35 and Robyn is able to claim Aiden as her QC for EIC purposes.

Next, you should confirm whether Mary could claim Robyn or Aiden as QC or QR. Quickly, Robyn is too old be a QC and has too much income to be a QR. However, Aiden could be a QC for Mary but only if Robyn does not claim Aiden (box 18) and only if Mary's AGI is more than Robyn's (box 24).

You can assist the taxpayers by helping them maximize their EIC in this case by comparing the results of (a) Robyn claims Aiden or (b) Mary claims Aiden.

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 at least 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 the day before, 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.

Collin (age 75) lives with his disabled adult son (age 50), Steven who receives a nominal amount of public assistance. After working through the QC/R Tool, you find that Steven is a QC for Collin because age does not matter if the potential QC dependent is totally and permanently disabled. Assuming Collin has earned income and otherwise qualifies, he can claim EIC with one qualifying child.

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 SSNs.

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. 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.

EIC calculation

The software computes EIC using worksheets and the Earned Income Credit tables — both are published in the Form 1040 instructions. The software completes Sch EIC and the 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."

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)

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 because he is not a full-time student.

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 for EIC purposes.

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

Once the tax return is completed, 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 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
- 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 or overpayment of taxes

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.

Refund Anticipation Loans (RALs) and Refund Anticipation Checks (RAC) are not in scope.

Taxpayers can use 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 (approximately) 4 weeks after mailing a paper return.

Options for an overpayment

Taxpayers can choose among three options:

Apply any portion of their overpayment to the following tax year

Taxpayers who pay quarterly estimated taxes may find easier for some or all of an overpayment to be applied to the next year. This will reduce the amount of estimated payments to be made for the next year.

Receive all or part of their refund using direct deposit

Direct deposit refunds are received faster than checks (usually within 10 to 21 days) and eliminates 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 (RTN), such as an account at a bank, credit union, or other financial institution; a prepaid debit card; or an IRA. 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.

Double-check the RTN of the financial institution and the account number before the return is transmitted. If the routing and account numbers are not valid, the refund will be delayed 4–6 weeks. The IRS is not responsible if a financial institution refuses a direct deposit. Nor is the IRS responsible if the routing or account number is incorrect and the refund ends up in the wrong account. If the direct deposit is rejected, a check will automatically be mailed to the address on the return.

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.

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.

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 check.

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.

If more than one account is selected for direct deposit, be sure that the total of the amounts on Form 8888 equals the refund amount on Form 1040.

Receive all or part of their refund as a check

The Treasury Department will not immediately issue paper checks after September 30, 2025. Individuals who do not have a bank account or other means of receiving a payment digitally, can go to www.fdic.gov/getbanked or https://mycreditunion.gov/. The IRS will send a letter to the taxpayer requesting direct deposit information. Failing that, a paper check will be issued after approximately 6 weeks.

IRS adjustments

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 an IRS 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.

If an IRS 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.

EXAMPLE

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*

IRS and other offsets

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, but he owed $290 for a prior year's taxes:

	Requested	*Actual*
Account 1	*$300*	*$300*
Account 2	*$300*	*$190*
Account 3	*$180*	*0*

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.

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.

For inquiries about refund offsets, taxpayers can call the Treasury Offset Program. Their phone number and other helpful contact information are on the back cover of NTTC 4012.

Exercises (Answers are at the end of this 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

Taxpayer owes tax

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 by the due date of the return to avoid interest and possible penalty charges. If the taxpayer is unable to pay the full amount, paying what they can as soon as possible will reduce those extra 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.

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.

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.

Remind taxpayers that filing an extension of time to file does not extend the time for payment.

Payment options

Of the several payment options, only the first one is available with the filing of the return. The others require the taxpayer to take action.

Electronic funds withdrawal (direct debit)

By supplying the taxpayer's banking information, the taxpayer can request the IRS to pull the designated amount directly from their bank account and can specify the date of that debit. 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. Enter the account number from left to right, but omit spaces and symbols. Enter the amount to be debited and the date on which the debit should occur. The taxpayer can select any date up to the April due date of the return.

If the taxpayer is not able to pay the full amount (see What if the taxpayer cannot pay? below), an amount less than the full amount owed can be entered.

Double-check the RTN of the financial institution, the account number, the direct debit amount, and the direct debit date 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 a change is made to the return after direct debit information is entered, be sure to recheck the direct debit amount. The software does not automatically update the amount to be debited.

Direct Pay on IRS.gov

The taxpayer can pay their amount owed and also make their estimated tax payments using Direct Pay. They will enter their identifying information along with their banking information (RTN and account number). The taxpayer may select a payment date of up to a year away. No fee is charged when using a bank account.

Debit card, credit card or digital wallet

These can be accomplished online at IRS.gov or over the phone. Fees are charged by the payment processor as detailed on the IRS website.

The IRS2Go app on a mobile device

Taxpayers can check the status of a refund, make a payment, find free tax preparation assistance, sign up for helpful tax tips, and more using the IRS2Go app. IRS2Go is available in both English and Spanish.

Check or money order submitted with Form 1040-V, Payment Voucher

IRS discourages mailing tax payments (checks or money orders) pursuant to an Executive Order and for practical reasons, such as potentially lost or delayed postal deliveries.

The check (including a cashier's or bank check) or money order is mailed with a voucher. The taxpayer's Social Security number (the SSN shown first if it's a joint return), the tax year and related tax form or notice number must appear on the check. The check or money order should also include the taxpayer's name, address and daytime phone number.

Cash at a retail partner

For unbanked taxpayers, IRS has a cash option with retail partners, who charge a small fee per payment. There are limits on the maximum amount of each payment and the number of payments that can be made. Must-read instructions and a list of partners are on IRS.gov. To avoid penalties and interest, the taxpayer needs to make their retail-partner cash payment at least seven business days before the due date.

Taxpayers should not mail cash with their returns. They will need to go to a retail partner to pay with cash if cash is their chosen option.

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.
    - You can print extra vouchers for taxpayers who need to send in multiple payments or they can make their payments using one of the other methods noted above.
- Monthly installment agreement payments as discussed below
- Contact a Low-Income Taxpayer Clinics (LITC) that offers services for free or a small fee.
    - 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 (discussed below). More information about LITCs and how to locate a local LITC is found in the NTTC 4012.
- Taxpayers who can show they will have substantial financial difficulty paying their tax by 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.

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.

Requesting an installment agreement

Taxpayers who owe can immediately establish an installment agreement online, using the Online Payment Agreement Application (OPA) or by filing Form 9465, Installment Agreement Request.

- Using an installment agreement, the taxpayer can pay their balance owing over as many as 72 months (6 years).
- A fee is charged for this option, in addition to interest and penalties. The fee is less if the taxpayer uses OPA on IRS.gov and uses the automatic withdrawal option.
- If the taxpayer is already on an installment payment plan, they may be able to add the current year's additional amount owing. The taxpayer should call IRS to make arrangements.
- If the return is being filed electronically, Form 9465, Installment Agreement Request, can be included with the e-filed 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 the installment plan request is not done directly using OPA.
- If the total amount due is more than $25,000, there are additional requirements.

Some low-income taxpayers may qualify for a modification of the 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 fee waivers and reimbursements on IRS.gov.

Refer to Form 9465 instructions.

Offers 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 for whom 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. Instead, refer the taxpayer to an LITC.

Taxpayers can access additional information and a pre-qualifier tool on IRS.gov and in the Form 656-B Offer in Compromise Booklet.

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

Estimated tax penalty

Generally, taxpayers may owe a penalty for underpayment of estimated tax if they did not pay enough tax during the tax year, 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.

EXAMPLE

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.

We do not volunteer an underpayment of estimated tax penalty. Form 2210 is complicated and 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

Reducing a balance due for future years

To avoid having a large balance due and possible penalties, taxpayers should arrange to pay their taxes during the year. Depending on the taxpayer's situation, there are basically two options:

- Taxpayers whose income is mostly from wages, pensions, taxable IRA distributions, 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

Withholding taxes from wages

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.

EXAMPLE *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.*

EXAMPLE *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.*

Withholding taxes from other income payments

Taxpayers can use the following withholding forms to request or change 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-4R, Withholding Certificate for Nonperiodic Payments and Eligible Rollover Distributions
  - The taxpayer can select any percentage from 0% to 100% to be withheld.
  - For distributions from an employer plan eligible to be rolled over into an IRA or another qualified plan, the taxpayer can request more than 20% withholding (20% is the minimum).
- 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
  - 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.

A taxpayer who has set up their MySSA.gov account is able to set up or modify the rate of withholding from the Social Security benefits. To set up their MySSA.gov account, the taxpayer may need to set up their ID.me account.

The taxpayer should contact the payer for the appropriate form to start or adjust their withholding.

Estimated tax payments

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.

Chris still owes $2,500 on his tax return, after his estimated tax payments of $1,600. His tax liability was therefore $4,100. Assuming his income next year will be similar to this year, you might suggest that he increase his estimated tax payments to total at least $4,100 so that he is protected from an underpayment of estimated tax penalty.

Form 1040-ES, Estimated Tax for Individuals, has instructions and vouchers for estimated tax payment to 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.

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 direct deposit. Direct deposits can be split among as many as three different accounts by using Form 8888. IRS will contact the taxpayer if they request a paper check for their refund, which will be delayed.

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 should file their tax return electronically now and can delay their payment of taxes up to the April due date of the return. They can pay with:

- An electronic funds withdrawal (direct debit) submitted with the e-filed return.
- Direct Pay or a credit card on IRS.gov. They can also download the IRS2Go app to make payments through a mobile device.
- A check or money order with a Form 1040-V voucher.
- Cash at a retail partner.

There are fees associated with certain payment options.

Taxpayers who are unable to pay may request an additional 180 days to pay (no fee) or an installment payment agreement (with a fee). 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.

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 for either direct deposit or direct debit.

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. A taxpayer may be able to adjust the withholding from their Social Security benefits directly on line if they have a MySSA.gov account

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.

Situations that 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.

- Refund Anticipation Loans (RALs) and Refund Anticipation Checks (RAC)
- Form 2210, Underpayment of Estimated Tax by Individuals, Estates, and Trusts
- Offers in Compromise
- Form 1127, Application for Extension of Time for Payment of Tax Due to Undue Hardship

Where to find more information

IRS.gov on underpayment of estimated tax penalty

Pub 505, Tax Withholding and Estimated Tax

IRS.gov online payment plans

Pub 4134, Low Income Taxpayer Clinic List

IRS.gov on offers in compromise

List of retail partners

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 online or 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

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 this 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 to file

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 and pay any taxes owing 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.

Extension of time to file a return

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.

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 and indicate that the payment is for an extension online at IRS.gov or by phone to the IRS (Form 4868 is not required with this option)
- File a paper Form 4868 with payment if needed

See “How to Make a Payment” on page 3 of Form 4868.

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. The only exception is when the combat zone extension applies — see Lesson 32, Military Finishing and Filing the Return.

If Form 4868 is filed late, the IRS will inform the taxpayer that the request was denied.

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 Lesson 32, Military Finishing and Filing the Return for taxpayers who live outside the United States and Puerto Rico.

Exercises (continued)

Question 2: 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

File a return with an 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.

Statute of limitations

In most situations, the statute of limitation for a taxpayer to claim a refund or the IRS to assess a tax runs three years from the original April due date, even if the return is filed prior to that due date. In the situation where the return is filed on extension, the three years starts on the date the return is actually filed, not the extended date (usual October 15).

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.

Return for a decedent

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.

EXAMPLE *Bob died in February 2026. His 2025 tax return – due in April 2026 – is not the final tax return. The final tax return would be the 2026 Form 1040, filed in 2027.*

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.

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.

Taxpayer's copy of the return

Tax-Aide sites use the IRS-provided 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 the consent forms
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.

Recordkeeping

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.

Site recordkeeping

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.

Exit interview

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.
- 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.
    - 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.
- 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).

Before seeing taxpayers off:

- Ensure that you have the contact information needed to reach taxpayers in case there are any problems with e-filing the return.
- 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. Make written notation on the outside of the tax documents envelope.
- 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.
- 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

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 or submit a payment marked as an extension payment on IRS.gov. 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)
- Pub 3, Armed Forces Tax Guide
- Pub 17, Your Federal Income Taxes

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

Members of the military may face added complications when they are moved from one post to another.

Where to file

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 (VITA) 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 to file

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 Lesson 31, Completing the Return.

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).

If filing Form 8822, it should be sent to the IRS service center based on the state where their last-filed return was filed. The service centers' addresses are listed in the instructions.

Refund or tax owed

This information was covered in the Lesson 30, Refund and Amount of Tax Owed. Refer to that lesson to review the taxpayer's options for refunds or to pay an amount owed.

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.

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, or
- Members of the Armed Forces on duty outside of the U.S. and Puerto Rico on the due date of the tax return

Taxpayers using the automatic two-month extension must attach a statement to their return stating that they meet these requirements.

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.

Merely traveling outside the United States and Puerto Rico on the due date does not qualify the taxpayer for an automatic two-month extension.

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.

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 this 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

Combat zone participants special extension of time

Situations that count as time served in a combat zone or qualified hazardous duty area are:

- Service in a combat zone or qualifying service outside of a combat zone.
- Deployment outside the United States away from his/her permanent duty station while participating in a contingency operation.
  - A contingency operation is a military operation that is designated by the Secretary of Defense or results in calling members of the uniformed services to active duty (or retains them on active duty) during a war or a national emergency declared by the President or Congress.
- Missing status such as missing in action or prisoner of war.
- 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

In addition to members of the military, support personnel, including Red Cross, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces, can also qualify for the special extension of time.

Extended due dates

For members of the Armed Forces serving in a combat zone or qualified hazardous duty area, the deadline for making an IRA contribution, 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 or 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). That is, the taxpayer usually has 3 1/2 months (Jan. 1 - April 15) to file the tax return for the preceding calendar year. 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, 2023. She remained there through March 31, 2025, 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 2023, 2024, and 2025 returns are determined as follows:

	TY 2023	*TY 2024*	*TY 2025*
Entered combat zone	*12/1/23*	*12/1/23*	*12/1/23*
Left combat zone	*3/31/25*	*3/31/25*	*3/31/25*
Normal due date	*4/15/24*	*4/15/25*	*4/15/26*
Days remain to file when entered the combat zone	*106 (1/1/24 – 4/15/24)*	*105 (1/1/25 – 4/15/25)*	*105 (1/1/26 – 4/15/26)*
Additional days	*180*	*180*	*180*
Total additional days	*286*	*285*	*285*
New filing deadline	*3/31/25 + 286 = 1/11/26*	*3/31/25 + 285 = 1/10/26*	*3/31/25 +285 = 1/10/26 so normal due date of 4/15/26 applies*

The extended dates apply to action by the IRS, such as assessments of tax, giving or making any notice or demand for the payment of any tax, collection by the IRS of any tax due

- Note. As a result of section 309 of Public Law 114-113, continuous qualified hospitalization doesn't apply when determining the period during which the IRS can take collection action for taxes, even those assessed before the law was enacted.

Pub 3 provides additional information for combat zone extension of deadlines.

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.

Exercises (continued)

Question 3: If a member of the Armed Forces served in a combat zone from December 30, 2025 through May 31, 2026 and was not injured, the deadline for filing a 2025 tax return would be extended by how many days?

a. 105
b. 285
c. None, regular due date applies

Notifying of service in a combat zone

The IRS works with the Department of Defense to identify taxpayers who are serving in a combat 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.

Deferral of tax relief

Reservists called to active duty for a period of more than 30 days and enlistees in the Armed Forces and command officers of the National Health Services of National Oceanic and Atmospheric Administration 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.

The deferral is not automatic; a taxpayer must apply for an extension of time to pay. See Pub 3, Armed Forces Tax Guide, for information required in the extension request. 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.

Third-party designee

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 of 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 2025 of wounds incurred in a terrorist attack in 2023. For what tax years are Private Kane's income tax liabilities forgiven?

a. 2022 through 2023
b. 2023 through 2025
c. 2022 through 2025

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 Lesson 31, Completing the Return, 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.
- 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. (including Puerto Rico)
- The taxpayer, spouse, authorized agent, or representative can notify the IRS about combat zone service by sending an email to combatzone@irs.gov.
- 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

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: b. The deadline for 2025 is extended for 285 days (180 plus 105) after leaving the combat zone. The deadline for filing the 2025 tax return is 180 days plus the number of days remaining for the Armed Forces member to take action after entering the combat zone, computed as 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 15, 2026).

Answer 4: c. His income tax liabilities are forgiven for all tax years from 2022 through 2025.

(A) Amended and Prior Year Returns

Introduction

This lesson will help you determine when to amend a federal income tax return. In addition, this lesson provides guidance on preparing prior year returns, and how to advise a taxpayer who may not have all the required tax documents.

What do I need?

- Tax-Aide Intake Booklet for the year being prepared
- NTTC 4012 for the year being prepared
- Tax-Aide Scope Manual 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, and when not to
- Determine the time limits for filing an amended return or a prior year return that claims a refund
- Identify the resources that are required to assist a taxpayer with either an amended or prior year return
- Provide guidance when preparing and filing amended or prior year returns

Why amend a return

Taxpayers should file amended returns using Form 1040-X to correct errors or omissions on a return they have already filed. While it is not a legal requirement to file an amended return, the taxpayer might receive a refund or, if there is a tax due, stop the accruing of interest on the outstanding balance. 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 or could have used a different filing status
- Have a change in their tax liability

If the federal return has to be amended, often the state return must also be amended.

Before preparing an amended return, be sure you have any and all IRS changes to the originally filed return.

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 a taxpayer receives a notice from the IRS requesting additional information or clarification, tell the taxpayer to provide the requested information to the IRS or refer them to the contact person and telephone number on the notice. If the IRS sends a notice of a change to the return as originally filed and it is confirmed to be correct, the taxpayer should follow the instructions on the notice and an amended return is not necessary in that situation.

IRS will process an amended return as a “superseding return” if it is filed before the original due date. This distinction is important because elections that are required to be made on an original return are still available with a superseding return. For example, changing from married filing jointly to married filing separately.

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.

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 reasons 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 Form 8379 to Form 1040-X.

Amending a return

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. It is advisable to give two to three weeks for IRS to process an e-filed tax return before submitting an amended return. *Where’s my refund* on IRS.gov can be used to confirm the status of the original return if it claimed a refund.

Amending a return that was not prepared at your site will often take twice as long to complete. Check with a more experienced Counselor or your Coordinator if you are unsure. It’s possible that the paid preparer who prepared the original return will process an amended return to correct an error at no charge.

EXAMPLE

Three 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. After waiting for the original return to be processed by the IRS, the volunteer then helps Bernard prepare Form 1040-X to include the additional Form W-2 on the current-year return.

Approach the amended return as you would the original return, starting with a completed Tax-Aide Intake Booklet for the respective year and a thorough interview. Follow the instructions in NTTC 4012 to enter data into the tax software.

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, Scope Manuals, NTTC Pubs 4012 and Worksheets are available in the Training and Tax Law Library and from NTTC’s Useful Tax Prep Links easily accessed from a Tax-Aide laptop computer.

See the discussion below for prior year returns in the event that the taxpayer is missing needed tax forms (generally, W-2 or 1099s).

Form 1040-X

Form 1040-X is the form to use to amend a return. It starts by showing the income, deductions, taxes, payments, credits, etc., on the original return (or as last determined by a prior amendment or IRS adjustment). You will enter the correct amounts and the software will figure out the differences to complete the form. Be sure to review the 1040-X carefully to make sure it is rendering the correct results.

An explanation of the changes is needed. It should be clear and concise. For example, "add W-2 received after filing original return," or "to claim childcare expenses on Form 2441," or "to claim head of household status."

Time limits

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-year period for an original return under extension filed before the extended due date begins on the date the return was 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 or 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 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.

Exercises (Answers are at the end of this lesson.)

Question 1: John e-filed his 2021 Form 1040 on March 29, 2022. John found an error on the 2021 return and mailed an amended 2021 return on April 15, 2025. Is this too late to qualify for the refund?

a. Yes
b. No

Question 2: Brenda and her husband, Derek, originally filed separately for 2021 under extension on September 1, 2022. They would like to now amend and file jointly. Assuming a refund would result, what is the last date that they can file an amended return?

a. April 15, 2025
b. April 15, 2026
c. September 1, 2025
d. October 15, 2025

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 (especially if it is paper-filed).

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.

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 is available on electronically filed amended returns or the taxpayer can submit payment on IRS.gov.

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 Lesson 30, Refund and Amount of Tax Owed, for more information on payment options.

Exercises (continued)

Question 3: IRS sent a notice to Gabriel saying he omitted a retirement distribution on his 2024 tax return. Gabriel and you agree that the notice is correct. Should Gabriel file an amended return to include the missed distribution?

a. Yes
b. No

Question 4: Jackson's original return was filed on February 15, 2026. He comes back to your site on February 20, 2026, with an additional W-2 wage statement showing taxable wages of $5,000 and federal tax withheld of $50. It is likely that adding the W-2 to his return will cause a balance owing. Which of these is appropriate (select all that apply)?

a. Tell Jackson that IRS may or may not catch it and to wait for an IRS notice.
b. Advise Jackson to file an amended return and pay the balance due by the April due date to avoid interest and possible penalties.
c. Tell Jackson to come back after two or three weeks to give IRS time to process the original return at which time an amended return can be e-filed and he can pay the additional tax owing.

Prior year returns

If your site allows, Tax-Aide can assist taxpayers in catching up with missed tax returns.

Taxpayers may be missing prior year original tax documents. A taxpayer can obtain a free transcript of their original or amended return for the last three years. The transcript will be "masked" unless the taxpayer specifically requests an unmasked transcript. An unmasked transcript is always preferred just in case the information that would be masked is needed, such as an employer's FEIN. The transcript can be requested:

- Using the IRS2Go phone app.
- By filing Form 4506T or Form 4506T-EZ, Request for Transcript of Tax Return.
- By downloading records from their IRS.gov online account (if the taxpayer has set up their IRS account).

Copies of up to seven years' actual tax returns can be requested using Form 4506, but there is a charge for each one.

Scope limitations

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. The requirements for a prior year amended return apply equally to a prior year return being filed late. The Tax-Aide preparer and reviewer must have been certified for the year being prepared at the appropriate certification level.

Tax-Aide sites are encouraged (but not required) to prepare prior year returns, but only if the tax software is available for that year.

Required resources and procedures

If your site chooses to prepare or amend prior year returns, at a minimum, the following are required:

- The tax software for the year must be available
- Completion of the respective year's Tax-Aide Intake Booklet
- A complete and thorough interview
- Confirm that the return is in scope by reference to the respective year's Tax-Aide Scope Manual
- NTTC 4012 for the respective year (and appropriate Worksheets)
- A complete quality review and exit interview

Prior year Tax-Aide Intake Booklets, Scope Manuals, NTTC Pubs 4012, and Worksheets are available in the Training and Tax Law Library and from NTTC's Useful Tax Prep Links easily accessed from a Tax-Aide laptop computer.

If your site does not have the necessary resources to prepare a prior year or amended return, 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.

Filing a prior year or amended return

Prior year or amended returns can be prepared up to six years using the tax software provided by the IRS. However, only the current tax year and two preceding years' returns can be filed electronically. Returns for older years must be paper-filed.

When a return that is beyond statute shows a refund, IRS may not issue that refund. IRS may, however, offset that refund against a balance owing. In this case, there is no downside to filing the return. On the other hand, the statute does not begin to run on a balance owing until the return is filed.

Unresolved tax issue for 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

Low Income Taxpayer Clinic

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.
- Offer services for free or for 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 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.

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)

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 accurately prepare all returns.

Amended returns should be filed to correct any error or omission that is within scope.

Additional notes:

- If you are amending the federal return, you usually have to amend the state return.
- Volunteers may only prepare returns within Tax-Aide scope.
- If a taxpayer requests return preparation assistance for a prior year return, the preparer and reviewer must be certified for that year.

Situations that 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

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]

[Pub 4134, Low Income Taxpayer Clinic List]

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: c, they have until three years from the date the return was actually filed. The fact that the extension was good until October 15, 2022 does not change the statute date.

Answer 3: b. No, Gabriel should reply to the IRS notice as it instructs. Paying the additional tax owed as soon as possible with stop the accruing of interest (and any penalties that IRS may have proposed).

Answer 4: b and c are appropriate. Jackson has until the April due date to pay the additional tax that will show on his amended return.

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