Your Federal Income Tax

For Individuals

Department of the Treasury

Internal Revenue Service

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For use in preparing

1994
Returns

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All material in this publication may be reprinted freely. A citation to Your Federal Income Tax (1994) would be appropriate.

The explanations and examples in this publication reflect the interpretation by the Internal Revenue Service (IRS) of:

- Tax laws enacted by Congress,
- Treasury regulations, and
- Court decisions.

However, the information given does not cover every situation and is not intended to replace the law or change its meaning.

This publication covers some subjects on which a court may have made a decision more favorable to taxpayers than the interpretation of the IRS. Until these differing interpretations are resolved by higher court decisions or in some other way, this publication will continue to present the interpretation of the IRS.

All taxpayers have appeal rights within the IRS and may appeal to the courts when they do not agree with the interpretation of the IRS. Appeal procedures are described in *The Examination and Appeals Process* in the back of this publication.

Introduction

This publication can help you prepare your own tax return by taking you through each part of the return. It supplements the information in your tax form instruction booklet. It explains the tax law and will help you understand your taxes so that you pay only as much tax as you owe and no more.

The publication begins with the rules for filing a tax return. It explains who must file a return, which tax form to use, when the return is due, and other general information. It will help you identify which filing status you qualify for, whether you can claim any dependents, and whether the income you are receiving is taxable. The publication goes on to explain the standard deduction, the kinds of expenses you may be able to deduct (like medical expenses, donations to charities, etc.), and the various kinds of credits you may be able to take to reduce your tax. This includes the rules for the earned income credit and the advance earned income credit.

Throughout the publication are examples showing how the tax law applies in typical situations. Sample forms and schedules show you how to fill out your return. Also throughout the publication are flowcharts and tables that present tax information in an easy-to-understand manner.

The index in the back of the publication will help you find the information you need.

Some of the material that was in previous editions of this publication has been taken out of this year's edition. That information can be found in your tax form instruction booklet and includes the following:

Tax Table,

Tax Rate Schedules,

Lists of where to report certain items listed on information documents,

List of mailing addresses for where to file returns,

List of recorded tax information topics (Tele-Tax),

List of phone numbers for calling the IRS, and

Lists of tax publications and tax forms.

If you operate your own business or have other self-employment income, such as babysitting or selling crafts, see these other publications for more information:

- Publication 334, *Tax Guide for Small Business,*
- Publication 533, *Self-Employment Tax,*
- Publication 535, *Business Expenses,* and
- Publication 587, *Business Use of Your Home.*

You can get free IRS publications and forms. Call 1–800–TAX–FORM (1–800–829–3676) or use the order form in the back of this publication. Many public libraries also have reference sets of these publications that you can use.

We welcome your suggestions for future editions of this publication. Please send your ideas to:

Internal Revenue Service
Technical Publications
Branch (PC:FP:P)
1111 Constitution Ave., NW
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your area code and daytime phone number along with your return address. ■

Customer Service Standards for 1995

The National Performance Review (NPR), chartered by the President and led by the Vice President, conducted an intensive study of the federal government to ensure a government that works for people. The NPR recognized the Internal Revenue Service as a leader among government agencies in customer service, but challenged the IRS to make even more progress toward customer service, with emphasis on quality, fairness, and efficiency.

IRS accepted the NPR's challenge. For 1995, we have set the following Customer Service Standards.

- To make it easier for you to meet your tax obligations, we will expand your opportunity for simplified return filing and payment of your taxes through our electronic filing, joint federal/state filing, touchtone phone, and electronic payment programs.
- You will have more convenient access to tax law and account information. Our pre-recorded tax information will continue to be available 24 hours a day, 7 days a week, and access to refund status information will be extended. We will also extend the time that you will be able to contact our tax assistors to 10 hours each business day. (Toll-free telephone numbers are in your tax form instruction booklet.)
- Our goal is to answer your questions and process your tax returns accurately. To reach that goal, we will continue to make improvements yearly.
- If you file a complete and accurate tax return and you are due a refund, your refund will be issued within 40 days if you file a paper return or within 21 days if you file electronically.
- Our goal is to resolve your account inquiries with one contact. To reach that goal, we will make improvements yearly.
- If you provide sufficient and accurate information to our tax assistors but are given and reasonably rely on an incorrect answer, we will cancel related penalties.
- If you have a problem that has not been resolved through normal processes, you may contact our Problem Resolution Office. A caseworker will contact you within one week and will work with you to resolve the problem. (The IRS number for your area is in your tax form instruction booklet.)
- We will make tax forms and instructions simpler and easier for you to use. We made some good changes this year, but we want your ideas for future improvements. Please call us toll free or write to us. You can call the IRS with your forms ideas at 1–800–829–9043 and leave a recorded message 24 hours a day, 7 days a week. Or, you can write to the Internal Revenue Service, Attention: Tax Forms Committee, PC:FP, Washington, DC 20224.

■

Important Changes for 1994

This section summarizes important tax changes that took effect in 1994. These changes are discussed in more detail throughout this publication.

Changes are also discussed in Publication 553, *Highlights of 1994 Tax Changes.*

Pending legislation. As this publication was being prepared for print, Congress was considering changes to the tax law that could affect items on your 1994 and 1995 income tax returns.

Beginning in ***1994,*** this legislation would deny the earned income credit based on income earned by an inmate at a penal institution.

Beginning in ***1995,*** this legislation would:

- Deny the earned income credit to certain nonresident aliens.
- Make U.S. military personnel stationed outside the U.S. eligible for the earned income credit and the advance payment of the earned income credit.
- Require you to list on your 1995 federal tax return the social security number for any person born before November 1, 1995, for whom you are claiming a dependency exemption or the earned income credit.

See Publication 553, *Highlights of 1994 Tax Changes,* for any further developments regarding this pending legislation.

Earned income credit modified and expanded. The maximum amount of money you can receive from the earned income credit has increased from $2,364 in 1993 to $2,528 in 1994. The health insurance credit and the extra credit for a child born during the year are no longer available, but you may now qualify for the credit even if you do not have a child or a qualifying child. See Chapter 35.

Claim earned income credit on Form 1040EZ. If you qualify for the earned income credit without a qualifying child, you can claim it on Form 1040EZ (in addition to Forms 1040 and 1040A). See Chapters 1 and 35.

Earned income credit with your pay. If you qualify for the earned income credit in 1995 and a qualifying child lives with you, you may be able to receive some of the credit with your paycheck. See Chapter 35.

More of your social security benefits may be taxable. If you received social security or equivalent tier 1 railroad retirement benefits, you may have to include up to 85% of that amount in your taxable income. See Chapter 12.

Moving expenses. For moving expenses incurred after 1993, certain items are no longer deductible, the distance requirement is increased, and the deduction is allowed as an adjustment to gross income on page 1 of Form 1040. See Chapter 19.

Points paid by seller. If you bought a main home after 1990 and the seller paid points for your mortgage, you may be able to deduct them as an interest expense on Schedule A. See Chapter 25.

Charitable contributions. If you make a contribution of $250 or more, you generally must have a written acknowledgment from the organization in order to deduct the contribution. If you make a payment that is more than $75 and it is partly a contribution and partly for goods or services, the organization must give you a written statement telling you that you can deduct only the amount that is more than the value of the goods or services. The statement will also give you a good faith estimate of the value of those goods or services. See Chapter 26.

Passive activity rules for rental activities. Beginning in 1994, rental activities in which you materially participate will no longer be passive activities if you meet certain eligibility requirements. Losses from these activities are not limited by the passive activity rules. See Chapter 10.

Capital gain distributions. If you received capital gain distributions but you do not need to file Schedule D (Form 1040), enter those distributions on line 13 of Form 1040 and write "CGD" on the dotted line next to line 13.

Filing requirements. Generally, the amount of income you can have before you are required to file a return has been increased. See Chapter 1.

Higher exemption amount. For 1994, you are allowed a $2,450 deduction for each exemption to which you are entitled. However, your exemption amount could be phased out if you have high income. See Chapter 3.

Standard deduction. For most people, the standard deduction has increased. Because of this increase, it may benefit you to take the standard deduction for 1994 even though you itemized deductions in past years. See Chapter 21.

Limit on itemized deductions. Some of your itemized deductions may be limited if your adjusted gross income is more than $111,800 ($55,900 if you are married filing separately). See Chapter 22.

Standard mileage rate. For 1994, the standard mileage rate for the business use of a car is 29 cents a mile for all business miles. See Chapter 28.

Business meals and entertainment. The amount you can deduct for business meals and entertainment expenses is reduced from 80% to 50%. See Chapter 28.

Club dues. Beginning in 1994, you are not allowed a deduction for dues (including initiation fees) for membership in any club organized for business, pleasure, recreation, or other social purpose.

Travel expenses paid for others. You generally cannot deduct travel expenses you pay or incur for a spouse, dependent, or other individual who accompanies you (or your employee) on business travel. See Chapter 28.

Form 2106–EZ. You may be able to use new Form 2106–EZ to claim your employee business expenses. See Chapters 28 and 30.

Self-employment tax. The maximum net earnings subject to the social security tax portion of self-employment tax (12.4%) has increased to $60,600. All net earnings of at least $400 ($108.28 for church employees) are now subject to the Medicare tax portion (2.9%). See Publication 533, *Self-Employment Tax.*

Social security and Medicare taxes. The maximum wages subject to social security tax (6.2%) has increased to $60,600. All wages are now subject to Medicare tax (1.45%).

Social security taxes for household employees. If you pay a domestic employee, such as a babysitter or a housekeeper, $1,000 or more to work in your home during 1994 or 1995, you will have to pay social security and Medicare taxes. Generally, after 1994, amounts paid to students under 18 are exempt. For more information, see Publication 926, *Employment Taxes for Household Employers.*

Payment Voucher. To modernize our payment system, this year we are sending **Form 1040–V,** *Payment Voucher,* to some taxpayers. Over the next few years, we will expand the use of this preprinted payment voucher to all taxpayers to help us process payments more accurately and efficiently.

If you have a balance due on your return and you receive Form 1040–V, use it to send us your payment. Follow the instructions that come with the form.

Deferred 1993 taxes due April 17, 1995. If you filed Form 8841 so you could pay part of your 1993 tax in installments, the second installment is due on April 17, 1995. You can apply part or all of your 1994 refund to this installment. See Chapter 1. ■

Important Reminders

Listed below are important reminders and other items that may help you file your 1994 tax return. Many of these items are explained in more detail later in this publication.

Forms W–2 and 1099. You should receive your 1994 Form W–2, *Wage and Tax Statement,* and your Forms 1099 by January 31, 1995. If you have not received them by January 31, ask your employer or payor for them. If you still do not receive them by February 15, call the IRS number for your area listed in your tax form instruction booklet.

Even if you do not receive these income statements, you must still report your earnings. If you lose your copy of Form W–2 or 1099, or if it is incorrect, ask your employer or payor for a new one.

Fast filing. You can have your return filed electronically instead of mailing it to the IRS. Electronic filing is a fast and accurate way to file. When you file electronically, you can have your refund deposited directly into your checking or savings account. See Chapter 1.

Electronic filing of federal and state returns. If you live in certain areas of the country, you may be able to electronically file both your federal and state returns. See Chapter 1.

Form 1040PC. Form 1040PC is a return that you prepare on a personal computer. It is a part of many tax preparation software packages you can get from computer stores. Form 1040PC is ***not*** available from the IRS. See Chapter 1.

Credit for electric vehicle. You may be allowed a 10% tax credit if you placed an electric vehicle in service after June 30, 1993. See Chapter 36.

Clean-fuel vehicles. You may be able to deduct from gross income a part of the cost of a clean-fuel vehicle you placed in service after June 30, 1993. See Chapter 15 of Publication 535, *Business Expenses.*

Employer-provided educational assistance. The exclusion of employer-provided educational assistance from wages is not available in tax years beginning after December 31, 1994. See Chapter 5 of Publication 535, *Business Expenses.*

Self-employed health insurance. The special rule that allowed self-employed individuals to deduct 25% of health insurance premiums from gross income expired December 31, 1993. However, at the time this publication was being prepared for print, Congress was considering legislation that would allow a deduction for 1994. See Publication 553, *Highlights of 1994 Tax Changes,* for later information about this deduction.

File one federal tax return. File only one federal tax return regardless of the number of jobs you had, Forms W–2 you received, or states you lived in during the year.

Free tax help. The IRS provides free tax information and services throughout the year, and there are approximately 100 publications available. Publication 910, *Guide to Free Tax Services,* describes the publications and the free tax information services you can receive.

Tele-Tax. This telephone service provides recorded tax information on about 140 topics. Tele-Tax can also tell you the status of your refund. See *What Is Tele-Tax?* in your tax form instruction booklet.

Telephone help. IRS representatives are available to answer your tax questions by telephone. If, after reading the tax form instructions and IRS tax publications, you are not sure how to fill out your return, or you have a question about an IRS notice, you can call the IRS number for your area. These numbers are listed in your tax form instruction booklet. You will not be charged for the call unless your phone company charges you for local calls.

Telephone service for hearing-impaired persons. If you are hearing-impaired and have access to TDD equipment, you can call 1–800–829–4059 with your tax questions or to order forms and publications. See your tax form instruction booklet for the hours of operation.

Written tax questions. You can send your written tax questions to your IRS District Director. You should get an answer in about 30 days. If you do not have the address, you can get it by calling the IRS number for your area that is listed in your tax form instruction booklet.

Walk-in help. Assistors are available in most IRS offices throughout the country to help you prepare your own return. An assistor will explain or ''walk through'' a Form 1040EZ, Form 1040A, or Form 1040 with Schedules A and B with you and a number of other taxpayers in a group setting. To find the location of the IRS office nearest you, look in the phone book under ''United States Government, Internal Revenue Service.''

If you want help with your tax return, you should bring in your tax package, Forms W–2 and 1099, and any other information (such as a copy of last year's return) that will help the assistor to help you.

At most IRS offices you can also get tax forms, publications, and help with questions about IRS notices or bills.

Videotaped instructions. Videotaped instructions for completing your tax return are available in either English or Spanish at participating libraries.

Braille tax materials. Braille tax materials are available for review from any of 142 Regional Libraries for the Visually Impaired in conjunction with the National Library Service for the Blind and Physically Handicapped. To locate your nearest library, write to the National Library Service for the Blind and Physically Handicapped, Library of Congress, 1291 Taylor St., NW, Washington, DC 20542.

Braille materials currently available for review include this publication, Publication 334, *Tax Guide for Small Business,* and Forms 1040, 1040A, and 1040EZ and their instructions.

Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE). Free help from volunteers is available in most communities. After completing IRS training, these volunteers help prepare basic tax returns for taxpayers with special needs, including persons with disabilities, the elderly, non-English-speaking people, and low income people. Call the IRS telephone number for your area for the location of the volunteer assistance site near you.

Tax return preparers. Choose your preparer carefully. If you pay someone to prepare your return, the preparer is required, under the law, to sign the return and fill in the other blanks in the Paid Preparer's area of your return. Remember, however, that you are still responsible for the accuracy of every item entered on your return. If there is any underpayment, you are responsible for paying it, plus any interest and penalty that may be due. Therefore, you should be careful to choose someone who understands tax matters and will prepare a complete and accurate tax return.

Check the name and social security number on your tax form. If both the name and social security number on your tax form do not agree with your social security card, your refund may be delayed or you may not receive credit for your social security earnings. If your Form W–2, Form 1099, or other tax document shows an incorrect social security number or name, notify your employer or the form-issuing agent. If the name or number on your social security card is incorrect, call the Social Security Administration toll free at 1–800–772–1213.

Rounding off. It is easier to complete your tax return if you round off all money amounts. This means that you drop amounts under 50 cents. For example, $25.32 becomes $25.00. You increase amounts that are 50 cents or more to the next dollar so that, for example, $25.50 becomes $26.00.

If you do round off, do so for all amounts on your return. However, if you have to add two or more amounts to figure the total to enter on a line, include cents when adding the amounts and round off only the total.

Records and receipts. Do not send in records, receipts, or canceled checks with your tax return. Keep your records available so that you can produce them if

the amounts you claim on your return are ever questioned.

You generally should keep records that support items of income or deductions on a return for 3 years from the date the return was filed or two years from the date the tax was paid, whichever is later.

You should keep records that relate to the basis of property as long as they are important in figuring the basis of the property. See Chapter 1.

Operation Desert Storm. There are tax benefits available to those who are involved in Operations Desert Shield and Desert Storm. These include the following items.

- Part or all of your pay for service in a combat zone as a member of the U.S. Armed Forces may be excluded from income. See Chapter 6.
- The deadlines for filing your tax return and paying your taxes may be extended. See Chapter 1.
- The income tax liability of a member of the Armed Forces who dies as a result of service in a combat zone may be forgiven.
- The running of the replacement period for postponing tax on any gain from the sale of your home may be suspended. See Chapter 16.

For more information on these and other items, see Publication 945, *Tax Information for Those Affected by Operation Desert Storm.*

Filing reminders. Before you file your return, be sure you do all of the following.

- Make sure the information on all Forms W–2 you receive is correct.
- Put all income, deductions, credits, and tax items on the correct lines.
- Check your social security numbers (SSNs). Incorrect or missing SSNs for you, your spouse, or your dependents may delay your refund.
- Use the correct chart or worksheet if you take the standard deduction.
- Use the correct column in the Tax Table or the appropriate Tax Rate Schedule.
- Fill out Schedule SE (Form 1040) if you had net earnings from self-employment of $400 or more (or Form W–2 wages of $108.28 or more from an electing church or church-controlled organization).
- Check your math carefully.
- Sign and date your return and enter your occupation. On a joint return both husband and wife must sign.
- If you received a tax return package with an address label, transfer the label to your return and make any necessary corrections to it. Use the label from your federal tax return package and not the one that came with your state tax return. Using the label helps us identify your account, saves processing time, and speeds refunds.
- If you are married filing a joint return and did not get a label, or you are married filing a separate return, enter your spouse's social security number in the space provided on Form 1040EZ (married filing a joint return only) or page 1 of Form 1040A or Form 1040.
- Attach all Forms W–2 to the left margin of the front page of your return.
- Attach all forms and schedules in attachment sequence number order. See Chapter 1.
- Enclose your check or money order for the full amount you owe. Write your social security number, address, daytime telephone number, form number, and tax year on your check or money order. Do not attach it to your return.
- If an addressed envelope came with your return, use it (unless you moved during the year) and be sure to use enough postage.

Note. If you pay the first installment of your 1995 estimated tax at the same time you file your 1994 return, ***do not*** send it with your return. Use a separate check or money order and mail it in a separate envelope to the address for your area given in the instructions for Form 1040–ES, *Estimated Tax for Individuals.*

Death of taxpayer. If a taxpayer died before filing a required return, the taxpayer's personal representative (and spouse, in the case of a joint return) must file and sign a return for that person. A personal representative can be an executor, administrator, or anyone who is in charge of the taxpayer's property. See Chapter 4.

Copy of return. Keep a copy of your tax return. It may be helpful in amending a filed return or preparing future returns. You can ask the IRS for a copy of a prior year tax return or a transcript of tax account information. See Chapter 1.

Gift to reduce the public debt. You can make a voluntary gift to reduce the public debt. To do so, enclose a separate check, payable to *Bureau of the Public Debt,* with your 1994 income tax return. See Chapter 1.

Where to file. If an addressed envelope came with your 1994 return, please use it. If you do not have one, or if you moved during the year, mail your return to the address listed for your area under *Where Do I File?* in your tax form instruction booklet.

File on time — even if you cannot pay. If you do not have the money to pay the amount you owe on your return, you should file your return on time and pay what you can. The IRS will bill you for the balance due, plus interest if the balance is not paid by the due date. You may also have to pay a failure-to-pay penalty.

If you do not file your return by the due date, you will have to pay interest on the amount you owe, and you may have to pay a failure-to-pay penalty plus interest on the penalty. You may also have to pay a failure-to-file penalty, plus interest. See Chapter 1.

Installment agreement. If you cannot pay the full amount due with your return, you may ask to make monthly installment payments. See Chapter 1.

Amended return. If you find changes in your income, deductions, or credits after you mail your return, file Form 1040X, *Amended U.S. Individual Income Tax Return,* to change the return you already filed. See Chapter 1.

Penalties. Certain ''accuracy'' penalties can be imposed, including the penalties for negligence and for substantial understatement of income tax. There are also penalties for failing to provide a social security number and for fraud. See Chapter 1.

Address change. If you move, be sure to notify the IRS using Form 8822, *Change of Address.* Mail it to the Service Center where you filed your last return. Addresses for the Service Centers are on the back of the form.

If you move after you file your return and you are expecting a refund, also notify the post office serving your old address. This will help to forward your check to your new address.

Refund information. You can use Tele-Tax to find out the status of your refund by telephone. (However, electronically filed return refund information may not be on your area's Tele-Tax system.) For details on how to use this service, see *What is Tele-Tax?* in your tax form instruction booklet.

Refund checks. Be sure to cash your refund check soon after you receive it. Checks not cashed within 12 months of the date of the check will be canceled. See Chapter 1.

Refund more or less than expected. If you receive a check for a refund you are not entitled to, or for an overpayment that should have been credited to estimated tax, do not cash the check. Call the IRS number for your area.

If you receive a check for more than the refund you claimed, do not cash the check until you receive a notice explaining the difference.

If your refund check is for less than you claimed, it should be accompanied by a notice explaining the difference. Cashing the check does not stop you from claiming an additional amount of refund.

If you did not receive a notice and you have any questions about the amount of your refund, you should wait two weeks. If you still have not received a notice, call the IRS number for your area.

Do you want more or less tax withheld in 1995? If your 1994 refund is large and you want to have less tax withheld from your pay, you should get Form W–4, *Employee's Withholding Allowance Certificate,* from your employer. Complete Form W–4 claiming any additional allowances you are entitled to, and return the form to your employer. If you owe tax this year, you may

need to give your employer a completed Form W–4 claiming fewer allowances or asking for an additional amount to be withheld from each paycheck. See Chapter 5.

Estimated tax. Tax changes for 1995 may affect whether you must make estimated tax payments and the amount of your payments. Generally, you must make estimated tax payments if you expect to owe at least $500 and you expect your withholding and credits to be less than the smaller of (1) 90% of the tax shown on your 1995 return or (2) 100% of the tax shown on your 1994 return. However, certain taxpayers may not be able to use 100% of their 1994 tax to figure their 1995 estimated tax payments. See Chapter 5.

Acquisition of U.S. real property interest from a foreign person or firm. If you acquire a U.S. real property interest from a foreign person or firm, you may have to withhold income tax on the amount you pay for the property (including cash, the fair market value of other property, and any assumed liability). If you fail to withhold, you may be held liable for the tax, applicable penalties, and interest. For more information, see *U.S. Real Property Interest* in Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Corporations.*

Corresponding with IRS. Be sure to include your social security number in any correspondence with IRS.

Unresolved tax problems. The Problem Resolution Program is for taxpayers who have been unable to resolve their problems with the IRS. If you have a tax problem you cannot clear up through normal channels, write to your local IRS District Director or call your local IRS office and ask for Problem Resolution assistance. Hearing-impaired taxpayers who have access to TDD equipment may call 1–800–829–4059 to ask for help from Problem Resolution.

This office cannot change the tax law or technical decisions. But it can help you clear up problems that resulted from previous contacts.

For more information about the Problem Resolution Program, get Publication 1546, *How to use the Problem Resolution Program of the IRS.*

Privacy Act and paperwork reduction information. The Privacy Act of 1974 and the Paperwork Reduction Act of 1980 say that when we ask you for information we must tell you what our legal right is to ask for the information, why we are asking for it, how it will be used, what could happen if we do not receive it, and whether your response is voluntary, required to obtain a benefit, or mandatory under the law. A complete statement on this subject can be found in your tax form instruction booklet. ■

Part One.

The Income Tax Return

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

1. Filing Information

Important Changes for 1994

Filing requirements. Generally, the amount of income you can receive before you are required to file a return has been increased.

Expanded Form 1040EZ. You may be able to claim the earned income credit on Form 1040EZ if you meet certain requirements. See *Which Form Should I Use?* later. See Chapter 35 for information about the earned income credit.

Important Reminders

Deferred 1993 taxes due April 17, 1995. If you filed Form 8841, *Deferral of Additional 1993 Taxes,* so you could pay part of your 1993 tax in installments, the second installment is due April 17, 1995. See *Paying Deferred 1993 Taxes,* later, for more information.

You cannot defer paying any part of your 1994 tax, except as described next.

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

Combat zone service. You are allowed additional time to take care of tax matters if you are a member of the Armed Forces who served in the Persian Gulf Area combat zone, or if you are not a member of the Armed Forces but served in the combat zone in support of the Armed Forces. You are allowed additional time for filing your tax returns, paying your taxes, and filing claims for refund. See *Extensions Related to Combat Zone*, later, under *When Do I Have To File?*

Change of address. If you change your address for any reason, you should use Form 8822, *Change of Address*, to notify the IRS. See *Change of Address*, later, under *What Happens After I File?*

Electronic filing. You may want to take advantage of filing your return electronically instead of on a paper form. Electronic filing can shorten the time for processing returns to within 3 weeks. See *Electronic Filing*, later, under *Where Do I File?*

Computerized returns. You may want to prepare your return on a personal computer. This return, called Form 1040PC, can be processed faster and more accurately than the regular tax return. Whenever this chapter refers to Form 1040, it generally also includes Form 1040PC. See *Computerized Returns*, later, under *Where Do I File?* for more information.

Introduction

This chapter discusses:

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

This chapter covers the requirements for filing a tax return. It refers you to other chapters for specific information on the income, deductions, and credits that you include on your return.

Do I Have to File a Return?

If you are a citizen or resident of the United States or a resident of Puerto Rico, you must file a federal income tax return if the filing requirements for any of the following categories apply to you:

- Individuals—In General
  - Surviving Spouses, Executors, Administrators, or Legal Representatives
  - U.S. Citizens Living Outside the U.S.
  - Residents of Puerto Rico
  - Individuals With Income From U.S. Possessions
- Dependents
- Children Under Age 14
- Self-Employed Persons
- Aliens

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

Note. Even if you are not required to file a return, it may be to your advantage to file a tax return. See *Who Should File*, later.

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

Individuals—In General

If you are a U.S. citizen or resident, your filing requirement depends on three factors:

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

However, you must file a return if your situation is one of those discussed later under *Other Situations When You Must File*.

Gross income. This includes all income you receive in the form of money, goods, property, and services that is not exempt from tax. Common types of income are discussed in the chapters in Part Two of this publication.

Community property. If you are married and have your permanent home in a community property state, half of any income described by state law as community income may be considered to be yours. This affects your federal taxes, including your filing requirement, if you file separate returns. See Publication 555, *Federal Tax Information on Community Property*, for more information.

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

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

Age. If you are 65 or older at the end of the year, the requirement to file a return may be different for you. You can generally have a higher amount of gross income than other taxpayers before you are required to file. See *Table 1–1*. You are considered 65 on the day before your 65th birthday. For example, if your 65th birthday was on January 1, 1995, you are considered 65 for 1994.

Filing requirements chart for most taxpayers. Generally, if you are a U.S. citizen or resident, you must file a tax return if your gross income for the year is at least as much as the amount shown for your filing status and age in *Table 1–1*. If your parent (or someone else) can claim you as a dependent, do not use this chart. See *Dependents*, later.

Surviving Spouses, Executors, Administrators, or Legal Representatives

You must file a final return for a decedent (a person who died) if:

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

For more information on rules for decedents, see Chapter 4.

U.S. Citizens Living Outside the U.S.

If you are a U.S. citizen living outside the United States, you must file a return if you meet the filing requirements. For more information on special tax rules that may apply to you, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*. It is available at most U.S. embassies and consulates, or you can order it using the order blank at the end of this publication.

Residents of Puerto Rico

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

If you are a resident of Puerto Rico for the entire year, gross income does not include income from sources within Puerto Rico, except for amounts received as an employee of the United States or a United States agency. If you receive income from Puerto Rican sources that is not subject to U.S. tax, the income level for your requirement to file a U.S. income tax return is lower than the applicable amount in *Table 1–1* or *Table 1–2*. See Publication 570, *Tax Guide for Individuals With Income From U.S. Possessions*, for further information.

Table 1-1. **1994 Filing Requirements Chart for Most Taxpayers**

To use this chart, first find your marital status at the end of 1994. Then, read across to find your filing status and age at the end of 1994. You must file a return if your gross income was at least the amount shown in the last column. Gross income means all income you received in the form of money, goods, property, and services that is not exempt from tax, including any gain on the sale of your main home (even if you may exclude or postpone part or all of the gain).

Also, see *Table 1-2* and *Table 1-3* for other situations when you must file.

Marital Status	Filing Status	Age*	Gross Income
Single (including divorced and legally separated)	Single	under 65	$6,250
		65 or older	$7,200
	Head of household	under 65	$8,050
		65 or older	$9,000
Married with a child and living apart from your spouse during the last 6 months of 1994	Head of household	under 65	$8,050
		65 or older	$9,000
Married and living with your spouse at end of 1994 (or on the date your spouse died)	Married, joint return	under 65 (both spouses)	$11,250
		65 or older (one spouse)	$12,000
		65 or older (both spouses)	$12,750
	Married, separate return	any age	$2,450
Married, not living with your spouse at the end of 1994 (or on the date your spouse died)	Married, joint or separate return	any age	$2,450
Widowed before 1994 and not remarried in 1994	Single	under 65	$6,250
		65 or older	$7,200
	Head of household	under 65	$8,050
		65 or older	$9,000
	Qualifying widow(er) with dependent child	under 65	$8,800
		65 or older	$9,550

* *If you were age 65 on January 1, 1995, you are considered to be age 65 at the end of 1994.*

Individuals With Income From U.S. Possessions

If you had income from Guam, the Northern Mariana Islands, American Samoa, the Virgin Islands, or Puerto Rico, special rules may apply in determining whether you must file a U.S. federal income tax return. In addition, you may have to file a return with the individual island government. See Publication 570 for more information.

Dependents

If you are a dependent (one who meets the **dependency tests** in Chapter 3), the requirement to file a return generally depends on:

- The amount of your earned and unearned income,
- The amount of your gross income,
- Whether you are single or married,
- Whether you are 65 or older, and
- Whether you are blind.

You also must file if your situation is one of those discussed later under *Other Situations When You Must File*. See *Table 1–2* to determine whether a dependent must file a return.

Earned income. This is salaries, wages, tips, professional fees, and other amounts received as pay for work actually done. For this purpose, earned income also includes any part of a scholarship that you must include in income. See *Scholarship and Fellowship Grants* in Chapter 13.

Unearned income. This is income that does not meet the definition of earned income. It

Table 1-2. **1994 Filing Requirements Chart for Dependents**
See Chapter 3 to find out if someone can claim you as a dependent.

If your parent (or someone else) can claim you as a dependent, and any of the four situations listed below applies to you, you must file a return.

In this chart, **unearned income** includes taxable interest and dividends. **Earned income** includes wages, tips, and taxable scholarship and fellowship grants.

Caution: If your gross income was $2,450 or more, you generally cannot be claimed as a dependent unless you were under 19 **or** under 24 and a full-time student. For details, see *Gross Income Test* in Chapter 3.

1. Single dependents under 65 and not blind.—You must file a return if—

Your unearned income was:	and	the total of that income plus your earned income was:
$1 or more		more than $600
$0		more than $3,800

2. Single dependents 65 or older or blind.—You must file a return if—

- Your earned income was more than $4,750 ($5,700 if 65 or older **and** blind), or
- Your unearned income was more than $1,550 ($2,500 if 65 or older **and** blind), or
- Your gross income was more than the total of your earned income (up to $3,800) or $600, whichever is larger, plus $950 ($1,900 if 65 or older **and** blind).

3. Married dependents under 65 and not blind.—You must file a return if—

- Your earned income was more than $3,175, or
- You had any unearned income and your gross income was more than $600, or
- Your gross income was at least $5 and your spouse files a separate return on Form 1040 and itemizes deductions.

4. Married dependents 65 or older or blind.—You must file a return if—

- Your earned income was more than $3,925 ($4,675 if 65 or older **and** blind), or
- Your unearned income was more than $1,350 ($2,100 if 65 or older **and** blind), or
- Your gross income was more than the total of your earned income (up to $3,175) or $600, whichever is larger, plus $750 ($1,500 if 65 or older **and** blind), or
- Your gross income was at least $5 and your spouse files a separate return on Form 1040 and itemizes deductions.

includes investment-type income such as interest, dividends, and capital gains. It also includes unemployment compensation, taxable social security benefits, pensions, and annuities. Distributions of interest, dividends, capital gains, and other unearned income from a trust are also unearned income to a beneficiary of the trust.

Responsibility of parent. If a dependent child with taxable income cannot file an income tax return, a parent, guardian, or other legally responsible person must file it for the child. If the child cannot sign the return, the filer must sign the child's name followed by the words ''By (signature), parent (or guardian) for minor child.''

If a child's tax is not paid, the parent or guardian is liable for the income tax on salaries and wages of the child.

Child's income. Amounts a child earns by performing services are his or her gross income. This is true even if under local law the child's parents have the right to the earnings and may actually have received them.

Children Under Age 14

If a child's only income is interest and dividends (including Alaska Permanent Fund dividends) and certain other conditions are met, a parent can elect to include the child's income on the parent's return. If this election is made, the child is not required to file a return. See *Parent's Election to Report Child's Unearned Income* in Chapter 32. Also see Publication 929, *Tax Rules for Children and Dependents*.

Self-Employed Persons

You are self-employed if you:

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

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

Filing Requirements for Self-Employed Persons

You must file Form 1040 if your gross income is at least as much as the filing requirement amount for your filing status and age ***or*** if your net earnings from self-employment are $400 or more. See *Table 1–1*.

Gross income. For purposes of the filing requirements, your gross income includes all income you receive in the form of money, goods, property, and services that is not exempt from tax. This includes the gross income amount on line 7 of Schedule C (Form 1040), *Profit or Loss From Business*, or line 1 of Schedule C–EZ (Form 1040), *Net Profit From Business*.

Net earnings of $400 or more. You must file a tax return if you had net earnings of $400 or more from self-employment. This applies regardless of your age.

Net earnings from self-employment generally is:

1) Net income (gross income minus deductible business expenses) from your business or profession, ***minus***
2) A 7.65% deduction that is used to figure self-employment tax. Multiply your net earnings by 0.9235 to get the 7.65% deduction (100% – 7.65% = 92.35% or 0.9235).

Minimum income. You must have $433.13 or more of net earnings from self-employment before reduction by the 7.65% deduction to be subject to self-employment tax (.9235 × $433.13 = $400). If your net earnings are less than $433.13 before the 7.65% reduction, you do not have to pay the tax.

Self-employment tax. If your net earnings from self-employment are $400 or more, you must pay self-employment tax. This tax is comparable to the social security and Medicare tax withheld from an employee's wages.

The combined self-employment tax rate for 1994 is 15.3%. The 15.3% rate is a total of 12.4% for social security and 2.9% for Medicare. Use **Schedule SE** (Form 1040), *Self-Employment Tax*, to figure your tax. Attach it to Form 1040. A copy of this schedule is shown in Chapter 39.

Maximum income. No more than $60,600 of your combined wages, tips, and net earnings in 1994 is subject to any combination of the 12.4% social security part of self-employment tax, social security tax, or railroad retirement tax.

However, all of your net earnings from self-employment in 1994 are subject to the 2.9% Medicare part of self-employment tax.

Foreign organizations or governments. If you are a U.S. citizen who works in the United States for an international organization, a foreign government, or a wholly owned instrumentality of a foreign government, and if your work is exempt from social security and Medicare taxes, you must pay self-employment tax on earnings from services performed in the United States.

Employees of churches. If you work for a church or a qualified church-controlled organization that elected exemption from social security and Medicare taxes, you will have to pay self-employment tax if you are paid $108.28 or more in a year by the church organization. See Publication 533 for more information.

Aliens

Your status as an alien—resident, nonresident, or dual-status—determines how you file your income tax return.

The rules used to determine if you are a resident or nonresident alien are discussed in Publication 519, *U.S. Tax Guide for Aliens*.

Resident aliens. If you are a resident alien for the entire year, you must file a tax return following the same rules that apply to U.S. citizens. Use the forms discussed in this publication.

Nonresident aliens. If you are a nonresident alien, the rules and tax forms that apply to you may be different from those that apply to U.S. citizens. See Publication 519 to find out if U.S. income tax laws apply to you and which forms you should file.

Dual-status taxpayers. If you were a resident alien for part of the tax year and a nonresident alien for the rest of the year, you are a dual-status taxpayer. Different rules apply for the part of the year you were a resident of the United States and the part of the year you were a nonresident. For information on dual-status taxpayers, see Publication 519.

Joint return. If you are an alien and you were married to a person who was a U.S. citizen or resident on the last day of the tax year, you may be able to file a joint return with your spouse. See Publication 519.

Other Situations When You Must File

You may need to file a tax return even if your gross income is **less** than the amount shown in *Tables 1–1* and *1–2*. You must file a return if any of the situations in *Table 1–3* apply.

Who Should File

Even if you are not required to file, you should file a federal income tax return to get money back if:

- You had income tax withheld from your pay, or
- You qualify for the earned income credit. See Chapter 35 for more information.

Which Form Should I Use?

You must use one of three forms to file your return—Form 1040EZ, Form 1040A, or Form 1040. *Table 1–4* may help you decide which form to use.

Form 1040EZ

If you are single or married filing jointly, you may be able to use the simpler Form 1040EZ.

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

- Your filing status is single or married filing jointly.
- You (and your spouse if married filing a joint return) were not 65 or older or blind.
- You do not claim any dependents.
- Your taxable income is less than $50,000.
- Your income is only from wages, salaries, tips, taxable scholarship and fellowship grants, and taxable interest of $400 or less.
- You did not receive any advance earned income credit (EIC) payments.
- If you were a nonresident alien at any time in 1994, your filing status is married filing jointly.
- If you are married filing jointly and either you or your spouse worked for more than one employer, the total wages of that person were not over $60,600.
- You do not itemize deductions, claim any adjustments to income or tax credits other than the earned income credit, or owe any

Table 1-3. **Other Situations When You Must File a 1994 Return**

If any of the four conditions listed below apply, you must file a return.

1. You owe any special taxes, such as:
   - Social security or Medicare tax on tips you did not report to your employer. (See Chapter 7.)
   - Uncollected social security, Medicare, or railroad retirement tax on tips you reported to your employer. (See Chapter 7.)
   - Uncollected social security, Medicare, or railroad retirement tax on your group-term life insurance. (See Chapter 31.)
   - Alternative minimum tax. (See Chapter 31.)
   - Tax on a qualified retirement plan, including an individual retirement arrangement (IRA). (See Chapter 18.)
   - Tax from recapture of investment credit or a low-income housing credit you claimed in a previous year. (See the instructions for Form 4255, *Recapture of Investment Credit* or Form 8611, *Recapture of Low-Income Housing Credit).*
   - Recapture tax on the disposition of a home purchased with a federally-subsidized mortgage. (See Chapter 16.)
   - Recapture of the qualified electric vehicle credit. (See Chapter 36.)
2. You received any advance earned income credit (EIC) payments from your employer. This amount should be shown in box 9 of your Form W-2. (See Chapter 35.)
3. You had net earnings from self-employment of at least $400. See (''Self-Employed Persons.'')
4. You had wages of $108.28 or more from a church or qualified church-controlled organization that is exempt from employer social security and Medicare taxes. (See Publication 533, *Self-Employment Tax*.)

taxes other than the amount from the Tax Table.

- If you claim the earned income credit, you meet the tests to file Form 1040EZ described in Chapter 35.

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

Form 1040A

If you do not qualify to use Form 1040EZ, you may be able to use Form 1040A.

You can use Form 1040A if:

- Your income is ***only*** from wages, salaries, tips, IRA distributions, pensions and annuities, taxable social security and railroad retirement benefits, taxable scholarship and fellowship grants, interest, dividends (except for Alaska Permanent Fund dividends), and unemployment compensation.
- Your taxable income is less than $50,000.
- Your only adjustment to income is the deduction for contributions to an IRA.
- You do not itemize your deductions.
- Your only taxes are the amount from the Tax Table, alternative minimum tax, and (if you received any) advance earned income credit (EIC) payments.
- Your only credits are:
  a) The credit for child and dependent care expenses (see Chapter 33).
  b) The credit for the elderly or the disabled (see Chapter 34).
  c) The earned income credit (see Chapter 35).

If you file Form 1040A, you can claim estimated tax payments for 1994 and the exclusion of interest from Series EE U.S. savings bonds issued after 1989.

If you do not meet all of the above requirements, you cannot use Form 1040A. For example, you may want to claim itemized deductions, which you cannot claim on Form 1040A. Check the list under *Form 1040* to see if you are required to use Form 1040.

Form 1040

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

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

You must use Form 1040 if:

- Your taxable income is $50,000 or more.
- You itemize your deductions.
- You received or paid accrued interest on securities transferred between interest payment dates.
- You received nontaxable dividends, capital gain distributions, or Alaska Permanent Fund dividends.
- You are required to complete Part III of Schedule B (Form 1040) because:
  - You were a grantor of, or transferor to, a foreign trust that existed during 1994, or
  - At any time during the year you had an interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country. ***Note***: If the combined value of the foreign account(s) is $10,000 or less during all of 1994, or if the account(s) was with a U.S. military banking facility operated by a U.S. financial institution, you may be able to use Form 1040A or Form 1040EZ.
- You had income that cannot be reported on Form 1040EZ or Form 1040A. This includes gain from the sale of your home or other property, barter income, alimony income, taxable refunds of state and local income taxes, and self-employment income (including farm income).
- You sold or exchanged capital assets or business property.
- You claim adjustments to gross income for moving expenses, the deduction for self-employment tax, payments to a Keogh or SEP plan, the penalty on early withdrawal of savings, alimony paid, certain required repayments of supplemental unemployment benefits, jury pay turned over to your employer, qualified performing artists' expenses, and other allowable adjustments to income.

Table 1-4. **Which Tax Forms Can I Use?**

Caution: You may have to file Form 1040 if you had a foreign account or were a grantor of, or transferor to, a foreign trust.	**1040EZ**	**1040A**	**1040**
Filing Status			
Single [1, 2]	•	•	•
Married filing jointly [2]	•	•	•
Any other [1]		•	•
Exemptions			
None	•	•	•
For you (and your spouse if married)	•	•	•
Any others		•	•
Income			
Total taxable income under$50,000	•	•	•
Total taxable income $50,000 or more			•
Wages andsalaries	•	•	•
Tips[3]	•	•	•
Scholarships and fellowships	•	•	•
Interest ($400 or less)[4]	•	•	•
Interest (over $400)[4]		•	•
Dividends[5]		•	•
Pensions, annuities, IRAs		•	•
Unemployment compensation		•	•
Taxable social security benefits		•	•
Taxable railroad retirement benefits		•	•
Self-employment income			•
Received as a partner in a partnership			•
Rents and royalties			•
Taxable state and local tax refunds			•
Capital gains			•
Sale of your home			•
Alimony			•
Any other			•
Adjustments to Income			
None	•	•	•
IRA contributions		•	•
Any other			•

- Your Form W–2 shows uncollected employee tax (social security and Medicare tax) on tips or group-term life insurance in box 13. See Chapter 7.
- You received $20 or more in tips in any one month, and you did not report all of these tips to your employer. See Chapter 7.
- You must pay tax on self-employment income. See Schedule SE (Form 1040), *Self-Employment Tax*.
- You have to repay an investment credit, a low-income housing credit, or a qualified electric vehicle credit you claimed in a previous year.
- You have to recapture tax on the disposition of a home purchased with a federally-subsidized mortgage. See Chapter 16.
- You have to pay tax on an excess golden parachute payment.
- You claim credits against your tax for any of the following:
  - Mortgage interest credit
  - Foreign tax credit
  - Any general business credit
  - Credit for prior year minimum tax
  - Credit for fuel from a nonconventional source
  - Credit for federal tax on fuels
  - Qualified electric vehicle credit
  - Regulated investment company credit
- You file any of the following:
  - Form 2119, *Sale of Your Home* (when filed in the year of sale)
  - Form 2555, *Foreign Earned Income*
  - Form 2555–EZ, *Foreign Earned Income Exclusion*
  - Form 4563, *Exclusion of Income for Bona Fide Residents of American Samoa*
  - Form 4970, *Tax on Accumulation Distribution of Trusts*
  - Form 4972, *Tax on Lump-Sum Distributions* (See Chapter 11.)
  - Form 5329, *Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts*
    Note: If you are filing only because you owe tax on an IRA or a qualified retirement plan, you only have to file Form 5329. (See Chapters 11 and 18.)
  - Form 8271, *Investor Reporting of Tax Shelter Registration Number*
  - Form 8814, *Parents' Election To Report Child's Interest and Dividends*

Table 1-4. *(Continued)*

	1040EZ	1040A	1040
Itemized Deductions			
None	•	•	•
Any itemized deductions			•
Other Taxes			
None	•	•	•
Advance earned income credit payments		•	•
Alternative minimum tax		•	•
Lump-sum distributions			•
Accumulation distribution of trusts			•
Self-employment tax			•
Uncollected social security and Medicare tax			•
Any other			•
Tax Credits			
None	•	•	•
Earned income credit[6]	•	•	•
Credit for child and dependent care expenses		•	•
Credit for the elderly or the disabled		•	•
Any other			•
Payments			
Federal income tax withheld	•	•	•
Excess social security and Medicare tax withheld		•	•
Excess railroad retirement tax withheld		•	•
Tax paid with filing extension request	•	•	•
Estimated tax payments		•	•
Any other			•

[1] You must file Form 1040 if you are a resident alien who was a nonresident at any time during 1994.
[2] You must file Form 1040A or Form 1040 if you (or your spouse, if married) were 65 or older or blind.
[3] You must file Form 1040 if you received tips of $20 or more in any month that you did not report to your employer, or your Form W-2 shows an amount for allocated tips in box 7.
[4] You must file Form 1040 if you received or paid accrued interest on securities transferred between interest payment dates, or you elect to report your child's interest on your return.
[5] You must file Form 1040 if you received nontaxable dividends, capital gain distributions, or Alaska Permanent Fund dividends, or you elect to report your child's dividends on your return.
[6] You must file Form 1040A or Form 1040 if you don't meet the tests to file Form 1040EZ described in Chapter 35.

When Do I Have To File?

April 17, 1995, is the due date for filing your 1994 income tax return if you use a calendar year. If you use a fiscal year (a year ending on the last day of any month except December, or a 52–53 week year), your income tax return is due by the 15th day of the 4th month after the close of your fiscal year.

When the due date for doing ***any*** act for tax purposes—filing a return, paying taxes, etc.—falls on a Saturday, Sunday, or legal holiday, you can do that act on the next business day.

Filing on time. Your return is filed on time if it is properly addressed and postmarked no later than the due date. The return must have sufficient postage. If you send a return by registered mail, the date of the registration is the postmark date. The registration is evidence that the return was delivered. If you send a return by certified mail and have your receipt postmarked by a postal employee, the date on the receipt is the postmark date. The postmarked certified mail receipt is evidence that the return was delivered.

Filing late. If you do not file your return by the due date, you may have to pay a failure-to-file penalty and interest. See *Penalties*, later.

Nonresident alien. If you are a nonresident alien and earn wages that are subject to U.S. income tax withholding, your 1994 U.S. income tax return (Form 1040NR) is due by:

- April 17, 1995, if you file on a calendar year basis, or
- The 15th day of the 4th month after the end of your fiscal year if you file on a fiscal year basis.

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

- June 15, 1995, if you file on a calendar year basis, or

- The 15th day of the 6th month after the end of your fiscal year, if you file on a fiscal year basis.

Get Publication 519, *U.S. Tax Guide for Aliens*, for more filing information.

Filing for a decedent. If you must file a final return as an executor, administrator, legal representative, or surviving spouse of a taxpayer who died during the year (a decedent), the income tax return is due by the 15th day of the 4th month after the end of the deceased taxpayer's normal tax year. See *Final Return for the Decedent* in Chapter 4. In most cases, for a 1994 return, this will be April 17, 1995.

Extensions

There are three types of extensions that may apply to your return. These are:

- Time to file,
- Time to file and pay, and
- Related to service in a combat zone.

Each extension is discussed separately.

Extensions of Time To File

If you are not able to file your return by the due date, you may be able to get an automatic 4–month extension of time to file your 1994 tax return. To get the automatic extension, you must file **Form 4868,** *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return.*

Example. If your return is due on April 17, 1995, you will have until August 15, 1995, to file.

Caution: You may not be eligible. If you want the IRS to figure your tax, you cannot use the automatic extension of time to file. If you are under a court order to file by the regular due date, you also cannot use the automatic extension of time to file.

When to file Form 4868. You must file Form 4868 by April 17, 1995. If you are filing a fiscal year return, file Form 4868 by the regular due date for your return. You can file Form 1040EZ, Form 1040A, or Form 1040 any time before the 4–month extension period ends.

An extension of time to file is not an extension of time to pay. You must make an accurate estimate of your tax for 1994. If you find you cannot pay the full amount due with Form 4868, you can still get the extension. You will owe interest on the unpaid amount.

You also may be charged a penalty for paying the tax late unless you have reasonable cause for not paying your tax when due. See *Penalties*, later.

Interest and penalties are assessed (charged) from the original due date of the return, which, for most taxpayers, is April 17, 1995.

When you file your return. Enter any payment you made with Form 4868 on line 57, Form 1040. If you file Form 1040EZ or Form 1040A, include in your total payments on line 8 of Form 1040EZ or line 28d of Form 1040A the amount paid with Form 4868. Also write ''Form 4868'' and the amount paid in the space to the left of line 8 or line 28d.

Extensions beyond the automatic 4–month extension. If you qualify for the 4–month extension and you later find that you are not able to file within the 4–month extension period, you may be able to get 2 more months to file, for a total of 6 months.

You can apply for an extension beyond the 4–month extension either by a letter to the IRS or by filing **Form 2688**, *Application for Additional Extension of Time To File U.S. Individual Income Tax Return*. You should request the extension early so that, if refused, you still will be able to file on time. Except in cases of undue hardship, Form 2688 or a request by letter will not be accepted until you have first used Form 4868 to get an automatic 4–month extension. Form 2688 or your letter will not be considered if you file it after the extended due date.

To get an extension beyond the automatic 4–month extension, you must give all the following information:

- The reason for requesting the extension.
- The tax year to which the extension applies.
- The length of time needed for the extension.
- Whether another extension of time to file has already been requested for this tax year.

You may sign the request for this extension, or it may be signed by your attorney, CPA, enrolled agent, or a person with a power of attorney. If you are unable to sign the request because of illness or for another good reason, a person in close personal or business relationship to you can sign for you, stating why you could not sign the request.

If your application for this extension is approved, you will be notified by the IRS. Attach the notice to your return when you file it.

If an extension is granted and the IRS later determines that the statements made on your request for this extension are false and misleading and an extension would not have been granted at the time based on the true facts, the extension is null and void. You will have to pay the failure-to-file penalty (discussed later).

If your application for this extension is not approved, you must file your return by the extended due date of the automatic extension. You may be allowed to file within 10 days of the date of the notice you get from the IRS if the end of the 10–day period is later than the due date. The notice will tell you if the 10–day grace period is granted.

No further extensions. An extension of more than 6 months will not be granted if you are in the United States. However, if you are outside the United States and meet certain tests, you may be granted a longer extension. See *When To File* in Publication 54 for more information.

Extensions of Time To File and Pay

You are allowed an automatic 2–month extension (until June 15, 1995, if you use a calendar year) to file your 1994 return and pay any federal income tax that is due if you are a U.S. citizen or resident and on the regular due date of your return:

- You are living outside of the United States and Puerto Rico, and your main place of business or post of duty is outside the United States and Puerto Rico, ***or***
- You are in military or naval service on duty outside the United States and Puerto Rico.

However, if you pay the tax due after the original due date, interest will be charged from the original due date until the date the tax is paid.

See *When To File* in Publication 54 for more information.

Note. If you served in a combat zone, see *Extensions Related to Combat Zone,* later, for special rules that apply to you.

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

How to receive the extension. To use this special automatic extension, you must attach a statement to your return explaining what situation qualified you for the extension.

Extensions beyond the automatic 2–month extension. If you are unable to file your return within the automatic 2–month extension period, you may be able to get an additional 2–month extension of time to file your return, for a total of 4 months. You must file Form 4868 by the end of the automatic extension period (usually June 15, 1995) to get this additional 2–month extension.

This additional 2–month extension of time to file is ***not*** an extension of time to pay. You must make an accurate estimate of your tax for 1994. If you cannot pay the full amount due with Form 4868 you can still get the extension. You will owe interest on the unpaid amount and may be charged a penalty for paying the tax late. See *Penalties,* later.

Extensions beyond 4 months. If you are still unable to file your return within the 4–month extension, you may be able to get an extension for 2 more months, for a total of 6 months. See *Extensions beyond the automatic 4–month extension*, earlier.

No further extensions. An extension of more than 6 months will generally not be

Table 1-5. **When to File Your 1994 Return** (For U.S. citizens and residents who file returns on a calendar year)

	For Most Taxpayers	For Certain Taxpayers Outside the U.S.
No extension requested	April 17, 1995	June 15, 1995
Form 4868 filed (1st extension)	August 15, 1995	August 15, 1995
Form 2688 filed after filing Form 4868 (2nd extension)	October 16, 1995	October 16, 1995

granted. However, if you are outside the United States and meet certain tests, you may be granted a longer extension. See *Filing Requirements* in Publication 54 for more information.

Extensions Related to Combat Zone

If you served in the Armed Forces in the Persian Gulf Area combat zone, the deadline for filing your tax return, paying any tax that you may owe, and filing a claim for refund is automatically extended. The deadline is also extended if you served in the combat zone in support of the Armed Forces, even though you were not a member of those forces. This category includes Red Cross personnel, accredited correspondents, and civilians under the direction of the Armed Forces in support of the Armed Forces.

For purposes of the deadline extension, the Persian Gulf Area became a combat zone on August 2, 1990. See Publication 945, *Tax Information for Those Affected by Operation Desert Storm*, for more information on these and other benefits.

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

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

In addition to the 180 days, your deadline is also extended by the number of days you had left to file when you entered the Persian Gulf Area combat zone. For example, you have 3½ months (January 1 – April 17, 1995) to file your 1994 tax return. Any days of this 3½–month period that are left when you entered the combat zone (or the entire 3½ months if you entered the combat zone before January 1, 1995) are added to the 180 days to find the end of your time extension for filing your 1994 return.

How Do I Prepare the Forms?

This section explains how to get ready to fill in your tax return, including when to report your income and expenses. It also explains how to complete certain sections of the form. You may find *Table 1–6* helpful when you prepare your return.

In most cases, the IRS will mail you either Form 1040, Form 1040A, or Form 1040EZ with related instructions, based on what you filed last year. Before you fill in your return, look over the forms to see if you need additional forms or schedules.

If you have not received a tax return package in the mail, or if you need other forms, you can order them. You can get most forms and publications you need from the IRS Forms Distribution Center for your state by using the order blank at the end of this publication or by calling the toll-free number 1–800–TAX–FORM (1–800–829–3676).

Form W–2. If you are an employee, you should receive Form W–2 from your employer. You will need the information from this form before you prepare your return.

If you do not receive Form W–2 by January 31, contact your employer. If you still do not get the form by February 15, the IRS can help you by requesting the form from your employer.

Form 1099. If you received certain types of income, you may get a form in the Form 1099 series. For example, if you received taxable interest of $10 or more, the payer generally must give you a Form 1099–INT. If you have not received it by January 31, contact the payer. If you still do not get the form by February 15, call the IRS for help.

Substitute tax forms. You cannot use your own version of a tax form unless it meets the requirements explained in Publication 1167, *Substitute Printed, Computer-Prepared, and Computer-Generated Tax Forms and Schedules*.

Tax help on videotape. A videotape of tax return instructions is available in either English or Spanish at participating libraries.

Table 1-6. **6 Steps for Preparing Your Return**

1—Get all of your records together for income and expenses.
2—Get all forms, schedules, and publications that you need.
3—Fill in your return.
4—Check your return to make sure it is correct.
5—Sign and date your return.
6—Attach all required forms and schedules.

When Do I Report My Income and Expenses?

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

Accounting Periods

Most individual tax returns cover a ***calendar year***—the 12 months from January 1 through December 31. This is one accounting period. Another accounting period is the ***fiscal year***. A regular fiscal year is a 12–month period that ends on the last day of any month except December. A 52–53 week fiscal year varies from 52 to 53 weeks and ends on a particular day of the week.

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

Changing your accounting period. To change your accounting period, you generally must get permission from the IRS. If you want to change your accounting period, get **Form 1128,** *Application To Adopt, Change, or Retain a Tax Year.* Form 1128 must be filed on or before the 15th day of the second calendar month of the requested accounting period. The new period cannot be used until you receive approval from IRS. A fee is charged to request a change in your accounting period.

Example. Last year, you were an employee and filed your income tax return on a calendar year basis. On July 1 this year you quit your job and open your own repair shop. For business reasons, you want to

file your income tax return on a fiscal year basis from July 1 to June 30. To change your accounting period, complete and submit Form 1128 by August 15.

Additional information. For more information on accounting periods, see Publication 538, *Accounting Periods and Methods*.

Accounting Methods

Your accounting method is the way you account for your income and deductions. Most taxpayers use either the cash method or an accrual method. You choose a method when you first file a return.

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

Constructive receipt. Income is constructively received when it is credited to your account, or is set apart in any way that makes it available to you. You do not need to have physical possession of it. For example, dividends or interest credited to your bank account on December 31, 1994, are taxable income to you in 1994 if you could have withdrawn them in 1994 (even if the amount is not entered in your passbook or withdrawn until 1995).

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

Brokerage and other accounts. Profits from a brokerage account, or similar account, are fully taxable in the year you earn them. This is true even if:

1) You do not withdraw the earnings,
2) The credit balance in the account may be reduced or eliminated by losses in later years, or
3) Current profits are used to reduce or eliminate a debit balance from previous years.

Debts paid for you. If another person cancels or pays your debts (but not as a gift or loan), you have constructively received the amount and generally must include it in your gross income for the year. See *Canceled debt* in Chapter 13 if you need more information.

Payment to third party. If a third party is paid income from property you own, you have constructively received the income. It structively received by you in the year the agent receives it. If you indicate in a contract that your income is to be paid to another person, you must include the amount in your gross income when the other person receives it.

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

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

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

Accrual method. If you use an accrual method, you report income when you earn it, whether or not you receive it. You deduct your expenses when you incur them, rather than when you pay them.

Income paid in advance. Prepaid income is generally included in gross income in the year you receive it. Your method of accounting does not matter as long as the income is available to you. Prepaid income includes rents or interest you receive in advance and compensation for services you will perform later.

Changing your accounting method. Once you have chosen your accounting method, you ordinarily cannot change it without the permission of the IRS. However, you can use a different method for each business you have.

Example. You work for a salary and use the cash method to report that income on your tax return. You open a gift shop and continue to work for a salary. Even though you use the cash method for your salary, you can use an accrual method for reporting income from your gift shop.

How to change. If you want to change your accounting method, get Form 3115, *Application for Change in Accounting Method*. In general, Form 3115 must be filed within 180 days after the beginning of the year of change. A fee is charged to request a change in your accounting method.

Additional information. For more information on accounting methods, get Publication 538.

Address Label

After you have completed your return, peel have someone prepare your return, give that person your label to use.

If you file a Form 1040PC, place the label over the name and address area on Form 1040PC. If you file electronically, use your label on Form 8453. (More information on electronic filing and Form 1040PC is found later in this chapter.)

The coding on the label is used by the IRS in processing your return. The label helps to correctly identify your account. It also saves processing costs and speeds up processing so that refunds can be issued sooner.

Correcting the label. Make necessary name and address changes on the label. If you have an apartment number that is not shown on the label, please write it in. If you and your spouse file a joint return and maintain separate homes, choose one address to enter on your return. If the label is for a joint return and the social security numbers are not listed in the same order as the first names, change the numbers to show the correct order. If your social security number is not correct, or if you changed your name, see the discussion under *Social Security Number*, later.

No label. If you did not receive a tax return package with a label, print or type your name, address, and social security number in the spaces provided at the top of Form 1040 or Form 1040A. If you are married filing a separate return, do not enter your spouse's name in the space at the top. Instead, enter his or her name in the space provided on line 3.

If you file Form 1040EZ and you do not have a label, print (do not type) this information in the spaces provided.

P.O. box. If your post office does not deliver mail to your street address and you have a P.O. box, write your P.O. box number on the line for your present home address instead of your street address.

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

1) City,
2) Province or state,
3) Foreign postal code, and
4) Name of foreign country.

Do not abbreviate the name of the country.

Social Security Number

You must show your social security number (SSN) on your return. If the number shown on the address label on the tax return package you received in the mail is

If you are married and you did not receive a tax return package with a label, enter the social security numbers for both you and your spouse, whether you file jointly or separately.

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

Dependent's social security number. If you claim an exemption for a dependent who is at least ***1 year old*** by December 31, 1994, you must list the dependent's SSN on Form 1040 or Form 1040A. The social security number requirement applies to ***all dependents*** (not just your children) claimed on the tax return who are at least 1 year old.

No social security number. If you or your dependent who is at least 1 year old does not have an SSN, file a **Form SS–5** with your local SSA office. It usually takes about 2 weeks to get an SSN.

If you are a U.S. citizen, you must show proof of age, identity, and citizenship with your Form SS–5. If you are 18 or older, you must appear in person.

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

If you don't provide a required SSN or if you provide an incorrect SSN, it will take longer to issue any refund shown on your return.

Nonresident alien dependents. If you claim dependents who are residents of Mexico or Canada, they must have SSNs. You can apply for an SSN with either the Social Security Administration or a U.S. consulate or embassy. See *Social Security Number for Dependents* in Chapter 3 for more information.

Nonresident alien spouse. If your spouse is a nonresident alien and you file a joint return, your spouse must get an SSN. If your spouse does not receive an SSN by the time you are ready to file, follow the instructions explained earlier under *No social security number.*

If you file a separate return and your spouse does not have an SSN or any income, enter ''NRA'' in the space provided for your spouse's number.

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

SSN on correspondence. If you write to the IRS about your tax account, be sure to include your SSN in your correspondence. Because your SSN is used to identify your account, this helps the IRS respond to your correspondence promptly.

Presidential Election Campaign Fund

This fund was set up to help pay for presidential election campaigns. You may have $3 of your tax liability go to this fund by checking the *Yes* box on Form 1040, Form 1040A, or Form 1040EZ. If you are filing a joint return, your spouse may also have $3 go to the fund. If you check *Yes*, it will not change the tax you pay or the refund you will receive.

Rounding Off Dollars

You may round off cents to whole dollars on your return and schedules. If you do round to whole dollars, you must round all amounts. To round, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar. For example, $1.39 becomes $1 and $2.50 becomes $3.

If you have to add two or more amounts to figure the amount to enter on a line, include cents when adding the amounts and round off only the total.

Example. You receive two W–2 forms: one showing wages of $5,000.55 and one showing wages of $18,500.73. On Form 1040, line 7, you would enter $23,501 ($5,000.55 + $18,500.73 = $23,501.28) instead of $23,502 ($5,001 + $18,501).

Additional Schedules

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

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

Form 1040A. If you file Form 1040A, you must complete and attach any of the following four schedules that apply.

- Schedule 1 to report your interest income or dividend income if either amount is more than $400, you claim the exclusion of interest from Series EE U.S. savings bonds, you received interest or dividends as a nominee, you received interest on a seller-financed mortgage from a buyer who uses the property as a main home, or you received a Form 1099–INT for tax-exempt interest.
- Schedule 2 to take the credit for child and dependent care expenses.
- Schedule 3 to take the credit for the elderly or the disabled.
- Schedule EIC to take the earned income credit.

Form 1040. If you file Form 1040, attach the necessary schedules or forms, such as:

- Schedule A to itemize your deductions.
- Schedule B to report over $400 in interest or dividends (including capital gain and nontaxable distributions), to answer the foreign accounts and foreign trusts questions, or if any of the following apply to you:
  - You claim the exclusion of interest from Series EE U.S. savings bonds,
  - You received interest or dividends as a nominee,
  - You received a Form 1099–INT for tax-exempt interest,
  - You received interest on a seller-financed mortgage from a buyer who uses the property as a main home,
  - You reduce your interest income for amortizable bond premium or for accrued interest on a bond bought between interest payment dates, or
  - You received a Form 1099–OID showing a larger amount of original issue discount than you are required to report as income.
- Schedule C or Schedule C–EZ to report profit or loss subject to self-employment tax from a business you operated or a profession you practiced as a sole proprietor, and to report wages and expenses you had as a statutory employee.
- Schedule D to report capital gains and losses.
- Schedule E to report income or loss from rental real estate, royalties, partnerships, estates, trusts, S corporations, and REMICs (residual interests).
- Schedule EIC to claim the earned income credit.
- Schedule F to report farm income and expenses.
- Schedule R to claim the credit for the elderly or the disabled.
- Schedule SE to figure self-employment tax.

Foreign financial accounts and foreign trusts. You must complete Part III of Schedule B (Form 1040) if:

1) You received more than $400 in either interest or dividends, or
2) You had a foreign account or were the grantor of, or transferor to, a foreign trust.

If you checked *Yes* to the question on line 11a, Part III of Schedule B, you must file Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts,* by June 30, 1995, with the Department of the Treasury at the address shown on the form. Form TD F 90–22.1 is not a tax return, so do not attach it to your Form 1040. Be sure to file your Form 1040 with the IRS. You can get Form TD F 90–22.1 by using the order blank at the end of this publication.

For more information, see the instructions for Part III of Schedule B (Form 1040).

Assembling your return. Attach all forms and schedules behind Form 1040 in

order of the ''Attachment Sequence Number'' shown in the upper right corner of the form or schedule. Attach all other statements or attachments at the end of your return, even if they relate to another form or schedule.

Form W–2. Form W–2, *Wage and Tax Statement,* is a statement from your employer of the wages and other compensation paid to you and the taxes withheld from your pay. You should have a Form W–2 from each employer. Be sure to attach the first copy or copy B of Form W–2 in the place indicated in the left margin of the front page of your return. Attach it only to the front page of your return, not to any attachments. For more information, see *Form W–2* in Chapter 5.

Signatures

You must sign and date your return. If you file a joint return, both you and your spouse must sign the return, even if only one of you had income.

Enter your occupation in the space provided in the signature section. If you file a joint return, enter both your occupation and your spouse's occupation.

If you prepare your own return, leave the space under your signature blank. If another person prepares your return and does not charge you, that person should not sign your return.

Paid preparer. Generally, anyone you pay to prepare, assist in preparing, or review your tax return must sign it and fill in the other blanks in the paid preparer's area of your return. Paid preparers of Form 1040EZ must sign the return and provide all other required information at the bottom of the form below the area for the taxpayer's signature.

If the preparer is self-employed (that is, not employed by any person or business to prepare the return), he or she should check the self-employed box in the *Paid Preparer's Use Only* space on Form 1040 or Form 1040A.

Signature stamps and labels are not acceptable. The preparer must give you a copy of your return in addition to the copy filed with the IRS.

If you have questions about whether a preparer must sign your return, please contact any IRS office.

Someone else can sign for you. You can appoint an agent to sign your return if you are:

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

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

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

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

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

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

Refunds

When you complete your return, you will determine if you paid more income tax than you owed. If so, you can get a refund of the amount you overpaid or, if you file Form 1040 or Form 1040A, you can choose to apply all or part of the overpayment to your next year's (1995) estimated tax.

If you have a 1994 overpayment applied to your 1995 estimated tax, you cannot have any of it refunded to you after the due date of your 1994 return. You also cannot use that overpayment in any other way after that date.

If you filed Form 8841, *Deferral of Additional 1993 Taxes,* so you could pay part of your 1993 tax in installments, you can choose to apply part or all of your overpayment to the installment due on April 17, 1995. See *Paying Deferred 1993 Taxes,* later.

Follow the instructions in your tax forms package to complete the entries to claim your refund and/or to apply your overpayment to your 1995 estimated tax.

Note. You cannot have your overpayment applied to your 1995 estimated tax if you file Form 1040EZ.

Overpayment less than one dollar. If your overpayment is less than one dollar, you will not receive a refund unless you request it in writing.

Cashing your refund check. U.S. Government checks must be cashed within 12 months of the date they are issued. Checks not cashed within 12 months will be canceled and the proceeds returned to the IRS. Cash your tax refund check soon after you receive it.

If your check has been canceled, you can apply to the IRS to have it reissued.

Amount You Owe

When you complete your return, you will determine if you have paid the full amount of tax that you owe. If you owe additional tax, you should pay it with your return. If you owe less than one dollar, you need not pay it.

If the IRS figures your tax for you, you will receive a bill for any tax that is due. You should pay this bill within 30 days (or by the due date of your return, if later). See *Tax Figured by IRS* in Chapter 31.

If you do not pay your tax when due, you may have to pay a failure-to-pay penalty. See *Penalties,* later. For more information about your balance due, see Publication 594, *Understanding the Collection Process*.

Interest

You will have to pay interest on any tax you owe that is not paid by the due date of your return. Interest is charged even if you get an extension of time for filing.

Note. If you choose to have the IRS figure your tax for you, interest cannot start earlier than the 31st day after the IRS sends you a bill. For information on this choice, see *Tax Figured by IRS* in Chapter 31.

Interest on penalties. Interest is charged on the failure-to-file penalty, the accuracy-related penalty, and the fraud penalty from the due date of the return (including extensions) to the date of payment. Interest on other penalties starts on the date of notice and demand, but is not charged on penalties paid within 10 days from the date of the notice.

Interest due to IRS error or delay. All or part of any interest you were charged for a deficiency or payment can be forgiven if the interest is due to an error or delay by an officer or employee of the IRS in performing a ministerial act. This is a procedural or mechanical act that occurs during the processing of a taxpayer's case.

The interest can be forgiven only if you are not responsible in any important way for the error or delay and the IRS has notified you in writing of the deficiency or payment. For more information, get Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund.*

How to Pay

If you pay by check or money order, make it out to *Internal Revenue Service.* Please show your correct name, address, social security number, daytime telephone number, and tax year and form number on the front of your check or money order.

For example, if you file Form 1040 for 1994 and you owe additional tax, show your name and address, social security number, daytime telephone number, and *1994 Form 1040* on your check or money order. If you file an amended return (Form 1040X) for 1993 and you owe tax, show your name and address, social security number, daytime telephone number, and *1993 Form 1040X* on the front of your check or money order.

Enclose your payment with your return, but do not attach it to the form.

Do not mail cash with your return. If you pay cash at an IRS office, keep the receipt as part of your records.

Do not include any estimated tax payment in your check or money order that is payment for your 1994 income tax return. Mail the estimated tax payment separately to the address shown in the Form 1040–ES instructions. The address for mailing estimated tax payments is different from the address for sending your tax return.

If your check or money order is not honored by your bank (or other financial institution) and IRS does not receive the funds, you still owe the tax.

Installment Agreement

If you cannot pay the full amount due with your return, you may ask to make monthly installment payments. However, you will be charged interest and a late payment penalty on the tax not paid by April 17, 1995, even if your request to pay in installments is granted. To limit the interest and penalty charges, pay as much of the tax as possible with your return. But before requesting an installment agreement, you should consider other less costly alternatives, such as a bank loan.

To ask for an installment agreement, use **Form 9465,** *Installment Agreement Request.* You can get Form 9465 by calling 1–800–TAX–FORM (1–800–829–3676). You should receive a response to your request for installments within 30 days. But if you file your return after March 31, it may take longer for a reply.

Paying Deferred 1993 Taxes

If you filed **Form 8841,** *Deferral of Additional 1993 Taxes,* so you could pay part of your 1993 tax in installments, you must pay the second installment by April 17, 1995.

You can pay it in either of two ways:

1) **Apply part or all of any overpayment from your 1994 return.** To do this, write ''1993 OBRA Installment'' and the dollar amount you want applied on the dotted line to the left of line 62 of Form 1040. Do not reduce the amount on line 62 by the amount applied. The amount you apply cannot be more than the total amount you paid for 1994 by April 17, 1995, by withholding, estimated tax payments, payments with a request for an extension of time to file, or payments with the return.

   If the amount you apply is less than the installment due, you may send a separate check for the balance, as explained in (2), next. Do not include that check with your return.

   Caution: If you choose to pay by applying an overpayment, the IRS will first apply your overpayment to any other tax you owe (including any other 1993 tax).

2) **Send the IRS a separate check or money order** payable to the Internal Revenue Service. Label your payment ''1993 OBRA Installment'' and write your social security number on it.

   If you have the payment voucher and return envelope that were included in a reminder notice sent to you in early January 1995, mail your payment in that envelope with the voucher. Do not send your payment with your tax return. If you don't have the payment voucher and envelope, send your payment by itself to the IRS Service Center for the area where you live. A list of Service Center addresses is in your tax forms package.

   If you choose this way of paying, the IRS will apply your payment to the second installment of your deferred 1993 taxes, even if you owe other taxes or debts.

You do not have to pay interest on this deferred 1993 tax if you pay it on time. If you do not pay it on time, the entire unpaid tax will be due immediately upon notice and demand from the IRS.

You cannot defer paying any part of your 1994 tax, except as described earlier under *Installment Agreement.*

Gift To Reduce the Public Debt

You can make a contribution (gift) to reduce the public debt. If you wish to do so, enclose a ***separate*** check in the envelope with your income tax return, and make it payable to *Bureau of the Public Debt.* You can deduct this gift as a charitable contribution on next year's tax return if you itemize your deductions on Schedule A (Form 1040). Please do not add it to any tax you owe. If you owe tax, include a separate check for the tax payable to *Internal Revenue Service.*

Where Do I File?

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

Mailing Your Return

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

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

Electronic Filing

You may be able to have your return filed electronically instead of on a paper form. Over 14 million taxpayers filed electronically last year. Most individuals can file electronically, whether their return shows a balance due or a refund.

Tax returns can be electronically filed through tax preparers, through a company that will transmit your return to the IRS, with your personal computer using on-line service providers, and through many IRS offices offering taxpayer assistance. Check your telephone book for tax preparers and other companies offering this service.

For more information on electronic filing, a recorded message is available on the Tele-Tax system. The Tele-Tax number for your area is listed in your tax forms package.

Advantages. Electronic filing can shorten the time for processing returns to within 3 weeks. Electronic filing uses automation to replace most of the manual steps needed to process paper returns. As a result, processing for electronic returns is faster and more accurate. However, errors on the return or problems with its transmission can delay processing.

If you are due a refund, you may be able to have it deposited directly into your savings or checking account.

As with a paper return, you are responsible for making sure your return contains accurate information and is filed on time. Electronic filing does not affect your chances of an IRS examination of your return.

Balance due. If you have a balance due with your return, you must make a full payment of any tax due on or before April 17, 1995 to avoid penalties and interest. Mail your payment with either:

1) The **Form 1040–V,** *Payment Voucher,* provided by your preparer,
2) The payment voucher included in some tax forms packages, or
3) The tear-off stub from the appropriate payment reminder notice.

Refunds. If you file a complete and accurate return, your refund will be issued within 21 days. However, some refunds may be temporarily delayed as a result of compliance checks. These checks make sure that

Table 1-7. **Benefits of Filing Electronically**

Accuracy	• Computer program quickly catches mistakes before they become problems
Acknowledgement	• IRS advises you that your return has been accepted for processing
File Now, Pay Later	• File early and pay the balance due by April 17
Refunds	• Normally issued within 3 weeks; electronic filing allows you to choose the safety and convenience of direct deposit
Simultaneous Federal/State Filing	• File both federal and state returns with the IRS at the same time (see *Where Do I File?* for a list of participating states)

returns are filed accurately and that the refund is correctly determined.

You can have a refund check mailed to you, or you can elect to have your refund deposited directly to your savings or checking account.

Direct deposit. To choose direct deposit of your refund, complete Part II of Form 8453. Your signature in Part III gives IRS your authorization to deposit the refund.

Errors in direct deposit information will cause delays in processing your refund. Review the information carefully. Make sure the ''routing transit number'' (RTN) of your financial institution contains 9 digits. Your return will be rejected if there are fewer than 9 digits. If this occurs, your electronic filer will be notified.

Your request for direct deposit may not be honored if one of the following occurs:

- You owe federal tax, a student loan, child support, or debts to other federal agencies.
- The IRS has certain special processing needs. (IRS will notify you and a paper check will be sent to you.)

Once an electronic return has been accepted by IRS, you cannot cancel the direct deposit election nor can you change your RTN or bank account number.

Offset against debts. As with a paper return, you will not get all of your refund if you owe federal tax, a student loan, child support, or other debts to federal agencies. Instead, part or all of your refund will be used to pay the debt.

Federal/State filing. Electronic filing is available to preparers in all 50 states. Also, in some states, you can file an electronic state return simultaneously with your federal return.

Federal/State electronic filing is offered statewide in Colorado, Connecticut, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Michigan, Mississippi, Missouri, New Mexico, New York, North Carolina, Oklahoma, Oregon, South Carolina, Utah, West Virginia, and Wisconsin. It is also offered in limited programs in Arkansas, Delaware, Georgia, Montana, Nebraska, New Jersey, Rhode Island, and Virginia. In these states, check with your preparer to see whether you can participate in this program.

Form 8453. Your preparer will ask you to sign Form 8453, *U.S. Individual Income Tax Declaration for Electronic Filing.* Both spouses must sign if a joint return is being filed. Your preparer will file the form with the IRS. Your signature on the declaration form:

- Certifies that the information on Form 8453 is correct and corresponds to the information on your return,
- Authorizes your preparer to file your return electronically,
- Authorizes the IRS, if you elect direct deposit, to deposit your refund directly into your checking or savings account, and
- Authorizes the IRS to disclose to the preparer when your refund was sent and the reasons for any delay in the processing of your return or refund.

Your preparer will give you the required preparer-signed copy of your return, including a copy of the completed Form 8453. This material is for your records. Do not mail this copy to the IRS; if you do, your refund may be delayed.

Refund inquiries. The IRS will notify your preparer of the date your electronic return was accepted for processing. If you do not receive your refund within 3 weeks after the return was accepted by IRS, you can call Tele-Tax Automated Refund Information. The Tele-Tax number for your area is listed in your tax forms package. Before you call Tele-Tax, please have the following information from your return available:

- The first social security number shown on the return,
- Your filing status, and
- The exact amount of your refund.

If the Tele-Tax recording tells you the date your refund was issued, you should receive the refund within a week of that date. If you do not receive the refund by the end of that week, contact your IRS office. See the telephone numbers listed under *Call the IRS With Your Tax Question* in your tax forms package.

If Tele-Tax has no information on your return, contact your preparer for the date IRS accepted your return. If your return was accepted more than 3 weeks ago, contact your local IRS office. Explain that you filed your return electronically and that Tele-Tax has no information on it. Also, provide the first social security number shown on your return and the date the IRS accepted your return.

Computerized Returns

Almost anyone who files a tax return can now file a Form 1040PC return. You prepare Form 1040PC on a personal computer.

The computer prints the return in a three-column ''answer sheet'' format. It prints line numbers and dollar amounts (and/or supporting explanations if necessary) only for lines on which you made an entry. Supporting tax forms and schedules are also printed in this format. As a result, an 11-page conventional return requiring forms and schedules can be printed as a two-page Form 1040PC return.

If you need to list more items than fit on a regular tax return (eight dependents, for example), you can list them all on the Form 1040PC and print them in order, without the need for attaching an additional statement.

If you file Form 1040PC and are getting a refund, you can have the refund deposited directly to your checking or savings account.

Form 1040PC tax preparation software is checked and accepted by the IRS. It can be processed faster and more accurately than the regular tax return. Software packages are available at many computer software stores. They are not available from the IRS. For more information, call the Tele-Tax number for your area listed in your tax forms package.

What Happens After I File?

After you send your return to IRS, you may have some questions. This section discusses some concerns that you may have about recordkeeping, your refund, and errors on your return.

What Records Should I Keep?

You must keep records so that you can prepare a complete and accurate income tax return. The law does not require any special form of records. However, you

should keep all receipts, canceled checks or other proof of payment, and documentation to support any deductions or credits you claim.

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

How long to keep records. You must keep your records for as long as they are important for any Internal Revenue law.

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

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

In property transactions, the basis of new or replacement property may depend on the basis of the old property. Keep the records of transactions relating to the basis of property for as long as they are important in figuring the basis of the original or replacement property. See Chapter 14 for information on determining basis.

Copies of returns. You should keep copies of tax returns you have filed and the tax forms package as part of your records. They may be helpful in amending filed returns or preparing future ones.

If you need a copy of a prior year tax return, you can obtain it from the IRS. Use **Form 4506.** There is a $14 charge for a copy of a return, which must be paid with Form 4506.

Transcript. You can also use Form 4506 to request a transcript of your return filed this year or during the 2 preceding years. It will show most lines from your original return, including accompanying forms and schedules. There is no charge for a transcript that you request before October 1, 1995.

Tax account information. If you need a statement of your tax account showing any later changes that you or the IRS made to the original return, you will need to request tax account information.

Do not use Form 4506 for tax account information. Instead, contact your local IRS office. You should have your name, social security number or employer identification number (if applicable), tax period, and form number available. You will receive the following information **free** of charge:

- Type of return filed
- Filing status
- Federal income tax withheld
- Tax shown on return
- Adjusted gross income
- Taxable income
- Self-employment tax
- Number of exemptions
- Amount of refund
- Amount of earned income credit
- Whether you claimed a mortgage interest deduction or real estate tax deduction.

For more information on recordkeeping, get Publication 552, *Recordkeeping for Individuals.*

Interest on Refunds

If you are due a refund, you may also be entitled to receive interest on your overpayment. The interest rates are adjusted quarterly.

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

Accepting a refund check does not change your right to claim an additional refund and interest. File your claim within the applicable period of time. See *Amended Returns and Claims for Refund,* later. If you do not accept a refund check, no more interest will be paid on the amount of the overpayment included in the check.

Interest on erroneous refund. All or part of any interest you were charged on an erroneous refund generally will be forgiven. Any interest charged for the period before demand for repayment was made will be forgiven unless:

1) You, or a person related to you, caused the erroneous refund in any way, or
2) The refund is more than $50,000.

For example, if you claimed a refund of $100 on your return, but the IRS made an error and sent you $1,000, you would not be charged interest for the time you held the $900 difference. You must, however, repay the $900 when requested by the IRS.

Offset Against Debts

If you are due a refund but have not paid certain obligations, all or part of your overpayment of tax may be used to pay all or part of the past-due amount. This includes past-due income tax, other federal debts (such as student loans), and child and spousal support payments. The IRS will notify you if the refund you claimed has been offset against your debts.

Joint return and injured spouse. When a joint return is filed and only one spouse is obligated to pay past-due child and spousal support or a federal debt, the spouse who is not obligated for the debt can be considered an ***injured spouse.*** An injured spouse can obtain a refund for his or her share of the overpayment that would otherwise be used to pay the past-due amount.

To be considered an injured spouse, you must:

1) File a joint return,
2) Have received income (such as wages, interest, etc.),
3) Have made tax payments (such as federal income tax withheld from wages or estimated tax payments),
4) Report the income and tax payments on the joint return, and
5) Have an overpayment, all or part of which may be applied against the past-due amount.

If you are an injured spouse, you can obtain your portion of the joint refund by completing **Form 8379,** *Injured Spouse Claim and Allocation.* Follow the instructions on the form.

Note. Refunds that involve community property states must be divided according to local law. If you live in a community property state in which all community property is subject to the debts of either spouse, your entire refund on a joint return is subject to offset. You do not qualify for injured spouse status.

Change of Address

If you move, always notify in writing the Internal Revenue Service Center where you filed your last return, or the Chief, Taxpayer Service Division, in your local IRS district office. You can use **Form 8822,** *Change of Address,* to notify us of your new address. If you move after filing your return and you are expecting a refund, also notify the post office servicing your old address. This will help to forward your check to your new address.

Be sure to include your social security number (and the name and social security number of your spouse, if you filed a joint return) in any correspondence with the IRS.

Past-Due Refund

If you do not get your refund within 8 weeks after filing your return, call Tele-Tax. For details on how to use this telephone service, see *What Is Tele-Tax?* in your tax forms package. Please wait 8 weeks after filing your 1994 tax return before using this service. However, if you filed your return

electronically, see *Where Do I File?*, earlier, for information about refund inquiries when you file an electronic return.

What If I Made a Mistake?

If there is an error on your tax return, you may have to pay one or more penalties. If you discover an error, you can file an amended return or claim for refund.

Penalties

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

Civil Penalties

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

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

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

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

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

Paying tax late. You will have to pay a ***failure-to-pay*** penalty of ½ of 1% of your unpaid taxes for each month, or part of a month, after the due date that the tax is not paid. This penalty does not apply during the extension period available by filing Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return,* if you paid at least 90% of your actual tax liability before the original due date of your return through withholding on wages, estimated tax payments, or a payment sent in with Form 4868.

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

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

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

Accuracy-related penalty. You may have to pay an accuracy-related penalty if:

1) There is any underpayment of tax on your return due either to ''negligence'' or to ''disregard'' of rules or regulations, or
2) You substantially understate your income tax.

The penalty is equal to 20% of the underpayment. Each term is discussed later.

The penalty will not be figured on any part of an underpayment on which a fraud penalty (discussed later) is charged.

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

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

The penalty is based on the part of the underpayment due to negligence or disregard of rules or regulations, not on the entire underpayment on the return.

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

Substantial understatement of income tax. You understate the tax if the tax shown on your return is less than the correct tax. You substantially understate your tax if the understatement is more than the larger of 10% of the correct tax or $5,000. However, the penalty is reduced to the extent that there is:

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

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

Disclosure statement. The understatement may also be reduced if you have adequately disclosed the relevant facts about your tax treatment of an item. To make this disclosure, use **Form 8275,** *Disclosure Statement.* You must also have a reasonable basis for treating the item the way you did.

In cases of substantial understatement only, items that meet the requirements of Revenue Procedure 94-36 (or later update) are considered adequately disclosed on your return without filing Form 8275.

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

Reasonable cause. You will not have to pay a penalty if you show a good reason (reasonable cause) for giving special tax treatment to a particular item.

Penalty for frivolous return. You may have to pay a penalty of $500 if you file a frivolous return. A frivolous return is one that does not include enough information to figure the correct tax or that contains information clearly showing that the tax you reported is substantially incorrect.

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

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

The penalty must be paid in full upon notice and demand from IRS even if you protest the penalty.

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

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

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

For example, if you have a bank account that earns interest, you must give your social security number to the bank. The number must be shown on the Form 1099–INT or other statement the bank sends you. If you do not give the bank your social security number, you will be subject

to the $50 penalty. (You also may be subject to "backup" withholding of income tax. See Chapter 5.)

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

Penalty for failure to furnish tax shelter registration number. A person who sells (or otherwise transfers) to you an interest in a tax shelter must give you the tax shelter registration number or be subject to a $100 penalty. If you claim any deduction, credit, or other tax benefit because of the tax shelter, you must attach **Form 8271,** *Investor Reporting of Tax Shelter Registration Number,* to your return to report this number. You will have to pay a penalty of $250 for each failure to report a tax shelter registration number on your return. The penalty can be excused if you have a reasonable cause for not reporting the number.

Criminal Penalties

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

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

Amended Returns and Claims for Refund

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

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

If you need a copy of your return, see *Copies of returns* under *What Records Should I Keep?*, earlier in this chapter.

Form 1040X. Use Form 1040X, *Amended U.S. Individual Income Tax Return,* to correct the Form 1040, Form 1040A, or Form 1040EZ you have already filed.

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

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

If you overpaid tax, you can have all or part of the overpayment refunded to you, or you can apply all or part of it to your 1995 estimated tax or an unpaid tax liability for any year. If you choose to get a refund, it will be sent separately from any refund shown on your original return.

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

File a separate form for each tax year involved.

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

If the last day for claiming a credit or refund is a Saturday, Sunday, or legal holiday, the claim is considered timely if it is filed on the next business day.

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

Note. If you did not file an original return when it was due, you generally can claim a refund by filing your return within 3 years from the time the tax was paid. See *Tax paid* in the discussion that follows.

Limit on amount of refund. If you file your claim within 3 years after the date you filed your return, the credit or refund cannot be more than the part of the tax paid within the 3 years (plus any extension of time for filing your return) before you filed the claim.

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

Example 1. You made estimated tax payments of $500 and got an automatic extension of time to August 15, 1991, to file your 1990 income tax return. When you filed your return on that date, you paid an additional $200 tax. On August 15, 1994, you filed an amended return and claimed a refund of $700. Because you filed within the 3 years plus the 4–month extension period, you can get a refund of up to $700.

Example 2. The situation is the same as in Example 1, except you filed your return on October 31, 1991, 2½ months after the extension period ended. You paid an additional $200 on that date. On October 26, 1994, you filed an amended return and claimed a refund of $700. Although you filed your claim within 3 years from the date you filed your original return, the refund was limited to $200. The estimated tax of $500 was paid before the 3 years plus the 4–month extension period.

If you file a claim after the 3–year period, but within 2 years from the time you paid the tax, the credit or refund cannot be more than the tax you paid within the 2 years immediately before you file the claim.

Example. You filed your 1990 tax return on April 16, 1991. You paid taxes of $500. On November 4, 1992, after an examination of your 1990 return, you had to pay an additional tax of $200. On May 3, 1994, you file a claim for a refund of $300. However, your refund will be limited to the $200 you paid during the 2 years immediately before you filed your claim.

Exceptions for special types of refunds. If you file a claim for one of the items listed below, the dates and limits discussed earlier (under *Time for filing a claim for refund* and *Limit on amount of refund*) may not apply. These items, and where to get more information, are:

- A bad debt (see *Nonbusiness Bad Debts* in Chapter 15).
- A worthless security (see *Worthless securities* in Chapter 15).
- Foreign tax paid or accrued (see Publication 514, *Foreign Tax Credit for Individuals*).
- Net operating loss carryback (see Publication 536, *Net Operating Losses*).
- Carryback of certain business tax credits (see Publication 334, *Tax Guide for Small Business*).
- A claim based on an agreement with the Service extending the period for assessment of tax.
- An injured spouse claim (see *Offset Against Debts,* earlier).

Processing claims for refund. Claims are usually processed shortly after they are filed. Your claim may be accepted as filed or may be subject to examination. If a claim is examined, the procedures are the same as in the examination of a tax return.

However, you should request in writing that your claim be immediately rejected if:

You are filing a claim for a credit or refund based solely on contested income tax or on estate tax or gift tax issues considered in your previously examined returns, and

You want to take your case to court instead of appealing it within the IRS.

You must file a timely claim with the IRS before going to court.

A notice of claim disallowance will then be promptly sent to you. You have 2 years from the date of mailing of the notice of disallowance to file a refund suit in the United States District Court having jurisdiction or in the United States Claims Court.

Interest on refund. If you receive a refund because of your amended return, interest will be paid on it from the due date of your original return or the date you filed your original return, whichever is later, to the date you filed the amended return. However, if the refund is not made within 45 days after you file the amended return, interest will be paid up to the date the refund is paid.

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

Also, your refund may be reduced by amounts you owe for past-due child support or debts to another federal agency. The IRS will notify you if this happens. The refund procedures discussed in this chapter will not be available to you to get back the reduction. However, if you are the spouse of a person who owes past-due amounts for these obligations and the reduced refund relates to an overpayment on a joint return, you may be able to get a refund of your share of the overpayment before or after it is used to pay the past-due amount. See *Offset Against Debts,* earlier.

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

2.

Filing Status

Introduction

This chapter discusses which filing status you should use. There are five filing statuses to choose from:

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

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

Your filing status is a category that identifies you based on your marital and family situation. State law governs whether you are married, divorced, or legally separated under a decree of divorce or separate maintenance.

Your filing status is an important factor in determining whether you are required to file (see Chapter 1), the amount of your standard deduction (see Chapter 21), and your correct amount of tax (see Chapter 31). Your filing status is also important in determining whether you can take other deductions and credits.

If you file Form 1040 or Form 1040A, indicate your filing status by checking the appropriate box on lines 1 through 5.

There are different tax rates for different filing statuses. To determine your correct amount of tax, use the column in the Tax Table or Tax Rate Schedule in your forms package that applies to your filing status.

Useful Items

You may want to see:

Publication

- ❑ **501** Exemptions, Standard Deduction, and Filing Information
- ❑ **519** U.S. Tax Guide for Aliens
- ❑ **555** Federal Tax Information on Community Property

Form (and Instructions)

- ❑ **1040X** Amended U.S. Individual Income Tax Return

Marital Status

In general, your filing status depends on whether you are considered single or married.

Single taxpayers. You are considered single for the whole year if, on the last day of your tax year, you are unmarried or separated from your spouse by a divorce or a separate maintenance decree.

Divorced persons. State law governs whether you are married, divorced, or legally separated under a decree of separate maintenance. If you are divorced under a final decree by the last day of the year, you are considered unmarried for the whole year.

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

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

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

Married taxpayers. You and your spouse may be able to file a joint return, or you may file separate returns. You are considered married for the whole year if on the last day of your tax year you are either:

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

Spouse died during the year. If your spouse died during the year, you are considered married for the whole year for filing status purposes.

If you did not remarry before the end of the tax year, you may file a joint return for yourself and your deceased spouse. For the next 2 years, you may be entitled to the special benefits described later under *Qualifying Widow(er) With Dependent Child.*

If you remarried before the end of the tax year, you may file a joint return with your new spouse. Your deceased spouse's filing status is married filing separately for that year.

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

Single

Your filing status is ***single*** if you are unmarried or separated from your spouse by a divorce or separate maintenance decree, and you do not qualify for another filing status. However, if you were considered married for part of the year and lived in a community property state (listed under *Married Filing Separately*), special rules may apply in determining your income and expenses. See Publication 555 for more information.

Your filing status may be single if you were widowed before January 1, 1994, and did not remarry in 1994. However, you may be able to use another filing status that will give you a lower tax. See *Head of Household* and *Qualifying Widow(er) With Dependent Child* to see if you qualify.

You may file Form 1040EZ (if you have no dependents and are under 65 and not blind), Form 1040A, or Form 1040. If you file Form 1040A or Form 1040, show your filing status as single by checking the box on line 1. Use the *Single* column of the Tax Table, or *Schedule X* of the Tax Rate Schedules, to figure your tax.

Married Filing Jointly

You may choose ***married filing jointly*** as your filing status if you are married and both you and your spouse agree to file a joint return. On a joint return, you report your combined income and deduct your combined allowable expenses.

If you and your spouse decide to file a joint return, your tax may be lower than your combined tax for the other filing statuses. Also, your standard deduction (if you do not itemize deductions) may be higher, and you may qualify for tax benefits that do not apply to other filing statuses. You may file a joint return even if one of you had no income or deductions. If you and your spouse each have income, you may want to figure your tax both on a joint return and on separate returns (using the filing status

of married filing separately). Choose the method that gives you the lower tax.

If you file as married filing jointly, you may use Form 1040EZ, Form 1040A, or Form 1040. If you file Form 1040A or Form 1040, show this filing status by checking the box on line 2. Use the *Married filing jointly* column of the Tax Table, or *Schedule Y–1* of the Tax Rate Schedules, to figure your tax.

Spouse died during the year. If your spouse died during the year, you are considered married for the whole year for filing status purposes.

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

Filing a Joint Return

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

Accounting period. Both of you must use the same accounting period, but you may use different accounting methods. See *Accounting Periods* and *Accounting Methods* in Chapter 1.

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

Exception. Under certain circumstances, you may not have to pay the tax, interest, and penalties on a joint return. You must establish that you did not know, and had no reason to know, that there was a substantial understatement of tax that resulted because your spouse:

1) Omitted a gross income item, or
2) Claimed a deduction, credit, or property basis in an amount for which there is no basis in fact or law.

When the facts and circumstances are considered, it also must be unfair to hold you liable for the tax due. One consideration in determining your responsibility for any tax, interest, and penalties is whether you significantly benefited from the substantial understatement of tax. Normal support received from your spouse is not a significant benefit. Being later divorced or deserted by your spouse may be another consideration.

This exception applies only if your spouse's action resulted in an understatement of tax of more than $500. In addition, if the tax understatement resulted from claiming a deduction, credit, or basis, the exception applies only if the additional tax, interest, and penalties are more than:

1) 10% of your adjusted gross income (AGI) for the preadjustment year, if your AGI was $20,000 or less, or
2) 25% of your AGI for the preadjustment year, if your AGI was more than $20,000.

Your preadjustment year is your most recent tax year ending before a deficiency notice was mailed. If you were married to a different person at the end of the preadjustment year, your AGI includes your new spouse's income, whether or not you filed a joint return for that year.

For purposes of this exception, community property rules do not apply to items of gross income (other than gross income from property).

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

Signing a joint return. For a return to be considered a joint return, both husband and wife must sign the return. If your spouse died before signing the return, see *Signing the return* in Chapter 4.

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

Injury or disease prevents signing. If your spouse cannot sign because of disease or injury and tells you to sign, you may sign your spouse's name in the proper space on the return followed by the words "By (your name), Husband (or Wife)." Be sure to also sign in the space provided for your signature. Attach a dated statement, signed by you, to the return. The statement should include the form number of the return you are filing, the tax year, the reason your spouse cannot sign, and that your spouse has agreed to your signing for him or her.

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

Other reasons spouse cannot sign. If your spouse cannot sign the joint return for any other reason, you may sign for your spouse only if you are given a valid power of attorney (a legal document giving you permission to act for your spouse). Attach the power of attorney to your tax return. You may use Form 2848, *Power of Attorney and Declaration of Representative.*

Spouse in combat zone. If your spouse is unable to sign the return because he or she is serving in a combat zone, such as the Persian Gulf Area, and you do not have a power of attorney or other statement, you may sign your joint return if you attach your own signed, written statement to your return that explains that your spouse is serving in the combat zone. When you file, write *"Desert Storm"* at the top of your return and on the envelope in which you mail it. For more information on special tax rules for persons who are serving in a combat zone, get Publication 945, *Tax Information for Those Affected by Operation Desert Storm.*

Nonresident alien or dual-status alien. A joint return generally cannot be made if either spouse is a nonresident alien at any time during the tax year. However, if at the end of the year one spouse was a nonresident alien or dual-status alien married to a U.S. citizen or resident, both spouses may choose to file a joint return. If you do file a joint return, you and your spouse are both taxed as U.S. citizens or residents for the entire tax year. See *Nonresident Spouse Treated as a Resident* in Chapter 1 of Publication 519.

Married Filing Separately

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

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

Unless you are required to file separately, you may want to figure your tax both ways (on a joint return and on separate returns). Do this to make sure you are using the method that results in the lower combined tax. However, you will generally pay more combined tax on separate returns than you would on a joint return because the tax rate is higher for married persons filing separately.

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

If you file as married filing separately, you may use Form 1040A or Form 1040. Select this filing status by checking the box on line 3 of either form. You must also write your spouse's social security number and full name in the spaces provided. Use the *Married filing separately* column of the Tax Table or *Schedule Y–2* of the Tax Rate Schedules, to figure your tax.

Separate Returns

Special rules apply if you file a separate return.

Community property states. If you live in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin and file separately, your income may be considered separate income or community income for income tax purposes. See Publication 555.

If you file a separate return:

1) Your spouse should itemize deductions if you itemize deductions, because he or she cannot claim the standard deduction. However, see *Married persons living apart,* earlier, and Chapter 21.

2) You cannot take the credit for child and dependent care expenses in most instances.

3) You cannot take the earned income credit.

4) You cannot exclude any interest income from series EE U.S. Savings Bonds that you used for higher education expenses.

5) You cannot take the credit for the elderly or the disabled unless you lived apart from your spouse for all of 1994.

6) You may have to include in income more of your social security benefits (or equivalent railroad retirement benefits) you received in 1994 than you would on a joint return.

Individual Retirement Arrangements (IRAs). If you make contributions to your Individual Retirement Account, your IRA deduction may be subject to a phaseout rule. The phaseout rule applies if either you or your spouse was covered by an employer retirement plan, you and your spouse file separate returns, and you lived together during the year. See *Deductible Contributions* in Chapter 18.

Rental activity losses. If your rental of real estate is a passive activity, you may generally offset a loss of up to $25,000 against your nonpassive income if you actively participate in the activity. However, married persons filing separate returns who lived together at any time during the year may not claim this offset. Married persons filing separate returns who lived apart at all times during the year, are each allowed a $12,500 maximum offset for passive real estate activities. See *Limits on Rental Losses* in Chapter 10.

Joint Return After Separate Returns

You may change your filing status by filing an amended return using Form 1040X, *Amended U.S. Individual Income Tax Return.*

If you or your spouse (or each of you) files a separate return, you may change to a joint return any time within 3 years from the due date of the separate return or returns. This does not include any extensions. A separate return includes a return filed by you or your spouse claiming married filing separately, single, or head of household filing status. If the amount paid on your separate returns is less than the total tax shown on the joint return, you must pay the additional tax due on the joint return when you file it.

Separate Returns After Joint Return

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

Exception. A personal representative for a decedent may change from a joint return elected by the surviving spouse to a separate return for the decedent. The personal representative has one year from the due date of the return to make the change. See Chapter 4 for more information on filing a return for a decedent.

Head of Household

You may be able to file as ***head of household*** if you are unmarried or considered unmarried on the last day of the year. In addition, you must have paid more than half the cost of keeping up a home for you and a qualifying person for more than half the year.

If you qualify to file as head of household, your tax rate will be lower than the rates for single or married filing separately. You will also receive a higher standard deduction than if you file as single or married filing separately. (You can claim the standard deduction only if you do not itemize deductions.)

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

Considered Unmarried

You are considered unmarried on the last day of the tax year if you meet ***all*** of the following tests.

1) You file a separate return.

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

3) Your spouse did not live in your home during the last 6 months of the tax year.

4) Your home was, for more than half the year, the main home of your child, stepchild, adopted child, or foster child whom you can claim as a dependent. However, you can still meet this test if you cannot claim your child as a dependent only because:

   a) You state in writing to the noncustodial parent that he or she may claim an exemption for the child, or

   b) The noncustodial parent provides at least $600 support for the dependent and claims an exemption for the dependent under a pre-1985 divorce or separation agreement.

The rules to claim an exemption for a dependent are explained in Chapter 3.

Note. If you were considered married for part of the year and lived in a community property state (listed earlier under *Married Filing Separately*), special rules may apply in determining your income and expenses. See Publication 555 for more information.

Qualifying Person

Each of the following individuals is considered a qualifying person.

1) Your child, grandchild, stepchild, or adopted child who is:

   a) Single. This child does not have to be your dependent. However, a foster child must be your dependent. See Chapter 3 for more information on dependents.

   b) Married. This child must qualify as your dependent. However, if your married child's other parent claims him or her as a dependent under the special rules for a *Noncustodial parent* discussed in Chapter 3 under *Support Test for Divorced or Separated Parents,* the child does not have to be your dependent.

If the qualifying person is a child but not your dependent, enter that child's name in the space provided on line 4 of Form 1040 or Form 1040A.

2) Any relative listed below whom you claim as a dependent. However, if your dependent parent does not live with you, a special rule applies. See *Father or mother,* later.

Parent	Brother-in-law
Grandparent	Sister-in-law
Brother	Son-in-law
Sister	Daughter-in-law
Stepbrother	
Stepsister	If related by blood:
Stepmother	Uncle
Stepfather	Aunt
Half brother	Nephew
Half sister	Niece
Mother-in-law	
Father-in-law	

You are related by blood to an uncle or aunt if he or she is the brother or sister of your mother or father.

You are related by blood to a nephew or niece if he or she is the child of your brother or sister.

Note. A dependent can qualify only one taxpayer to use the head of household filing status for any tax year.

Dependents. If the person you support is required to be your dependent, you do not qualify as a head of household if you can only claim the exemption under a multiple support agreement. See *Multiple Support Agreement* in Chapter 3.

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

Temporary absences. You are considered to occupy the same household despite the temporary absence due to special circumstances of either yourself or the other person. Temporary absences due to special circumstances include those due to illness, education, business, vacation, and military service. It must be reasonable to assume that you or the other person will return to the household after the temporary absence, and you must continue to maintain a household in anticipation of the return.

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

Example. You are unmarried. Your mother lived in an apartment by herself. She died on September 2, 1994. The cost of the upkeep of her apartment for the year until her death was $6,000. You paid $4,000 and your brother paid $2,000. Your brother made no other payments towards your mother's support. Your mother had no income. Since you paid more than half the cost of keeping up the apartment for your mother from January 1, 1994, until her death, and she qualifies as your dependent, you may file as a head of household.

Nonresident alien spouse. You are considered unmarried for head of household purposes if your spouse was a nonresident alien at any time during the year and you do not choose to treat your nonresident spouse as a resident alien. Your spouse is not considered your relative. You must have another qualifying relative and meet the other tests to be eligible to file as a head of household. However, you are considered married if you have chosen to treat your spouse as a resident alien. See *Nonresident Spouse Treated as a Resident* in Chapter 1 of Publication 519.

Dual-status and nonresident alien taxpayers. These taxpayers may not claim head of household status.

Keeping Up a Home

You are keeping up a home only if **you pay more than half** of the cost of its upkeep. You may determine whether you paid more than half of the cost of keeping up a home by using the *Cost of Maintaining a Household* worksheet, later.

Costs you include. Include such costs as rent, mortgage interest, taxes, insurance on the home, repairs, utilities, and food eaten in the home.

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

State AFDC (Aid to Families with Dependent Children). State AFDC payments you use to keep up your home do not count as amounts you paid. They are amounts paid by others that you must include in the total cost of keeping up your home to figure if you paid more than half.

Cost of Maintaining a Household

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

If you paid more than others paid, you meet the requirement of maintaining a household.

Qualifying Widow(er) With Dependent Child

If your spouse died in 1994, you may use married filing jointly as your filing status for 1994 if you would otherwise qualify. See *Married Filing Jointly,* earlier.

You may be eligible to use ***qualifying widow(er) with dependent child*** as your filing status for 2 years following the year of death of your spouse. For example, if your spouse died in 1993, and you have not remarried, you may be able to use this filing status for 1994 or 1995.

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

Indicate your filing status by checking the box on line 5 of either Form 1040A or Form 1040. (You may not file Form 1040EZ). Write the year your spouse died in the space provided on line 5. Use the *Married filing jointly* column of the Tax Table or *Schedule Y–1* of the Tax Rate Schedules, to figure your tax.

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

1) You were entitled to file a joint return with your spouse for the year your spouse died. (It does not matter whether you actually filed a joint return).

2) You did not remarry before the end of the tax year.

3) You have a child, stepchild, adopted child, or foster child who qualifies as your dependent for the year.

4) You paid more than half the cost of keeping up a home that is the main home for you and that child for the entire year, except for temporary absences. See *Temporary absences* and *Keeping Up a Home,* discussed earlier under *Head of Household.*

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

Example. John Reed's wife died in 1992. John has not remarried. He has continued during 1993 and 1994 to keep up a home for himself and his dependent child. For 1992 he was entitled to file a joint return for himself and his deceased wife. For 1993 and 1994 he may file as qualifying widower with a dependent child. After 1994 he may file as head of household if he qualifies.

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

3.

Personal Exemptions and Dependents

Important Changes for 1994

Exemption amount. The amount you may deduct as an exemption has increased from $2,350 in 1993 to $2,450 in 1994.

Exemption phaseout. In 1994 you will lose all or part of the benefit of your exemptions if your adjusted gross income goes above a certain level. The income level ranges from $83,850 (for married filing separately) to $167,700 (for married filing jointly) depending upon your filing status. See *Phaseout of Exemptions,* later.

Important Reminder

Social security numbers for dependents. If you claim a dependent on a tax return, you have to list the dependent's social security number if he or she is age ***one or older.*** If you do not provide a dependent's social security number when it is required, or if you list an incorrect number, you may be subject to a $50 penalty.

Introduction

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

- Personal exemptions — You generally can take one for yourself and, if you are married, one for your spouse.
- Dependency exemptions — You must meet five dependency tests for each dependent you claim. If you are entitled to claim an exemption for a dependent, that dependent cannot claim a personal exemption on his or her own tax return.
- Phaseout of exemptions — You get less of a deduction when your taxable income goes above a certain amount.
- Social security number (SSN) requirement for dependents — You must list an SSN for any dependent age one or older.

Exemptions are amounts that reduce your taxable income. For 1994, each exemption is worth $2,450. How you claim an exemption on your tax return depends on which form you file.

If you file Form 1040EZ, you are allowed an exemption for yourself (and your spouse if married filing a joint return), unless someone else can claim you (or your spouse if married filing a joint return) as a dependent. The exemption amount is combined with the standard deduction amount and entered on line 4.

If you file Form 1040A or Form 1040, follow the instructions for the form. The total number of exemptions you can claim is the total in the box on line 6e. Also complete line 21 (Form 1040A) or line 36 (Form 1040) by multiplying the total number of exemptions shown in the box on line 6e by $2,450.

Caution. If your adjusted gross income is $83,850 or more, see *Phaseout of Exemptions,* later.

Useful Items

You may want to see:

Form (and Instructions)

- ❑ **2120** Multiple Support Declaration
- ❑ **8332** Release of Claim to Exemption for Child of Divorced or Separated Parents

Exemptions

There are two types of exemptions: personal exemptions and dependency exemptions. While these are both worth the same amount, different rules apply to each type.

Personal Exemptions

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

Your Own Exemption

You may take one exemption for yourself unless you can be claimed as a dependent by another taxpayer.

Single persons. If another taxpayer is entitled to claim you as a dependent, you may not take an exemption for yourself. This is true even if the other taxpayer does not actually claim your exemption.

Married persons. If you file a joint return, you may take your own exemption. If you file a separate return, you may take your own exemption only if another taxpayer is not entitled to claim you as a dependent.

Your Spouse's Exemption

Your spouse is never considered your dependent. You may be able to take one exemption for your spouse only because you are married. See *Separate return* later.

Joint return. If your spouse had ***any gross income,*** as defined in Chapter 1, you may claim his or her exemption only if you file a joint return.

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

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

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

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

Final decree of divorce or separate maintenance during the year. If you obtain a final decree of divorce or separate maintenance by the end of the year, you may not take your former spouse's exemption. This rule applies even if you provided all of your former spouse's support.

Exemptions for Dependents

You are allowed one exemption for each person you can claim as a dependent. This is called a dependency exemption.

A person is your dependent if ***all five*** of the dependency tests, discussed later, are met. You may take an exemption for your dependent even if your dependent files a return. But that dependent cannot claim his or her own personal exemption if you are entitled to do so. However, see *Joint Return Test* later in this chapter.

Child born alive. If your child was born alive during the year, and the dependency tests are met, you may take the full exemption. This is true even if the child lived only for a moment. Whether your child was born alive depends on state or local law. There must be proof of a live birth shown by an official document, such as a birth certificate. You may not claim an exemption for a stillborn child.

Death of dependent. If your dependent died during the year and otherwise qualified as your dependent, you can take his or her exemption.

Example. Your dependent mother died on January 15. You can take a full exemption for her on your return.

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

Dependency tests. The following five tests must be met for you to claim a dependency exemption for a person:

1) Member of Household or Relationship Test
2) Citizenship Test
3) Joint Return Test
4) Gross Income Test
5) Support Test

Member of Household or Relationship Test

To meet this test, a person must live with you for the entire year as a member of your household or be related to you. If at any time during the year the person was your spouse, you may not claim that person as a dependent. See *Personal Exemptions,* earlier.

Temporary absences. You are considered to occupy the same household despite the temporary absence due to special circumstances of either yourself or the other person. Temporary absences due to special circumstances include those due to illness, education, business, vacation, and military service.

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

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

Test not met. A person does not meet the member of household test if at any time during your tax year the relationship between you and that person violates local law.

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

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

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

Adoption. Before legal adoption, a child is considered to be your child if he or she was placed with you for adoption by an authorized agency. Also, the child must have been a member of your household. If the child was not placed with you by such an agency, the child will meet this test only if he or she was a member of your household for your entire tax year.

Foster individual. A foster child or adult must live with you as a member of your household for the entire year to qualify as your dependent.

However, if a state, one of its political subdivisions, or a tax-exempt child-placing agency makes payments to you as a foster parent, you may not take the child as your dependent. Your expenses are incurred on behalf of the agency that made payments to you. Expenses you incur in excess of nontaxable payments you receive are allowed as charitable contributions. You may deduct these contributions on Schedule A (Form 1040) if you itemize deductions. If you receive taxable payments, your expenses may be deductible as business expenses. See *Foster-care providers* under *Income Not Taxed* in Chapter 13 and *Foster parents* in Chapter 26.

Cousin. Your cousin will meet this test only if he or she lives with you as a member of your household for the entire year. A cousin is a descendant of a brother or sister of your father or mother and does not qualify under the relationship test.

Joint return. If you file a joint return, you do not need to show that a dependent is related to both you and your spouse. You also do not need to show that a dependent is related to the spouse who provides support.

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

Citizenship Test

To meet the citizenship test, a person must be a U.S. citizen or resident, or a resident of Canada or Mexico, for some part of the calendar year in which your tax year begins.

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

If you were a U.S. citizen when your child was born, the child may be a U.S. citizen although the other parent was a nonresident alien and the child was born in a foreign country. If so, and the other dependency tests are met, the child is your dependent and you may take the exemption. It does not matter if the child lives abroad with the nonresident alien parent.

If you are a U.S. citizen who has legally adopted a child who is not a U.S. citizen or resident, and the other dependency tests are met, the child is your dependent and you may take the exemption if your home is the child's main home and the child is a member of your household for your entire tax year.

Foreign students' place of residence. Foreign students brought to this country under a qualified international education exchange program and placed in American homes for a temporary period generally are not U.S. residents and do not meet the citizenship test. They may not be claimed as dependents. However, if you provided a home for a foreign student, you may be able to take a charitable contribution deduction. See *Expenses Paid for Student Living With You* in Chapter 26.

Joint Return Test

Even if the other dependency tests are met, you are generally not allowed an exemption for your dependent if he or she files a joint return.

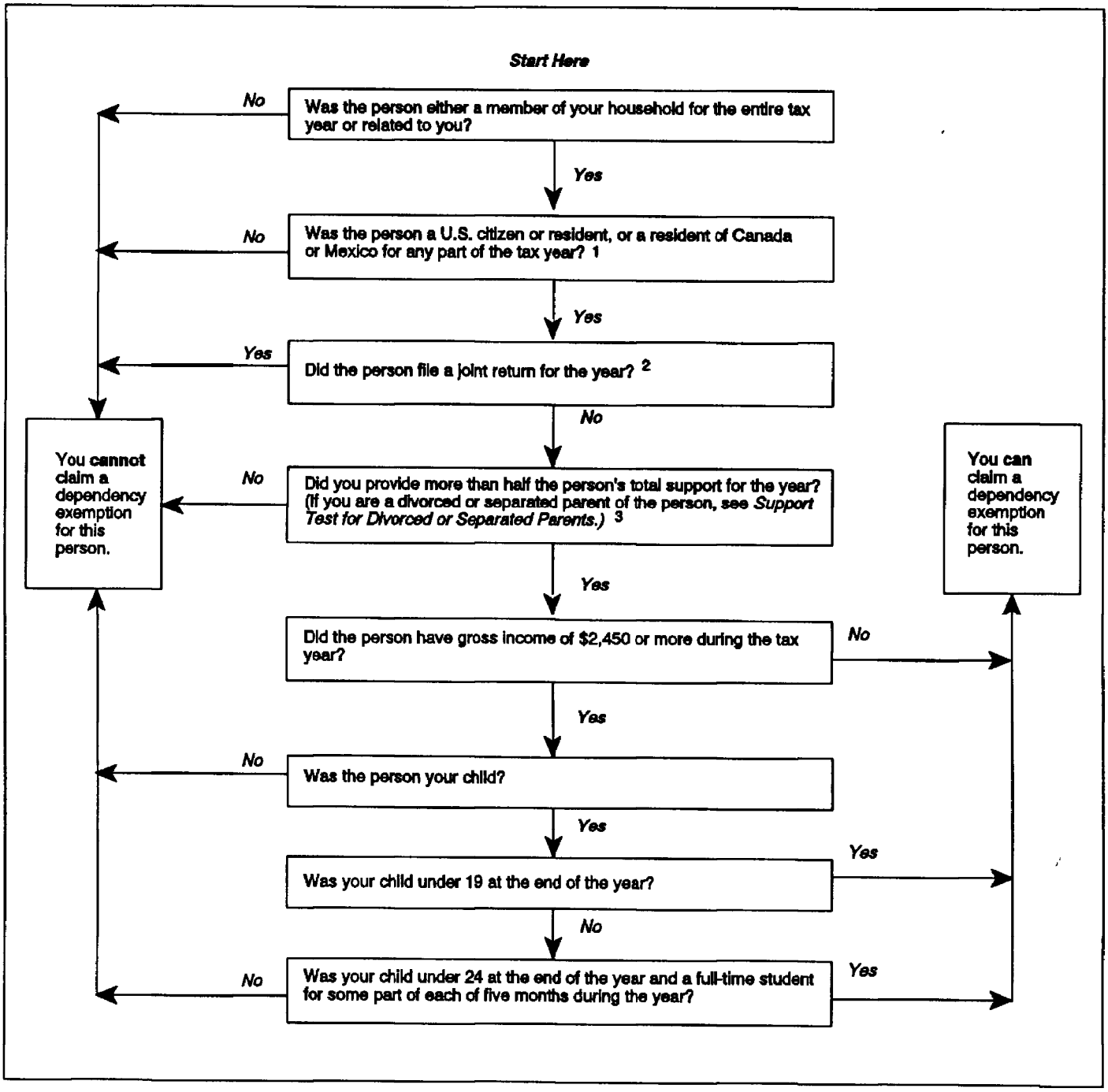
Example. You supported your daughter for the entire year while her husband was in the Armed Forces. The couple files a joint return. Even though all the other tests are met, you may not take an exemption for your daughter.

Exception. If the other dependency tests are met, you may take an exemption for your married dependent who files a joint return if:

1) Neither your dependent nor your dependent's spouse is required to file a return,
2) Neither your dependent nor your dependent's spouse would have a tax liability if they filed separate returns, and
3) They only file a joint return in order to get a refund of tax withheld.

Example. Your son and his wife each had less than $2,000 of wages and no unearned income. Neither is required to file a tax return. Taxes were withheld from their income, so they file a joint return to get a refund. You are allowed exemptions for your

Figure 3-A. **Can You Claim a Dependency Exemption?**



1 If the person was your legally adopted child and lived in your home as a member of your household for the entire tax year, answer "yes" to this question.

2 If neither the person nor the person's spouse is required to file a return but they file a joint return to claim a refund of tax withheld, you may answer "no" to this question.

3 Answer "yes" to this question if you meet the multiple support requirements under *Multiple Support Agreement*.

son and daughter-in-law if the other dependency tests are met.

Gross Income Test

Generally, you may not take an exemption for a dependent if that person had gross income of $2,450 or more for the year. This test does not apply if the person is your child and is either under age 19, or a student under age 24, as discussed later.

If you file on a fiscal year basis, the gross income test applies to the calendar year in which your fiscal year begins.

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

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

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

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

Gross income also includes all unemployment compensation and certain scholarship and fellowship grants. Scholarships received by degree candidates that are used for tuition, fees, supplies, books, and equipment required for particular courses are not included in gross income. For more information, see Chapter 13.

Tax-exempt income, such as certain social security payments, is not included in gross income. See *Income Not Taxed* in Chapter 13.

For this gross income test, gross income does not include income received by a permanently and totally disabled individual at a sheltered workshop. The availability of medical care must be the main reason the individual is at the workshop. Also, the income must come solely from activities at the workshop that are incident to this medical care. A sheltered workshop is a school operated by certain tax-exempt organizations, or by a state, a U.S. possession, a political subdivision of a state or possession, the United States, or the District of Columbia, that provides special instruction or training designed to alleviate the disability of the individual.

Child defined. For purposes of the gross income test, your child is your son, stepson, daughter, stepdaughter, a legally adopted child, or a child who was placed with you by an authorized placement agency for your legal adoption. A foster child who was a member of your household for your entire tax year is also considered your child. See *Foster individual,* earlier.

Child under 19. If your child is under 19 at the end of the year, the gross income test does not apply. Your child may have any amount of income and still be your dependent if the other dependency tests are met.

Example. Marie Grey, 18, earned $2,700. Her father provided more than half her support. He can claim her as a dependent because the gross income test does not apply and the other dependency tests were met.

Student under age 24. If your child is a student, the gross income test does not apply if the child is under age 24 at the end of the calendar year. The other dependency tests must still be met.

Student defined. To qualify as a student your child must be, during some part of each of 5 calendar months during the calendar year (not necessarily consecutive):

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

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

School defined. The term ''school'' includes elementary schools, junior and senior high schools, colleges, universities, and technical, trade, and mechanical schools. It does ***not*** include on-the-job training courses, correspondence schools, and night schools.

Example. James Clay, 22, attends college as a full-time student. During the summer, James earned $2,700, which he spent for his support. His parents provided more than $2,700 toward his support and the other dependency tests were met. On their return, they may take the exemption for James as a dependent.

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

Night school. Your child is not a full-time student while attending school only at night. However, full-time attendance at a school may include some attendance at night as part of a full-time course of study.

Support Test

You must provide more than half of a person's total support during the calendar year to meet the support test. You figure whether you have provided more than half by comparing the amount you contributed to the person's support with the entire amount of support the person received from all sources. This amount includes the person's own funds used for support. You may not include in your contribution any part of your child's support that is paid for by the child with the child's own wages, even if you pay the wages. See *Total Support,* later. For exceptions to the support test, see *Multiple Support Agreement* and *Support Test for Divorced or Separated Parents,* later.

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

Example. Your mother received $2,400 in social security benefits and $300 in interest. She paid $2,000 for lodging, $400 for recreation, and $300 for life insurance premiums.

Even though your mother received a total of $2,700, she spent only $2,400 for her own support. Life insurance premiums are not support items. If you spent more than $2,400 for her support and no other support was received, you have provided more than half of her support.

Cost determines support. The total cost, not the period of time you provide the support, determines whether you provide more than half of the support.

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

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

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

Example. You are in the Armed Forces. You authorize an allotment for your widowed mother that she uses for the support of herself and your sister. If it provides more than half of their support, you may take an exemption for each of them, even though you authorize the allotment only for your mother.

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

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

Example 1. You provide $2,000 toward your mother's support during the year. She has taxable income of $600, nontaxable social security benefit payments of $1,800, and tax-exempt interest of $200. She uses all these for her support. You may not claim your mother as a dependent because the $2,000 you provide is not more than half of her total support of $4,600.

Example 2. Your daughter takes out a student loan of $2,500 and uses it to pay her college tuition. She is personally responsible for the loan. You provide $2,000 toward her total support. You may not claim your daughter as a dependent because you provide less than half of her support.

Social security benefit payments. If a husband and wife each receive payments that are paid by one check made out

to both of them, half of the total paid is considered to be for the support of each spouse, unless they can show otherwise.

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

State benefit payments (welfare, food stamps, housing, etc.). These types of payments are considered as support provided by the state. They are included in determining the total support of the recipient. For example, AFDC (Aid to Families with Dependent Children) is support provided by the state. However, payments based on the needs of the recipient will not be considered as used entirely for that person's support if it is shown that part of the payments were not used for that purpose.

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

Total Support

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

Generally, the amount of an item of support is the amount of the expense incurred in providing that item. Expenses that are not directly related to any one member of a household, such as the cost of food for the household, must be divided among the members of the household. If the item is lodging, the amount of such item is its fair rental value.

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

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

You must figure the dependency status of each parent separately. You provide $2,000 ($1,000 lodging, $1,000 food) of your father's total support of $4,100—less than half. You provide $2,600 to your mother ($1,000 lodging, $1,000 food, $600 medical)—more than half of her total support of $4,700. You may claim your mother as a dependent, but not your father. Heat and utility costs are included in the fair rental value of the lodging, so these are not considered separately.

Lodging defined. Lodging is the fair rental value of the room, apartment, or house in which the person lives. It includes a reasonable allowance for the use of furniture and appliances, and for heat and other utilities.

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

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

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

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

If you help to keep up the home by paying interest on the mortgage, real estate taxes, fire insurance premiums, ordinary repairs, or other items directly related to the home, or give someone cash to pay those expenses, reduce the total fair rental value of the home by those amounts in figuring that person's own contribution.

Example. You provide $6,000 cash for your father's support during the year. He lives in his own home, which has a fair rental value of $6,600 a year. He uses $800 of the money you give him to pay his real estate taxes. Your father's contribution for his own lodging is $5,800 ($6,600 – $800 for taxes).

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

Property. Property provided as support is measured by its fair market value.

Capital expenses. Capital items, such as furniture, appliances, and cars, that are bought for a person during the year may be included in total support under certain circumstances.

The following examples show when a capital item is or is not support.

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

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

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

Example 4. Your 17-year-old son, using personal funds, buys a car for $4,500. You provide all the rest of your son's support — $4,000. Since the car is bought and owned by your son, the car's fair market value ($4,500) must be included in his support. The $4,000 support you provide is less than half of his total support of $8,500. You cannot claim your son as a dependent.

Medical insurance premiums. Medical insurance premiums you pay, including premiums for supplementary Medicare

coverage, are included in the total support you provide.

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

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

Example. During the year, your son receives $2,200 from the government under the GI Bill. He uses this amount for his education. You provide the rest of his support — $2,000. Because GI benefits are included in total support, your son is not your dependent.

Other support items. Other items may be considered as support depending on the facts in each case. For example, if you pay someone to provide child care or disabled dependent care, you may include these payments as support, even if you claim a credit for them. For information on the credit, see Chapter 33.

Do Not Include in Total Support

The following items are not included in total support:

1) Federal, state, and local income taxes paid by persons from their own income.
2) Social security and Medicare taxes paid by persons from their own income.
3) Life insurance premiums.
4) Funeral expenses.
5) Scholarships received by your child if your child is a full-time student. (If a child is committed to a state training school because of antisocial behavior, the value of the room, board, and education provided is not a scholarship. It must be included in support.)
6) Survivors' and Dependents' Educational Assistance payments used for support of the child who receives them.

Multiple Support Agreement

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

When this happens, you may agree that any one of you who individually provides more than 10% of the person's support, but ***only one,*** may claim an exemption for that person. Each of the others must sign a written statement agreeing not to claim the exemption for that year. The statements must be filed with the income tax return of the person who claims the exemption. **Form 2120,** *Multiple Support Declaration,* is used for this purpose.

Example 1. You, your sister, and your two brothers provide the entire support of your mother for the year. You provide 45%, your sister 35%, and your two brothers each provide 10%. Either you or your sister may claim an exemption for your mother. The other must sign a Form 2120 or a written statement agreeing not to take an exemption for her. Because neither brother provides more than 10% of the support, neither can take the exemption. They do not have to sign a Form 2120 or the written statement.

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

Example 3. Your father lives with you and receives 25% of his support from social security, 40% from you, 24% from his brother, and 11% from a friend. Either you or your uncle may take the exemption for your father. A Form 2120 or a written statement from the one not claiming the exemption must be attached to the return of the one who takes the exemption.

Support Test for Divorced or Separated Parents

The support test for a child of divorced or separated parents is based on special rules that apply only if:

1) The parents are divorced or legally separated under a decree of divorce or separate maintenance, or separated under a written separation agreement, or lived apart at all times during the last 6 months of the calendar year,
2) One or both parents provide more than half of the child's total support for the calendar year, and
3) One or both parents have custody of the child for more than half of the calendar year.

''Child'' is defined earlier under the *Gross Income Test.*

Exceptions. This discussion does not apply in any of the following situations:

1) A third party, such as a relative or friend, provides half of the child's support or more,
2) The child is in the custody of a person other than the parents for half of the year or more,
3) The support of the child is determined under a multiple support agreement, as discussed earlier, or
4) The parents are separated under a written separation agreement or are living apart, but they file a joint return for the tax year.

Custodial parent. The parent who has custody of the child for the greater part of the year (the custodial parent) is generally treated as the parent who provides more than half of the child's support. It does not matter whether the custodial parent actually provided more than half of the support. The noncustodial parent is the parent who has custody of the child for the shorter part of the year or who does not have custody at all.

Custody. Custody is usually determined by the terms of the most recent decree of divorce or separate maintenance, or a later custody decree. If there is no decree, use the written separation agreement. If neither a decree nor agreement establishes custody, then the parent who has the physical custody of the child for the greater part of the year is considered to have custody of the child. This also applies if the validity of a decree or agreement awarding custody is uncertain because of legal proceedings pending on the last day of the calendar year.

If the parents are divorced or separated during the year and had joint custody of the child before the separation, the parent who has custody for the greater part of the rest of the year is considered to have custody of the child for the tax year.

Example 1. Under the terms of your divorce, you have custody of your child for 10 months of the year. Your former spouse has custody for the other 2 months. You and your former spouse provide the child's total support. You are considered to have provided more than half of the support of the child. However, see *Noncustodial parent,* below.

Example 2. You and your former spouse provided your child's total support for 1994. You had custody of your child under your 1991 divorce decree, but on August 31, 1994, a new custody decree granted custody to your former spouse. Because you had custody for the greater part of the year, you are considered to have provided more than half of your child's support.

Noncustodial parent. The noncustodial parent will be treated as providing more than half of the child's support if:

1) The custodial parent signs a written declaration that he or she will not claim the exemption for the child, and the noncustodial parent attaches this written declaration to his or her return,
2) A decree or agreement went into effect after 1984 and it unconditionally

Table 3-1. **Worksheet for Determining Support**

Income	
1) Did the person you supported receive any income, such as wages, interest, dividends, pensions, rents, social security, or welfare? (If yes, complete lines 2, 3, 4, and 5)	❑ Yes ❑ No
2) Total income received	$
3) Amount of income used for support	$
4) Amount of income used for other purposes	$
5) Amount of income saved	$
(The total of lines 3, 4, and 5 should equal line 2)	
Expenses for Entire Household (where the person you supported lived)	
6) Lodging (Complete item a or b)	
a) Rent paid	$
b) If not rented, show fair rental value of home. If the person you supported owned the home, include this amount in line 20.	$
7) Food	$
8) Utilities (heat, light, water, etc. not included in line 6a or 6b)	$
9) Repairs (not included in line 6a or 6b)	$
10) Other. Do not include expenses of maintaining home, such as mortgage interest, real estate taxes, and insurance.	$
11) Total household expenses (Add lines 6 through 10)	$
12) Total number of persons who lived in household	
Expenses for the Person You Supported	
13) Each person's part of household expenses (line 11 divided by line 12)	$
14) Clothing	$
15) Education	$
16) Medical, dental	$
17) Travel, recreation	$
18) Other (specify)	$
19) Total cost of support for the year (Add lines 13 through 18)	$
20) Amount the person provided for own support (line 3, plus line 6b if the person you supported owned the home)	$
21) Amount others provided for the person's support. Include amounts provided by state, local, and other welfare societies or agencies. Do not include any amounts included on line 2.	$
22) Amount you provided for the person's support (line 19 minus lines 20 and 21)	$
23) 50% of line 19	$
If line 22 is more than line 23, you meet the support test for the person. If the person meets the other dependency tests, you may claim an exemption for that person. If line 23 is more than line 22, you may still be able to claim an exemption for that person under a multiple support agreement. See *Multiple Support Agreement* in this chapter.	

states that the noncustodial parent can claim the child as a dependent, or

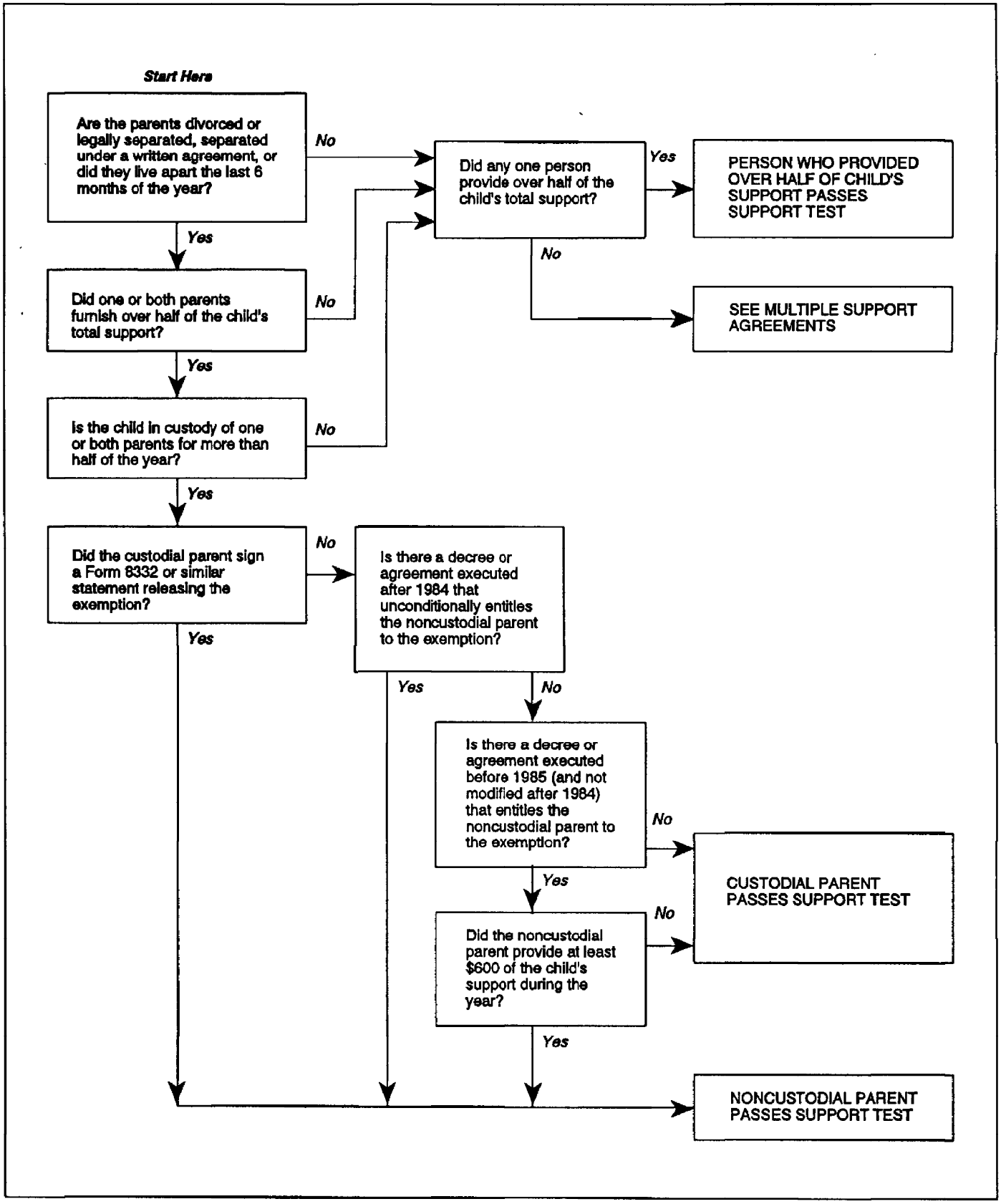
3) A decree or agreement executed before 1985 provides that the noncustodial parent is entitled to the exemption, and he or she provides at least $600 for the child's support during the year, unless the pre-1985 decree or agreement is modified after 1984 to specify that this provision will not apply.

Example. Under the terms of your 1982 divorce decree, your former spouse has custody of your child. The decree specifically states that you are entitled to the exemption. You provide at least $600 in child support during the calendar year. You are considered to have provided more than half of the child's support.

Written declaration. The custodial parent should use **Form 8332,** *Release of Claim to Exemption for Child of Divorced or Separated Parents,* or a similar statement, to make the written declaration to release the exemption to the noncustodial parent. The noncustodial parent must attach the form or statement to his or her tax return.

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

Figure 3-B. Support Test for Children of Divorced or Separated Parents



year for which the noncustodial parent claims the exemption.

Children who didn't live with you. If you are claiming a child who didn't live with you under the rules for children of divorced or separated parents, enter the number of children who did not live with you (or who lived with their other parent for the greater part of the year) on the line to the right of line 6c of Form 1040 or Form 1040A labeled "No. of your children on 6c who didn't live with you due to divorce or separation."

Then you must either:

1) Check the box on line 6d of your Form 1040 or Form 1040A if your divorce decree or written separation agreement was in effect before 1985 and it states that you can claim the child as your dependent, or

2) Attach Form 8332 or a similar statement to your return. If your divorce decree or separation agreement went into effect after 1984 and it unconditionally states that you can claim the child as your dependent, you may attach a copy of the following pages from the decree or agreement instead of Form 8332:

   a) Cover page (write the other parent's social security number on this page),

   b) The page that unconditionally states you can claim the child as your dependent, and

   c) Signature page showing the date of the agreement.

Enter the total number of children who did not live with you for reasons other than divorce or separation on the line labeled "Dependents on 6c not entered above." Include your dependent children who were not U.S. citizens and who lived in Canada or Mexico during 1994.

Child support. All child support payments actually received from the noncustodial parent are considered used for the support of the child.

Example. The noncustodial parent provides $1,200 for the child's support. This amount is considered as support provided by the noncustodial parent even if the $1,200 was actually spent on things other than support.

Support payments for an earlier year. If support payments made this year are not more than the amount required of the noncustodial parent, the amount of support provided by that parent is not reduced by any payment of support that parent owed for an earlier year. If the support payments are more than the amount required for this year, any payment for an earlier year is not support provided by the noncustodial parent for either the earlier year or for this year. It is reimbursement to the custodial parent for amounts paid for the support of the children in an earlier year.

Example. Under your divorce decree, you must pay $400 a month to your former spouse for the support of your two children. Last year you paid $4,000 instead of $4,800 ($400 × 12 months) due for the year. This year, if you pay the full amount, the entire $4,800 is considered support that you provided. If you also pay any part of the $800 you owe from last year, that amount is not included as support provided by you in either year.

Third-party support. Support provided by a third party for a divorced or separated parent is not included as support provided by that parent. However, see *Remarried parent,* below.

Example. You are divorced. During the whole year, you and your child live with your mother in a house she owns. The fair rental value of the lodging provided by your mother for your child is $1,000. The home provided by your mother is not included in the amount of support you provide.

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

Example. You have two children from a former marriage who live with you. You have remarried and are living in a home owned by your present spouse. The fair rental value of the home provided to the children by your present spouse is treated as provided by you.

Home jointly owned. If you and your former spouse have the right to use and live in the home, each of you is considered to provide half of your child's lodging. However, if the divorce decree gives only you the right to use and live in the home, you are considered to provide your child's entire lodging. It does not matter if the legal title to the home remains in the names of both parents.

Phaseout of Exemptions

The amount you can claim as a deduction for exemptions is phased out once your adjusted gross income (AGI) goes above a certain level for your filing status. These levels are as follows:

Filing Status	AGI Level Which Reduces Exemption Amount
Married filing separately	$ 83,850
Single	111,800
Head of household	139,750
Married filing jointly	167,700
Qualifying widow(er)	167,700

You must reduce the dollar amount of your exemptions by 2% for each $2,500, or part of $2,500 ($1,250 if you are married filing separately), that your AGI exceeds the amount shown above for your filing status. If your AGI exceeds the amounts shown above by more than $122,500 ($61,250 if married filing separately), the amount of your deduction for exemptions is reduced to zero.

If your AGI exceeds the level for your filing status, use the *Deduction for Exemptions Worksheet* in the instructions for Form 1040 to figure the amount of your deduction for exemptions.

Social Security Number for Dependents

If you claim a dependent who is at least ***one year old*** by the end of your tax year, you must list the dependent's social security number (SSN) on your Form 1040 or Form 1040A. If you do not list the dependent's SSN when required or if you list an incorrect SSN, you may be subject to a $50 penalty. This penalty may be waived if you can show reasonable cause for not providing your dependent's SSN.

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

It usually takes about 2 weeks to get an SSN.

Dependents living in Mexico or Canada. Taxpayers who claim dependents living in Mexico or Canada must have SSNs for these dependents.

To obtain SSNs for these dependents, complete Form SS–5 and check the "Other" box for line 3, Citizenship. Attach a statement to explain that the SSN is needed for income tax purposes for a dependent living in Mexico or Canada.

A dependent living in **Mexico** may apply for an SSN at the U.S. Embassy in Mexico City or at any U.S. consulate in Mexico. If you claim a dependent who lives in Mexico, enter "MX" instead of a number in column (5) of line 6c of your Form 1040 or Form 1040A.

A dependent living in **Canada** may apply for an SSN at the American Embassy in Ottawa or at a consulate. Those living near the U.S. border may also apply at an SSA office in a nearby American city. If you claim a dependent who lives in Canada, enter "CN" instead of a number in column (5) of line 6c of your Form 1040 or Form 1040A.

4.

Decedents

Introduction

This chapter discusses the tax responsibilities of the person who is in charge of the property of a decedent (person who died). It covers the following topics:

- Who is responsible for the decedent's tax matters
- Filing the decedent's final return
- Tax effects on survivors and beneficiaries

This chapter does not discuss the requirements for filing an income tax return of an estate (Form 1041). For information on Form 1041, see *Income Tax Return of an Estate–Form 1041* in Publication 559, *Survivors, Executors, and Administrators.* This chapter also does not discuss the requirements for filing an estate tax return (Form 706). For information on Form 706, see Publication 448, *Federal Estate and Gift Taxes.*

Useful Items

You may want to see:

Publication

❑ **559** Survivors, Executors, and Administrators

Form (and Instructions)

❑ **56** Notice Concerning Fiduciary Relationship

❑ **1310** Statement of Person Claiming Refund Due a Deceased Taxpayer

❑ **4810** Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)

Personal Representatives

A personal representative of an estate can be an executor, an administrator, or anyone who is in charge of the decedent's property.

The surviving spouse may or may not be the personal representative, depending on the terms of the decedent's will or the court appointment.

Generally, an ***executor*** (or executrix) is named in a decedent's will to administer the estate (property and debts left by the decedent) and distribute properties as the decedent has directed. An ***administrator*** (or administratrix) is usually appointed by the court if no will exists, if no executor was named in the will, or if the named executor cannot or will not serve. In general, an executor and an administrator perform the same duties and have the same responsibilities. For simplicity, the term ***personal representative*** will be used throughout this chapter.

Duties. The primary duties of a personal representative are to collect all of the decedent's assets, pay the creditors, and distribute the remaining assets to the heirs or other beneficiaries.

The personal representative must also:

1) Notify the IRS that he or she is acting as the personal representative,
2) File any income tax return that is due, and
3) Make sure that any income tax that is due is paid.

You can use **Form 56,** *Notice Concerning Fiduciary Relationship,* to notify the IRS.

For more information on the duties and responsibilities of the personal representative, see *Duties* under *Personal Representatives* in Publication 559.

Final Return for the Decedent

The same filing requirements that apply to individuals (income, age, and filing status) determine if a final income tax return must be filed for the decedent and whether Form 1040, Form 1040A, or Form 1040EZ should be used. Filing requirements are discussed in Chapter 1.

If none of the filing requirements are met, but the decedent had tax withheld or paid estimated tax, a final return should be filed to get a refund. A final return should also be filed if the decedent was entitled to a refundable credit such as the earned income credit. See Chapters 35 and 36 for additional information on refundable credits.

Methods of accounting. The method of accounting used by the decedent generally determines what income you must include and what deductions you can take on the final return. Generally, individuals use one of two methods of accounting: cash or accrual.

Cash method. If the decedent used the cash method of accounting, which most people use, report only the items of income that the decedent actually or constructively received before death and deduct only the expenses the decedent paid before death. For an exception for certain medical expenses not paid before death, see *Medical costs,* later, under *Deductions.*

Accrual method. If the decedent used an accrual method of accounting, report only those items of income that the decedent accrued, or earned, before death. Deduct those expenses the decedent was liable for before death, regardless of whether the expenses were paid.

Additional information. For more information on the cash and accrual methods, see *Accounting Methods* in Chapter 1.

Who must file the return? The personal representative of the decedent is responsible for filing any income tax returns and making sure that any income tax that is due is paid. This includes the final income tax return of the decedent (for the year of death) and any returns not filed for preceding years.

Example. Roberta Russell died on February 5, 1995, before filing her 1994 tax return. Her personal representative must file her 1994 tax return as well as her final tax return for 1995.

Exception. Under certain circumstances, a surviving spouse may be able to file a joint final return or joint returns for preceding years for which returns have not yet been filed. See *Joint return,* later.

Filing the return. When you file a return for the decedent, either as the personal representative or as the surviving spouse, you should write ''DECEASED,'' the decedent's name, and the date of death across the top of the tax return. This same information should be included on any Form 1040X, *Amended U.S. Individual Income Tax Return,* that you file for the decedent.

If the decedent and surviving spouse are filing a joint return, you should write the name and address of the decedent and the surviving spouse in the name and address space. If a joint return is not being filed, write the decedent's name in the name space and the personal representative's name and address in the remaining space.

Example. John Stone died in early 1994. The top of his final return is filled in as shown later.

Signing the return. If a personal representative has been appointed, the personal representative must sign the return. If a joint return is filed, the surviving spouse must also sign it. If no personal representative has been appointed by the due date for filing the return, the surviving spouse (on a joint return) should sign the return and write in the signature area ''Filing as surviving spouse.'' See *Joint return,* later.

If no personal representative has been appointed and if there is no surviving spouse, the person in charge of the decedent's property must file and sign the return as ''personal representative.''

Example. Assume in the John Stone example above that Mrs. Stone is filing as a surviving spouse. No personal representative has been appointed. She signs their final joint return as shown later.

DECEASED John S. Stone February 28, 1994

Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** (T) **1994**

IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 1994, or other tax year beginning , 1994, ending , 19 OMB No. 1545-0074

Label (See instructions on page 12.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial: LP 765-00-4321 JOHN S. STONE

Last name: CAR-RT SORT CH01 123-00-4567 S29 30 JANE M. STONE

Apt. no.: 1992 OAK ST. 103

City, town or post office, state, and ZIP code: SHERIDAN, WY 82801

IRS 12.

Your social security number

Spouse's social security number

For Privacy Act and Paperwork Reduction Act Notice, see page 4.

Presidential Election Campaign (See page 12.)

	Yes	No
Do you want $3 to go to this fund?	✓	
If a joint return, does your spouse want $3 to go to this fund?	✓	

Note: *Checking "Yes" will not change your tax or reduce your refund.*

Sign Here Keep a copy of this return for your records.

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

Your signature: Jane M. Stone — Date: 4-1-95 — Your occupation: Engineer

Spouse's signature. If a joint return, BOTH must sign. Filing as surviving spouse — Date — Spouse's occupation

Paid Preparer's Use Only

Preparer's signature — Date — Check if self-employed ☐ — Preparer's social security no.

Firm's name (or yours if self-employed) and address — E.I. No. — ZIP code

Printed on recycled paper

Claiming a refund. Generally, a person who is filing a return for a decedent and claiming a refund must file **Form 1310,** *Statement of Person Claiming Refund Due a Deceased Taxpayer,* with the return. However, if you are a surviving spouse filing a joint return with the decedent, you do not have to file Form 1310. If you are a court appointed or certified personal representative filing Form 1040, Form 1040A, or Form 1040EZ for the decedent, you also do not have to file Form 1310, but you must attach to the return a copy of the court certificate showing your appointment.

Example. Joe Brown died on January 14, 1995, before filing his 1994 tax return. On April 4, 1995, you are appointed the personal representative for Joe's estate, and you file his Form 1040 for 1994 showing a refund due. You do not need to attach Form 1310 to claim the refund, but you must attach to his return a copy of the court certificate to show that you are the appointed personal representative of Joe's estate.

When and where to file. The final return is due by the date the decedent's return would have been due had death not occurred. The final return for a calendar year taxpayer is generally due by April 15 of the year following the year of death. However, when the due date for filing tax returns falls on a Saturday, Sunday, or legal holiday, you can file on the next business day.

You can mail the decedent's final income tax return to the Internal Revenue Service Center for the area where you live.

Request for prompt assessment of tax. As the personal representative for the decedent's estate, you must see to it that any additional taxes that the decedent may owe are paid. The IRS usually has 3 years after the filing of a return to charge any additional tax that may be due. Returns filed before the due date are treated as filed on the due date.

You can shorten the time that the IRS has to charge the decedent's estate any additional tax by requesting a prompt assessment of the decedent's income taxes. This request reduces the time the IRS has to charge any additional tax from 3 years from the date the return is filed to 18 months from the date the IRS receives the request. This may permit a quicker settlement of the tax responsibilities of the estate and earlier distribution of the decedent's assets, such as money and property, to the beneficiaries.

You can make the request for any tax year still subject to additional tax charges, even if the return was filed before the decedent's death.

Note. Requesting this prompt assessment will not shorten the time the IRS has to charge any additional tax if it can be charged beyond the 3 years from the date

the return was filed or due. For example, additional tax can still be charged because of a substantial understatement of income or if a fraudulent return was filed.

How to request. You can use **Form 4810,** *Request for Prompt Assessment Under Internal Revenue Code Section 6501(d),* for making this request. If Form 4810 is not used, you must clearly indicate that you are requesting a prompt assessment under Section 6501(d) of the Internal Revenue Code and specify the year(s) involved. You must file the request separately from any other document. Send it to the IRS office where the decedent's return was filed.

Joint return. Generally, the personal representative and the surviving spouse can file a joint return for the decedent and the surviving spouse. However, the surviving spouse alone can file the joint return if:

1) The decedent did not file a return for that year, and
2) No personal representative is appointed before the due date for filing the return of the surviving spouse.

This also applies to the return for the preceding year if the decedent died after the close of the preceding tax year and before the due date for filing that return. The final joint return must show the decedent's income before death and the surviving spouse's income for the entire year.

If the surviving spouse remarried before the end of the year in which the decedent died, a final joint return with the deceased spouse cannot be filed. The filing status of the deceased spouse is then married filing separately.

Change to joint return. If a separate return was filed by or for the decedent, and the due date for filing that return has expired, that return can be changed to a joint return only by the personal representative on behalf of the decedent. The surviving spouse must also agree to the change. A surviving spouse cannot change a separate return to a joint return if no personal representative has been appointed.

Change to separate return. If the surviving spouse files a joint return with the decedent and a personal representative is later appointed by the court, the personal representative can change the joint return election. The personal representative has one year from the due date of the return to file a separate return for the decedent. The joint return would then become the separate return of the surviving spouse. The decedent's items would be excluded, and the tax liability would be refigured on the separate return.

How to Report Certain Income

This section explains how to report certain types of income on the final return. The rules on income discussed in the other chapters of this publication also apply to a decedent's final return. See Chapters 6 through 17, if they apply.

Interest and Dividend Income (Forms 1099)

Payers of interest and dividends report amounts on Forms 1099 using the name and identification number of the person to whom the account is payable. After a person's death, the Forms 1099 must reflect the new owner's (the estate's or beneficiary's) name and identification number. As the personal representative, you must furnish this information to the payers.

For example, if an interest-bearing account becomes part of the estate, you must provide the estate's name and identification number to the payer so that the Form 1099–INT, *Interest Income,* can reflect the correct payee information. If the interest-bearing account is transferred to a surviving joint owner, you must provide the survivor's name and identification number to the payer.

You should receive Forms 1099 for the decedent that report amounts of interest and dividends earned prior to death. The estate or beneficiary should receive separate Forms 1099 that report the amounts earned after death and that are payable to them.

If you receive Forms 1099 that include both income earned before the date of death (reportable on the decedent's final return) and income earned after the date of death (reportable by the estate or other recipient), then you will need to request new Forms 1099. You should contact the payers to ask them for corrected Forms 1099 that properly identify the recipient of the income (by name and identification number) and the correct amounts.

Capital Loss

A capital loss sustained by a decedent during his or her last tax year can be deducted only on the final return filed for the decedent. The capital loss limits discussed in Chapter 17 still apply in this situation. The loss cannot be deducted by the estate or carried over to following years.

Business Income

This section discusses some of the business income which may have to be included on the final return.

Partnership income. If the decedent was a partner, his or her death generally does not close the partnership's tax year. See *Closing of Partnership Year* under *Liquidation of Partner's Interest* in Publication 541, *Tax Information on Partnerships,* for how to treat partnership income if the partnership year does end with the death of a partner.

As the personal representative, you must include on the final return the decedent's share of partnership income for the partnership's tax year that ends within or with the decedent's last tax year (year ending on the date of death).

Do not include on the final return the decedent's share of partnership income for a partnership's tax year that ends after the date of death. In this case, partnership income earned up to and including the date of death is income in respect of the decedent, which is discussed later in this chapter. Income earned after the date of death to the end of the partnership's tax year is income to the estate or successor in interest (beneficiary).

Example. The XYZ Partnership and all the partners use a calendar year as their tax year. One of the partners dies on June 10. The decedent's share of the partnership income from January 1 through June 10 is income in respect of a decedent. The share of partnership income after June 10 is income to the estate or beneficiary.

S corporation income. If the decedent was a shareholder in an S corporation, you must include on the final return the decedent's share of S corporation income for the corporation's tax year that ends within or with the decedent's last tax year (year ending on the date of death). The final return must also include the decedent's pro rata share of the S corporation's income for the period between the end of the corporation's last tax year and the date of death.

The income for the part of the S corporation's tax year after the shareholder's death is income to the estate or other person who has acquired the stock in the S corporation.

Self-employment income. You must include on the final return the self-employment income that the decedent actually or constructively received or accrued, depending on the decedent's accounting method. For self-employment tax purposes only, the decedent's self-employment income will include the decedent's distributive share of a partnership's income or loss through the end of the month in which death occurred. For more information on how to compute the decedent's self-employment income, see Publication 533, *Self-Employment Tax.*

Deductions, Credits, and Exemptions

Generally, the rules for deductions, credits, and exemptions that apply to individuals also apply to the decedent's final income tax return. On the final return, claim deductible items that were paid before the decedent's death (or accrued, if the decedent reported deductions on an accrual method).

Deductions

All of the deductions that are discussed in this publication also apply to the final return as long as the decedent was eligible for the deduction at the time of death.

You can generally choose to claim itemized deductions or the standard deduction on the final return. See *Standard deduction,* later, for instances when you cannot choose the standard deduction or when the amount of the standard deduction may be limited.

If you have a choice, you should figure the amount of the decedent's itemized deductions before you decide whether to itemize or claim the standard deduction to be sure that you are using the method that gives you the lower tax.

Itemized deductions. If the total of the decedent's itemized deductions are more than the decedent's standard deduction, the federal income tax will generally be less if you claim itemized deductions on the final return. See Chapters 23 through 30 for the types of expenses that are allowed as itemized deductions.

Note. The amount you can deduct for most itemized deductions is limited if adjusted gross income is more than $111,800 ($55,900 if married filing separately). See Chapter 22 for more information.

Medical costs. If you itemize deductions on the final return, you may be able to deduct medical expenses of the decedent even though they were not paid before the date of death. See *Decedents* in Chapter 23 for an explanation of how this election can be made.

Unrecovered investment in pension. If the decedent was receiving a pension or annuity and died without a surviving annuitant, you can take a deduction on the decedent's final return for the amount of the decedent's investment in the pension or annuity contract that remained unrecovered at death. The deduction is a miscellaneous itemized deduction that is not subject to the 2% of adjusted gross income limit. See Chapter 30.

Standard deduction. You can generally claim the full amount of the standard deduction on the decedent's final return. However, you cannot use the standard deduction if the surviving spouse files a separate return and itemizes deductions. In that event, you must also itemize deductions on the decedent's final return.

The amount of the standard deduction for a decedent's final return is the same as it would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed.

If another taxpayer can claim the decedent as a dependent, the amount you can claim for the decedent's standard deduction may be limited. See Chapter 21 for more information on how to determine the amount of the standard deduction.

Credits

Any of the tax credits that are discussed in this publication also apply to the final return if the decedent was eligible for the credits at the time of death. These credits are discussed in Chapters 33 through 36 of this publication.

Tax withheld and estimated payments. There may have been income tax withheld from the decedent's pay, pensions, or annuities before death, and the decedent may have paid estimated income tax. To get credit for these tax payments, you must claim them on the decedent's final return. For more information, see *Credit for Withholding and Estimated Tax* in Chapter 5.

Exemptions

You can claim the full amount of the personal exemption on the decedent's final return unless the decedent can be claimed as a dependent by another taxpayer. In that case, the decedent's own exemption amount on the final return is zero. See Chapter 3 for more information on this limit and on other dependency exemptions that may be allowed on the final return.

Tax Effect on Others

This section contains information about the effect of an individual's death on the income tax liability of others: the survivors (including the widow or widower), the beneficiaries, and the estate. Any survivor or beneficiary should coordinate the filing of his or her own tax return with the personal representative handling the decedent's estate. The personal representative can coordinate filing status, exemptions, income, and deductions so that the final return and the income tax returns of the survivors, beneficiaries, and estate are all filed correctly.

Survivors

If you are a survivor, you may qualify for certain benefits when filing your own income tax return. This section addresses some issues that may apply to you.

Inherited property. Property received as a gift, bequest, or inheritance is not included in your income. However, if the property you receive in this manner later produces income, such as interest, dividends, or rentals, then that income is taxable to you. If the gift, bequest, or inheritance you receive is the income from property, that income is taxable to you.

If you inherited the right to receive income in respect of the decedent, see *Income in Respect of the Decedent,* later.

Joint return by surviving spouse. A surviving spouse may be able to file a joint return with the decedent for the year of death as long as the survivor has not remarried before the end of that year. See *Joint return,* earlier.

If there is a dependent child, the surviving spouse may also be entitled to use the standard deduction amount and the tax rates that apply to joint returns for the 2 following years. See *Qualifying Widow(er) With Dependent Child* in Chapter 2 for information on how to qualify.

The decedent as a dependent. If the decedent qualified as your dependent for the part of the year before death, you can claim the full exemption amount for the dependent on your tax return.

Income in Respect of the Decedent

All gross income that the decedent had a right to receive and that is not properly includible on the decedent's final return is called income in respect of the decedent. Instead of being reported on the final return of the decedent, the income is included, for the tax year when received, in the gross income of:

1) The decedent's estate, if the estate acquires the right to receive the income from the decedent,
2) The person who acquires the right to the income directly from the decedent without going through the estate, or
3) Any person to whom the estate properly distributes the right to receive the income.

Example 1. Thornton Jones owned and operated an orchard, and he used the cash method of accounting. He sold and delivered $2,000 worth of fruit to a customer, but he did not receive payment before his death. When the estate was settled, payment had still not been made, and the estate gave the right to receive the payment to his niece. When she collects the $2,000, she must include it in her income. It is not reported on the final return of the decedent nor on the estate's income tax return.

Example 2. If, in Example 1, Thornton Jones had used the accrual method of accounting, the income from the fruit sale must be included on his final return. Neither his estate nor his niece will report the income when the money is later paid.

Example 3. Mary Smith was entitled to a large salary payment at the time of her death. It was to be paid in five yearly payments. Her estate, after collecting two payments, distributes the right to the remaining payments to you, the beneficiary. None of the payments would be included on the decedent's final return. The estate must include in its gross income, as income in respect of the decedent, the two payments it received. You must include in your gross income each of the three remaining payments as you receive them.

Transferring your right to income. If you transfer your right to receive income in respect of a decedent, you must include in your income the larger of:

1) The amount you receive for the right, or
2) The fair market value of the right at the time of the transfer. Fair market value is defined in Chapter 14 under *Other Basis.*

Giving your right to income as a gift. If you give your right to receive income in respect of a decedent as a gift, you must include in your gross income the fair market value of the right at the time you make the gift.

Type of income. The character, or type, of income that you receive in respect of a decedent is generally the same as it would have been had the decedent continued to live and had received it. For example, if the income would have been a long-term capital gain to the decedent, it will be a long-term capital gain to you.

Interest on certificates of deposit (CDs). Interest on CDs that is not received by the date of death but that is earned between the date of the last interest payment and the date of death is interest income in respect of the decedent. Interest income earned on the account after the decedent's death that becomes payable on CDs after death is not income in respect of a decedent. Such interest is ordinary income that belongs to the respective recipients and must be included in their gross income.

Installment payments. If the decedent had sold property using the installment method and you receive the right to collect the payments after the date of death, the payments you collect are income in respect of the decedent. You will use the same gross profit percentage that the decedent used to figure the part of each payment that represents profit. Include in your income the same profit the decedent would have included had death not occurred. See Publication 537, *Installment Sales,* for more information on the installment method.

Sale or exchange. If you sell or exchange an installment obligation that you received from a decedent, the rules explained in Publication 537 for figuring the gain or loss on the disposition will apply. However, your basis in the obligation is the same as the decedent's basis, adjusted for all installment payments you received before the sale or exchange.

Other income. For examples of other income situations concerning decedents, see *Specific Types of Income in Respect of a Decedent* in Publication 559.

Deductions in Respect of the Decedent

Deductions in respect of the decedent are items, such as business expenses, income-producing expenses, interest, and taxes, for which the decedent was liable, but which are not deductible on the decedent's final income tax return. When paid, these expenses may be deducted by:

1) The estate, or
2) If the estate is not liable for the expenses, the person who, because of the decedent's death, acquired the decedent's property subject to that liability.

Federal estate tax deduction. Income that a decedent had a right to receive is included in the decedent's gross estate and is subject to estate tax. This income in respect of a decedent is also taxed when received by the estate or beneficiary. However, an income tax deduction is allowed to the person (or estate) receiving the income. If you must include in your gross income an amount of income in respect of a decedent, then you can claim a deduction for part of any estate tax paid. The deduction must be claimed in the same tax year that the income is included in your gross income.

You can claim the deduction only as a miscellaneous itemized deduction on Schedule A (Form 1040). This deduction is not subject to the 2% limit on miscellaneous itemized deductions as discussed in Chapter 30.

If the income is capital gain income, then in figuring the maximum capital gain tax or any net capital loss limitation, the amount of the gain must be reduced, but not below zero, by the amount of any estate tax deduction attributable to such gain.

For more information, see *Estate Tax Deduction* in Publication 559.

5.

Tax Withholding and Estimated Tax

Tax Law Changes

1994. There are several changes in the tax law that might affect your 1994 return. You must consider these changes in computing your tax and any underpayment penalty for 1994. You will also need to consider many of these items when you figure your estimated tax for 1995. These changes are briefly discussed under *Changes Effective in 1994.*

1995. There are also several changes in the tax law that will become effective in 1995. You will need to consider these changes when you figure your estimated tax for 1995. These changes are briefly discussed under *Changes Effective in 1995.*

Changes Effective in 1994

Changes to be considered. You should consider the items in this section when figuring your tax and any underpayment penalty for 1994. Unless an item applies only to 1994, you should also consider it when figuring your estimated tax for 1995. For more information on important tax changes, see Publication 553, *Highlights of 1994 Tax Changes.*

Excess social security or railroad retirement tax withholding. You will have excess social security or tier 1 railroad retirement tax withholding for 1994 only if your wages from two or more employers exceeded $60,600. See *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld* in Chapter 36.

Earned income credit. Beginning in 1994, the rules to determine eligibility for the credit and the rules for computing the credit have changed. See Chapter 35.

Taxability of social security and railroad retirement benefits. Beginning in 1994, certain taxpayers will need to include 85% of benefits received in taxable income. For more information, see Chapter 12.

Changes Effective in 1995

Changes to be considered. You should consider the items in this section when you figure your income tax withholding or estimated tax for 1995. Remember to also consider the items that apply from *Changes Effective in 1994.* For more information on important tax changes, see Publication 553, *Highlights of 1994 Tax Changes.*

Personal exemption. For 1995, the personal exemption amount for you, your spouse, and each dependent has increased to $2,500.

Phaseout of personal exemptions. Your deduction for personal exemptions is reduced by 2% for each $2,500 ($1,250 if you are married filing separately), or part of that amount, by which your adjusted gross income exceeds an amount based on your filing status. The amounts for 1995 are:

Single	$114,700
Married filing jointly or qualifying widow(er)	$172,050
Married filing separately	$ 86,025
Head of household	$143,350

Standard deduction. Individuals who do not itemize deductions have an increased standard deduction for 1995. For more information, see Publication 505, *Tax Withholding and Estimated Tax.*

Reduction of itemized deductions. For 1995, certain itemized deductions are reduced by 3% of your adjusted gross income that exceeds $114,700 ($57,350 if you are married filing separately). The reduction cannot be more than 80% of your affected deductions. Itemized deductions subject to the reduction are those other than medical expenses, investment interest, casualty and theft losses, or gambling losses. This reduction does not apply when computing alternative minimum tax, nor does it apply to estates or trusts.

Self-employment tax. For 1995, the social security (old-age, survivor, and disability insurance) part of the tax is 12.4% of net earnings up to a certain amount. The Medicare (hospital insurance) part of the self-employment tax is 2.9% of all net earnings. See Publication 505.

Lump-sum distributions. Beginning in 1995, you may be able to figure the tax on a lump-sum distribution under the 5-year tax option even if the plan participant was born after 1935. For more information, see Publication 575, *Pension and Annuity Income (Including Simplified General Rule).*

Important Reminders

Estimated tax payments — limit on the use of prior year's tax. Certain taxpayers (other than farmers and fishermen) may not be able to avoid an underpayment penalty by using 100% of their 1994 tax to figure their 1995 required annual payment. See Chapter 2 of Publication 505 if your 1994 adjusted gross income was more than $150,000 (more than $75,000 if you were married filing separately).

Underpayment penalty. A similar special rule applies to the underpayment penalty. See Chapter 4 of Publication 505.

Claiming withholding and estimated tax payments. When you file a federal income tax return, be sure to take credit for all federal income tax and excess social security or railroad retirement taxes withheld from your salary, wages, pensions, etc., and any backup withholding shown on Forms 1099. Also take credit for all estimated tax payments you made for that year. For example, all estimated tax payments made for 1994 should be claimed on the tax return you file for the 1994 tax year. You should file a return and claim these credits even if you do not owe tax. See *Credit for Withholding and Estimated Tax,* later in this chapter.

Introduction

This chapter discusses how to pay your tax as you earn or receive income during the year. In general, the federal income tax is a pay-as-you-go tax. There are two ways to pay as you go:

- ***Withholding.*** If you are an employee, your employer probably withholds income tax from your pay. Tax may also be withheld from certain other income — including pensions, bonuses, commissions, and gambling winnings. In each case, the amount withheld is paid to the Internal Revenue Service (IRS) in your name.
- ***Estimated tax.*** If you do not pay your tax through withholding, or do not pay enough tax that way, you might have to pay estimated tax. People who are in business for themselves generally will have to pay their tax this way. You may have to pay estimated tax if you receive income such as dividends, interest, rent, royalties, and unemployment compensation. Estimated tax is used to pay not only income tax, but self-employment tax and alternative minimum tax as well.

This chapter explains both of these methods. In addition, it explains:

- ***Credit for withholding and estimated tax.*** When you file your 1994 income tax return, take credit for all the income tax

withheld from your salary, wages, pensions, etc., and for the estimated tax you paid for 1994.

- ***Underpayment penalty.*** If you did not pay enough tax in 1994 either through withholding or by making estimated tax payments, you will have an underpayment of estimated tax, and you may have to pay a penalty. The IRS usually can compute this penalty for you. See *Underpayment Penalty,* near the end of this chapter.

Useful Items

You may want to see:

Publication

- ❑ **505** Tax Withholding and Estimated Tax
- ❑ **553** Highlights of 1994 Tax Changes
- ❑ **919** Is My Withholding Correct for 1995?

Form (and Instructions)

- ❑ **W–4** Employee's Withholding Allowance Certificate
- ❑ **W–4P** Withholding Certificate for Pension or Annuity Payments
- ❑ **W–4S** Request for Federal Income Tax Withholding From Sick Pay
- ❑ **1040–ES** Estimated Tax for Individuals
- ❑ **2210** Underpayment of Estimated Tax by Individuals, Estates, and Trusts

Withholding

Income tax is withheld from the following kinds of income:

Salaries and wages. Income tax is withheld from the pay of most employees. Your pay includes bonuses, commissions, and vacation allowances, in addition to your regular pay. It also includes reimbursements and other expense allowances paid under a nonaccountable plan. See *Supplemental Wages,* later.

Military retirees. Military retirement pay is treated in the same manner as regular pay for income tax withholding purposes, even though it is treated as a pension or annuity for other tax purposes.

Household workers. If you are a household worker, you can ask your employer to withhold income tax from your pay. Tax is withheld only if you want it withheld and your employer agrees to withhold it. If you do not have enough income tax withheld, you may have to make estimated tax payments, as discussed later under *Estimated Tax.*

Farmworkers. Income tax is generally withheld from your cash wages for work on a farm unless your employer:

1) Pays you cash wages of less than $150 during the year, and
2) Has expenditures for agricultural labor totaling less than $2,500 during the year.

If you receive either cash wages not subject to withholding or noncash wages, you can ask your employer to withhold income tax. If your employer does not agree to withhold tax, or if not enough is withheld, you may have to make estimated tax payments, as discussed later under *Estimated Tax.*

Tips. The tips you receive and report to your employer while working as an employee are counted in with your regular wages to figure the amount withheld.

Taxable fringe benefits. Your employer will withhold income tax from most taxable fringe benefits paid to you either at a flat 28% rate or at your regular rate of withholding.

Sick pay. Income tax is withheld from sick pay you receive from your employer or an agent of your employer, just as it is from your salaries and wages. If you receive sick pay from someone who is not acting as an agent of your employer, such as an insurance company, you can usually arrange to have income tax withheld from the sick pay. A special rule covers sick pay paid to you under certain union agreements.

Pensions and annuities. Income tax is generally withheld from your pension or annuity. In certain cases, however, you can choose not to have it withheld.

Gambling winnings. Income tax is withheld from certain gambling winnings at a flat 28% rate.

Withholding on Salaries and Wages

The amount of income tax withheld from your regular pay depends on two things:

1) The amount you earn, and
2) The information you give your employer on **Form W–4.**

Form W–4 includes three types of information that your employer will use to figure your withholding:

1) Whether to withhold at the single rate or at the lower married rate,
2) How many withholding allowances you claim (each allowance reduces the amount withheld), and
3) Whether you want an additional amount withheld.

If your income is low enough that you will not have to pay income tax for the year, you may be exempt from withholding. See *Exemption From Withholding,* later.

Note. You must specify a filing status and a number of withholding allowances on Form W–4. You cannot specify only a dollar amount of withholding.

New job. When you start a new job, you must fill out Form W–4 and give it to your employer. Your employer should have copies of the form. If you later need to change the information you gave, you must fill out a new form.

If you work only part of the year (for example, you start working after the beginning of the year), too much tax may be withheld. You may be able to avoid overwithholding if your employer agrees to use the part-year method. See *Part-year method* in Chapter 1 of Publication 505 for more information.

Changing your withholding. Events during the year may change your marital status or the exemptions, adjustments, deductions, or credits you expect to claim on your return. When this happens, you may need to give your employer a new Form W–4 to change your withholding status or allowances.

You ***must*** give your employer a new Form W–4 within 10 days after:

1) Your divorce, if you have been claiming married status, or
2) Any event that decreases the withholding allowances you can claim.

Generally, you can submit a new Form W–4 at any time you wish to change your withholding allowances for any other reason.

If events in 1995 will decrease your withholding allowances for 1996, you must give your employer a new Form W–4 by December 1, 1995. If the event occurs in December 1995, submit a new Form W–4 within 10 days.

Cumulative wage method. If you change your withholding allowances during the year, too much or too little tax may have been withheld for the period before you made the change. You may be able to compensate for this if your employer agrees to use the cumulative wage withholding method for the rest of the year. You must request in writing that your employer use this method.

To be eligible, you must have been paid for the same kind of payroll period (weekly, biweekly, etc.) since the beginning of the year.

Checking your withholding. After you have given your employer a Form W–4, you can check to see whether the amount of tax withheld from your pay is too little or too much. See *Getting the Right Amount of*

Tax Withheld, later. If too much or too little tax is being withheld, you should give your employer a new Form W–4 to change your withholding.

Note. You cannot give your employer a payment for any retroactive withholding or any estimated tax.

Completing Form W–4

The following discussions explain how to complete your Form W–4.

Marital status (line 3). There is a lower withholding rate for married people who can use the tax rates for joint returns. Everyone else must have tax withheld at the higher single rate.

You must claim ***single*** status if either of the following applies.

1) **You are single.** If you are divorced, or separated from your spouse under a court decree of separate maintenance, you are considered single.
2) **You are married, but you are neither a citizen nor a resident of the United States,** or your spouse is neither a citizen nor a resident of the United States. However, if one of you is a citizen or a resident, you can choose to have the other treated as a resident. You can then file a joint return and claim married status on your Form W–4. See *Nonresident Spouse Treated as a Resident* in Chapter 1 of Publication 519, *U.S. Tax Guide for Aliens,* for more information.

You can claim ***married*** status if either of the following applies.

1) **You are married and neither you nor your spouse is a nonresident alien.** You are considered married for the whole year even if your spouse died during the year.
2) **You expect to be able to file your return as a qualifying widow or widower.** You usually can use this filing status if your spouse died within the previous two years and you provide a home for your dependent child. However, you must file a new Form W–4 showing your filing status as single by December 1 of the last year you are eligible to file as qualifying widow or widower. See *Qualifying Widow(er) With Dependent Child* in Chapter 2.

Some married people find that they do not have enough tax withheld at the married rate. This can happen, for example, when both spouses work. To avoid this, you can choose to have tax withheld at the higher single rate (even if you qualify for the married rate).

Withholding allowances (line 5). The more allowances you claim on Form W–4, the less income tax your employer will withhold. You will have the most tax withheld if you claim ''0'' allowances. The number of allowances you can claim depends on:

1) How many exemptions you can take on your tax return,
2) Whether you have income from more than one job,
3) What deductions, adjustments to income, and credits you expect to have for the year, and
4) Whether you will file as head of household.

If you are married, it also depends on whether your spouse also works and claims any allowances on his or her own Form W–4. If you both work, you should figure your combined allowances on one Form W–4 worksheet. You then should divide the allowances among the Forms W–4 you each file with every employer. See *Two jobs,* later.

Form W–4 worksheets. Form W–4 has worksheets to help you figure how many withholding allowances you can claim. The worksheets are for your own records. Do not give them to your employer.

You are not required to use the worksheets if you use a more accurate method of figuring withholding allowances. See *Alternative method of figuring withholding allowances* under *Completing Form W–4 and Worksheets* in Chapter 1 of Publication 505 for more information.

Withholding and estimated tax. Before you figure your withholding allowances, use your estimated adjustments, deductions, and tax credits to reduce the amount of estimated tax you must pay. The *Deductions and Adjustments Worksheet* on page 2 of Form W–4 does this for you. But if you use an alternative method of figuring withholding allowances, take into account only the amount of these items remaining after you have reduced the estimated tax you must pay to zero.

Two jobs. If you have income from two jobs at the same time, complete only one set of Form W–4 worksheets. Then split your allowances between the Forms W–4 for each job. You cannot claim the same allowances with more than one employer at the same time. You can claim all your allowances with one employer and none with the other, or divide them in any other way you wish.

If both you and your spouse are employed and you expect to file a joint return, figure your withholding allowances using your combined income, adjustments, deductions, exemptions, and credits. Use only one set of worksheets. You can divide your total allowances in any way you wish, but you cannot claim an allowance that your spouse also claims.

If you and your spouse expect to file separate returns, figure your allowances separately based on your own individual income, adjustments, deductions, exemptions, and credits.

Personal Allowances Worksheet. Use the *Personal Allowances Worksheet* on page 1 of Form W–4 to figure your withholding allowances for exemptions. Add the special allowance for only one job, the allowance for head of household status, and the allowance for the child and dependent care credit (if they apply) to your total allowances.

Special allowance (worksheet line B). You can claim the special allowance if any of the following apply.

1) You are single, and you have only one job at a time.
2) You are married, you have only one job at a time, and your spouse does not work.
3) Your wages from a second job or your spouse's wages (or the total of both) are $1,000 or less.

Head of household (worksheet line E). You can claim one additional withholding allowance if you expect to file as head of household on your tax return. To find out whether you qualify, see *Head of Household* in Chapter 2.

Child and dependent care credit (worksheet line F). You can claim one additional withholding allowance if you expect to have at least $1,500 of qualifying child or dependent care expenses that you plan to claim a credit for on your tax return. For information on this credit, see Chapter 33.

Instead of using line F, you can choose to figure allowances for the child and dependent care credit (and other credits you expect to claim on your return) as explained next.

Deductions and Adjustments Worksheet. To adjust your withholding allowances for deductions, adjustments to income, and tax credits, use the *Deductions and Adjustments Worksheet* on page 2 of Form W–4. Chapter 1 of Publication 505 explains this worksheet.

Nonwage income. You may need to reduce the number of withholding allowances you would otherwise claim if you expect to receive taxable nonwage income. This includes interest, dividends, net rental income, unemployment compensation, alimony received, gambling winnings, prizes and awards, hobby income, capital gains, royalties, and partnership income.

Two-Earner/Two-Job Worksheet. You may need to complete this worksheet if you have two jobs or a working spouse. You should also use this worksheet to figure additional withholding if you expect to owe an amount other than income tax, such as self-employment tax.

For more information about Form W–4 and a filled-in example, see Chapter 1 of Publication 505.

Getting the Right Amount of Tax Withheld

In most situations, the tax withheld from your pay will be close to the tax you figure on your return if:

1) You accurately complete all the Form W–4 worksheets that apply to you, and
2) You give your employer a new Form W–4 when changes occur.

But because the worksheets and withholding methods do not account for all possible situations, you may not be getting the right amount withheld. This is most likely to happen in the following situations.

1) You are married and both you and your spouse work.
2) You have more than one job at a time.
3) You have nonwage income, such as interest, dividends, alimony, unemployment compensation, or self-employment income.
4) You will owe additional amounts with your return, such as self-employment tax.
5) Your withholding is based on obsolete Form W–4 information for a substantial part of the year.
6) Your earnings exceed $150,000 if you are single or $200,000 if you are married.

To make sure you are getting the right amount of tax withheld, get Publication 919. It will help you compare the total tax to be withheld in 1995 with the tax you can expect to figure on your return. It also will help you determine how much additional withholding is needed each payday to avoid owing tax when you file your return. If you do not have enough tax withheld, you may have to make estimated tax payments, as explained under *Estimated Tax,* later.

Rules Your Employer Must Follow

The following are some of the withholding rules that can affect how you fill out your Form W–4 and how you handle problems that may arise. For other rules, see *Rules Your Employer Must Follow* in Chapter 1 of Publication 505.

Putting a new Form W–4 into effect. When you start a new job, your employer should give you a Form W–4 to fill out. Your employer will use the information you give on the form to figure your withholding, beginning with your first payday.

If you later fill out a new Form W–4, your employer can put it into effect as soon as it is practical to do so. The deadline for putting it into effect is the start of the first payroll period ending 30 or more days after you turn it in.

Withholding without a Form W–4. If you do not give your employer a completed Form W–4, your employer must withhold at the highest rate—as if you were single and claimed no allowances.

Repaying withheld tax. If you find you are having too much tax withheld because you did not claim all the withholding allowances you are entitled to, you should give your employer a new Form W–4. Your employer cannot repay you any of the tax withheld under your old Form W–4.

However, if your employer has withheld more than the correct amount of tax for the Form W–4 you have in effect, you do not have to fill out a new Form W–4 to have your withholding lowered to the correct amount. Your employer can repay you the amount that was incorrectly withheld. If you are not repaid, you will receive credit on your tax return for the full amount actually withheld.

Exemption From Withholding

If you claim exemption from withholding, your employer will not withhold federal income tax from your wages. The exemption applies only to income tax, not to social security or Medicare tax.

You can claim exemption from withholding for 1995 only if ***both*** the following situations apply.

1) For 1994 you had a right to a refund of all federal income tax withheld because you had no tax liability.
2) For 1995 you expect a refund of all federal income tax withheld because you expect to have no tax liability.

Use *Figure 5–A* in this chapter to help you decide whether you can claim exemption. Do not use the chart if you are 65 or older or blind, or if you will itemize deductions or claim dependents or tax credits on your 1995 return. These situations are discussed later.

Student. If you are a student, you are not automatically exempt. See Chapter 1 to see if you must file a return. If you work only part time or only during the summer, you may qualify for exemption from withholding.

Example 1. You are a high school student and expect to earn $2,500 from a summer job. You do not expect to have any other income during 1995, and your parents will be able to claim you as a dependent on their tax return. You worked last summer and had $375 federal income tax withheld from your pay. The entire $375 was refunded when you filed your 1994 return. Using *Figure 5–A,* you find that you ***can*** claim exemption from withholding.

Example 2. The facts are the same as in Example 1, except that you have a savings account and expect to have $20 interest income in 1995. Using *Figure 5–A,* you find that you ***cannot*** claim exemption from withholding because your unearned income will be $1 or more and your total income will be more than $650.

Age 65 or older or blind. If you are 65 or older or blind, use one of the worksheets in Chapter 1 of Publication 505, under *Exemption From Withholding,* to help you decide whether you can claim exemption from withholding. Do not use either of those worksheets if you will itemize deductions or claim dependents or tax credits on your 1995 return—see the following discussion instead.

Itemizing deductions or claiming dependents or tax credits. If you had no tax liability for 1994 and you will itemize your deductions or claim dependents or tax credits on your 1995 return, use the 1995 Estimated Tax Worksheet in Form 1040–ES (or see Chapter 2 of Publication 505) to figure your 1995 expected tax liability. You can claim exemption from withholding only if your total expected tax liability (line 13c of the worksheet) is zero.

Claiming exemption. To claim exemption, you must give your employer a Form W–4. Write in the word ''EXEMPT'' on line 7.

Your employer must send the IRS a copy of your Form W–4 if you claim exemption from withholding and your pay is expected to usually be more than $200 a week. If it turns out that you do not qualify for exemption, the IRS will send both you and your employer a written notice.

If you claim exemption, but later your situation changes so that you will have to pay income tax after all, you must file a new Form W–4 within 10 days after the change. If you claim exemption in 1995, but you expect to owe income tax for 1996, you must file a new Form W–4 by December 1, 1995.

An exemption is good for only one year. You must give your employer a new Form W–4 by February 15 each year to continue your exemption.

Supplemental Wages

Supplemental wages include bonuses, commissions, overtime pay, and certain sick pay. Your employer or other payer of supplemental wages may withhold income tax from these wages at a flat rate of at least 28%. The payer can also figure withholding using the same method used for your regular wages.

Also see *Withholding on Sick Pay,* later.

Expense allowances. Reimbursements or other expense allowances paid by your employer under a nonaccountable plan are treated as supplemental wages.

Reimbursements or other expense allowances paid under an accountable plan are treated as paid under a nonaccountable plan to the extent they are more than your proven expenses. However, this does not apply if you return the excess payments within a reasonable period of time.

For more information about accountable and nonaccountable expense allowance plans, see *Reimbursements* in Chapter 28.

Penalties

You may have to pay a penalty of $500 if:

1) You make statements or claim withholding allowances on your Form W–4 that reduce the amount of tax withheld, and
2) You have no reasonable basis for such statements or allowances at the time you prepare your Form W–4.

There is also a criminal penalty for willfully supplying false or fraudulent information on your Form W–4 or for willfully failing to supply information that would increase the amount withheld. The penalty upon conviction can be either a fine of up to $1,000 or imprisonment for up to one year, or both.

These penalties will apply if you deliberately and knowingly falsify your Form W–4 in an attempt to reduce or eliminate the proper withholding of taxes. A simple error — an honest mistake — will not result in one of these penalties. For example, a person who has tried to figure the number of withholding allowances correctly, but claims seven when the proper number is six, will not be charged a W–4 penalty.

Withholding on Tips

The tips you receive while working on your job are considered part of your pay. You must include your tips on your tax return on the same line as your regular pay. However, tax is not withheld directly from tip income, as it is from your regular pay. Nevertheless, your employer will take into account the tips you report when figuring how much to withhold from your regular pay.

See Chapter 7 for information on reporting your tips to your employer. For more information on the withholding rules for tip income, see Publication 531, *Reporting Tip Income.*

Figuring the amount to withhold. The tips you report to your employer are counted as part of your income for the month you report them. Your employer can figure your withholding in either of two ways:

1) By withholding at the regular rate on the sum of your pay plus your reported tips, or
2) By withholding at the regular rate on your pay plus an amount equal to 28% of your reported tips.

Not enough pay to cover taxes. If your regular pay is too low for your employer to withhold all the tax (including social security tax, Medicare tax, or railroad retirement tax) due on your pay plus your tips, you may give your employer money to cover the shortage.

If you do not give your employer money to cover the shortage, your employer will first withhold as much social security tax, Medicare tax, or railroad retirement tax as possible, up to the proper amount, and then withhold income tax up to the full amount of your pay. If not enough tax is withheld, you may have to make estimated tax payments. When you file your return, you also may have to pay any social security tax, Medicare tax, or railroad retirement tax your employer could not withhold.

Allocated tips. Your employer should not withhold income tax, social security tax, Medicare tax, or railroad retirement tax on any allocated tips. Withholding is based only on your pay plus your ***reported tips.*** Your employer should refund to you any incorrectly withheld tax. See *Tip Allocation* in Chapter 7 for more information.

Withholding on Taxable Fringe Benefits

The value of certain noncash fringe benefits you receive from your employer is considered part of your pay. Your employer generally must withhold income tax on these benefits from your regular pay for the period the benefits are paid or considered paid.

For information on taxable fringe benefits, see *Fringe Benefits* under *Employee Compensation* in Chapter 6.

Your employer can choose not to withhold income tax on the value of your personal use of a car, truck, or other highway motor vehicle provided by your employer. Your employer must notify you if this choice is made.

For more information on withholding on taxable fringe benefits, see Chapter 1 of Publication 505.

Withholding on Sick Pay

''Sick pay'' is a payment to you to replace your regular wages while you are temporarily absent from work due to sickness or personal injury. To qualify as ''sick pay,'' it must be paid under a plan to which your employer is a party.

If you receive sick pay from your employer or an agent of your employer, income tax must be withheld just as it is from your regular pay.

However, if you receive sick pay from a third party who is not acting as an agent of your employer, income tax will be withheld only if you choose to have it withheld. See *Form W–4S,* later.

If you receive payments under a plan in which your employer does not participate (such as an accident or health plan where you paid all the premiums), the payments are not sick pay and usually are not taxable.

Union agreements. If you receive sick pay under a collective bargaining agreement between your union and your employer, the agreement may determine the amount of income tax withholding on sick pay. See your union representative or your employer for more information.

Form W–4S. If you choose to have income tax withheld from sick pay paid by a third party, such as an insurance company, you must fill out Form W–4S, *Request for Federal Income Tax Withholding From Sick Pay.* Its instructions contain a worksheet you can use to figure the amount you want withheld. They also explain restrictions that may apply.

Give the completed form to the payer of your sick pay. The payer must withhold according to your directions on the form.

If you do not request withholding on Form W–4S, or if you do not have enough tax withheld, you may have to make estimated tax payments. If you do not pay enough estimated tax or have enough income tax withheld, you may have to pay a penalty. See *Who Must Make Estimated Tax Payments* and *Underpayment Penalty,* later in this chapter.

Withholding on Pensions and Annuities

Income tax usually will be withheld from your pension or annuity distributions, unless you choose not to have it withheld. This rule applies to distributions from:

1) An individual retirement arrangement (IRA),
2) A life insurance company under an endowment, annuity, or life insurance contract,
3) A pension, annuity, or profit-sharing plan,
4) A stock bonus plan, and
5) Any other plan that defers the time you receive compensation.

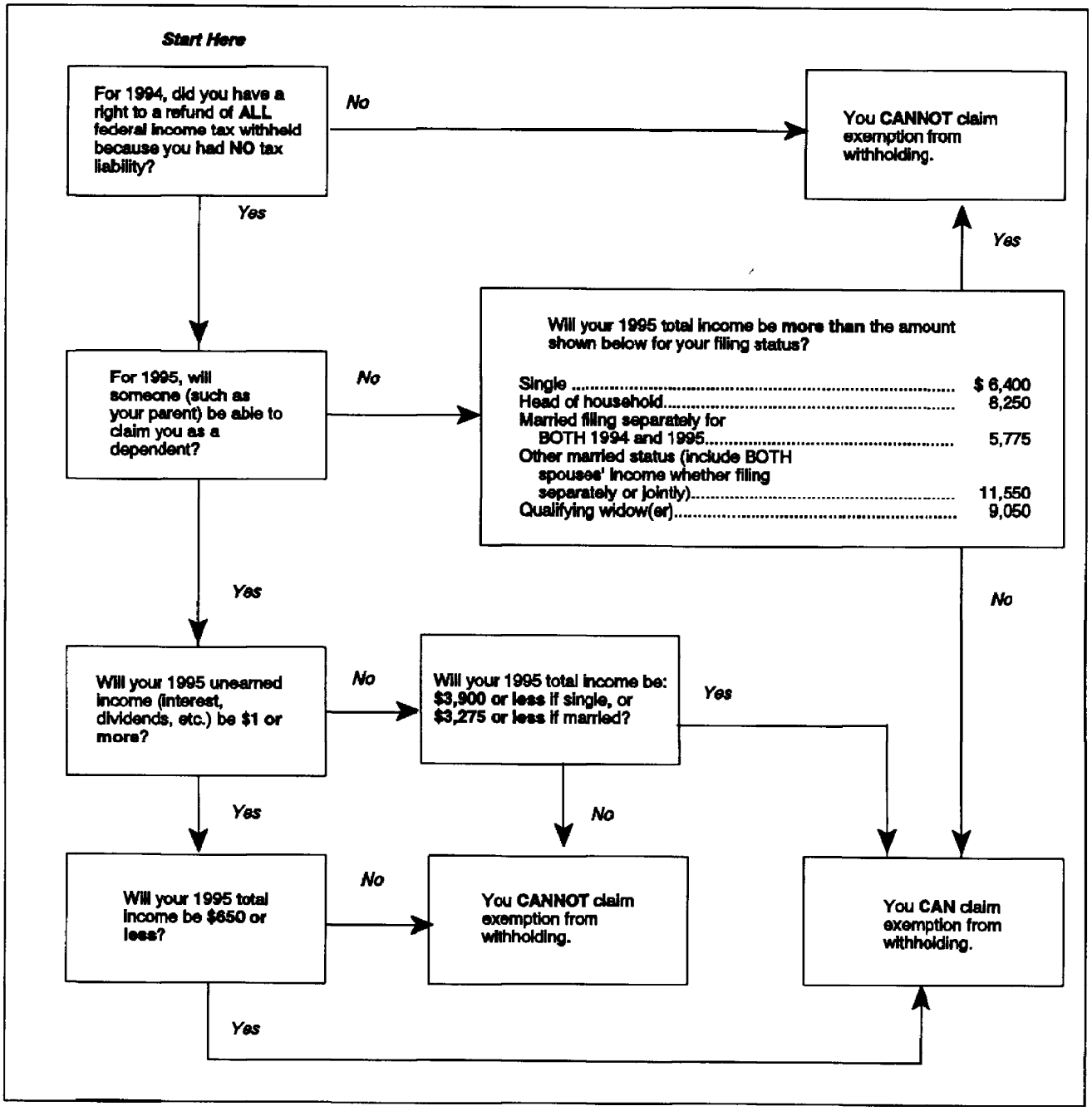
This rule does not apply to eligible rollover distributions.

The amount withheld depends on whether you receive payments spread out over more than one year (periodic payments) or whether you receive all the payments within one year (nonperiodic payments).

More information. For more information on distributions (including eligible rollover distributions) from and taxation of qualified retirement plans and annuities, see Chapter 11. For information on IRAs, see Chapter 18. For more information on withholding on pensions and annuities, including a discussion of **Form W–4P,** *Withholding Certificate for Pension or Annuity Payments,* see *Withholding on Pensions and Annuities* in Chapter 1 of Publication 505.

Figure 5-A. Exemption From Withholding on Form W-4

NOTE: Do not use this chart if you are 65 or older or blind, or if you will itemize your deductions or claim dependents or tax credits. Instead, see the discussions in this chapter under *Exemption From Withholding*.



Withholding on Gambling Winnings

Income tax is withheld from certain kinds of gambling winnings. The amount withheld from proceeds (the amount of your winnings minus the amount of your bet) paid is 28%.

Gambling winnings of more than $5,000 from the following sources are subject to income tax withholding:

1) Any sweepstakes, wagering pool, or lottery, and

2) Any other wager, if the proceeds are at least 300 times the amount of the bet.

It does not matter if payment is in cash, property, or as an annuity. Proceeds not in money shall be taken into account at their fair market value.

Gambling winnings from bingo, keno, and slot machines are not subject to income tax withholding. If you receive gambling winnings not subject to withholding, you may need to make estimated tax payments. (See *Estimated Tax,* later.)

If you do not pay enough tax through withholding or estimated tax payments, you may be subject to a penalty. (See *Underpayment Penalty,* later.)

Form W–2G. If a payer withholds income tax from your gambling winnings, you should receive a Form W–2G, *Certain Gambling Winnings,* showing the amount you won and the amount withheld. Report your winnings on line 21 of Form 1040 and report the tax withheld on line 54 of Form 1040. Gambling losses are deductible only to the extent that they offset gambling winnings. You must use Schedule A of Form 1040 to deduct your losses and to deduct state tax withholding.

Backup Withholding

Banks and other businesses that pay you certain kinds of income must file an information return (Form 1099) with the IRS. The information return shows how much you were paid during the year. It also includes your name and taxpayer identification number (TIN). Your TIN is either a social security number or an employer identification number.

These payments generally are not subject to withholding. However, ''backup'' withholding is required in certain situations. And, backup withholding can apply to most kinds of payments that are reported on Form 1099.

Payments made to you are subject to backup withholding at a flat 31% rate in the following situations.

1) You do not give the payer your TIN in the required manner.
2) The IRS notifies the payer that the TIN you gave is incorrect.
3) You are required, but fail, to certify that you are not subject to backup withholding.
4) The IRS notifies the payer to start withholding on interest or dividends because you have underreported interest or dividends on your income tax return. The IRS will do this only after it has mailed you four notices over at least a 120-day period.

See *Backup Withholding* in Chapter 1 of Publication 505 for more information.

Penalties. There are civil and criminal penalties for giving false information to avoid backup withholding. The civil penalty is $500. The criminal penalty, upon conviction, is a fine of up to $1,000, or imprisonment of up to one year, or both.

Estimated Tax

Estimated tax is the method used to pay tax on income that is not subject to withholding. This includes income from self-employment, unemployment compensation, interest, dividends, alimony, rent, gains from the sale of assets, prizes, and awards. You also may have to pay estimated tax if the amount of income tax being withheld from your salary, pension, or other income is not enough. To figure and pay estimated tax, use **Form 1040–ES,** *Estimated Tax for Individuals.*

Estimated tax is used to pay both income tax and self-employment tax, as well as other taxes and amounts reported on Form 1040. If you do not pay enough tax through withholding or by making estimated tax payments, you may be charged a penalty. If you do not pay enough by the due date of each payment period (see *When to Pay Estimated Tax,* later), you may be charged a penalty even if you are due a refund when you file your tax return. For information on when the penalty applies, see *Underpayment Penalty,* later.

Who Must Make Estimated Tax Payments

If you had a tax liability for 1994, you may have to pay estimated tax for 1995.

General rule. You must make estimated tax payments for 1995 if you expect to owe at least $500 in tax for 1995 after subtracting your withholding and credits, and you expect your withholding and credits to be less than the smaller of:

1) 90% of the tax to be shown on your 1995 tax return, or
2) 100% of the tax shown on your 1994 tax return. Your 1994 tax return must cover all 12 months.

Note. If all your 1995 income will be subject to income tax withholding, you probably do not need to make estimated tax payments.

Exceptions. There are exceptions to the general rule if you are a farmer or fisherman or your 1994 adjusted gross income was more than $150,000 ($75,000 if you were married filing separately). See Chapter 2 of Publication 505 for more information.

To whom the rules apply. The estimated tax rules apply to:

- U.S. citizens and residents,
- Residents of Puerto Rico, the Virgin Islands, Guam, the Commonwealth of the Northern Mariana Islands, and American Samoa, and
- Nonresident aliens (use Form 1040–ES(NR)).

If you also receive salaries or wages, you can avoid having to make estimated tax payments by asking your employer to take more tax out of your earnings. To do this, file a new Form W–4 with your employer.

No tax liability last year. You do not have to pay estimated tax for 1995 if you meet all three of the following conditions:

1) You had no tax liability for your 1994 tax year,
2) You were a U.S. citizen or resident for the whole year, and
3) Your 1994 tax year covered a 12-month period.

You had no tax liability for 1994 if your total tax (defined later under *Required annual payment*) was zero or you did not have to file an income tax return.

Married taxpayers. To figure whether you must make estimated tax payments for 1995, apply the rules discussed here to your 1995 separate estimated income. If you can make joint estimated tax payments, you can apply these rules on a joint basis.

You and your spouse can make joint payments of estimated tax even if you are not living together.

You and your spouse cannot make joint estimated tax payments if you are separated under a decree of divorce or separate maintenance. Also, you cannot make joint estimated tax payments if either spouse is a nonresident alien or if you have different tax years.

Whether you and your spouse make joint estimated tax payments or separate payments will not affect your choice of filing a joint tax return or separate returns for 1995.

Change from 1994 separate returns to 1995 joint return. If you plan to file a joint return with your spouse for 1995, but you filed separate returns for 1994, your 1994 tax is the total of the tax shown on your separate returns. You filed a separate return for 1994 if you filed as single, head of household, or married filing separately.

Change from 1994 joint return to 1995 separate return. If you plan to file a separate return for 1995, but you filed a joint return with your spouse for 1994, your 1994 tax is your share of the tax on the joint return. You file a separate return for 1995 if you file as single, head of household, or married filing separately. To figure your share, first figure the tax both you and your spouse would have paid had you filed separate returns for 1994 using the same filing status as for 1995. Then multiply your joint tax liability by the following fraction:

$$\frac{\text{Your separate tax liability}}{\text{Both spouses' separate tax liabilities}}$$

Example. Joe and Phyllis filed a joint return for 1994 showing taxable income of $48,000 and a tax of $8,507. Of the $48,000 taxable income, $40,000 was Joe's and Phyllis was responsible for the rest. For 1995, they plan to file married filing separately. Joe figures his share of the tax on the 1994 joint return as follows:

Tax on $40,000 based on a separate return	$ 8,737
Tax on $8,000 based on a separate return	1,204
Total	$ 9,941

Joe's portion of total ($8,737 ÷ $9,941)	88%
Joe's share of joint return tax ($8,507 × 88%)	$ 7,486

Aliens. Resident and nonresident aliens have to make estimated tax payments. Resident aliens should follow the rules in this chapter unless noted otherwise. Nonresident aliens should get **Form 1040–ES(NR),** *U.S. Estimated Tax for Nonresident Alien Individuals.*

How to Figure Estimated Tax

To figure your estimated tax for 1995, you must figure your expected adjusted gross income, taxable income, and taxes and credits for the year.

When figuring your 1995 estimated tax, it may be helpful to use your income, deductions, and credits for 1994 as a starting point. Use your 1994 federal tax return as a guide. You will also need Form 1040–ES to figure and pay your estimated tax for 1995. You must be careful to make adjustments both for changes in your own situation and for recent changes in the tax law. For 1995, there are several important changes in the law. These changes are discussed under *Tax Law Changes* at the beginning of this chapter.

Form 1040–ES includes a worksheet to help you figure your estimated tax. Keep the worksheet for your records.

For complete information and examples on how to figure your estimated tax for 1995, see Chapter 2 of Publication 505.

Expected adjusted gross income. Your expected adjusted gross income for 1995 is your expected total income minus your expected adjustments to income. Include all the income you expect to receive during the year, even income that is subject to withholding. However, do not include income that is tax exempt. Be sure to subtract all the adjustments to income you expect to take on your 1995 tax return. These are the adjustments shown on the 1994 Form 1040, that you included in the total on line 30. On the 1994 Form 1040A, these are the adjustments included in the total on line 15c.

If you expect to receive social security benefits, you can use *Worksheet 2.1* in Chapter 2 of Publication 505 to figure your expected taxable benefits.

If you are self-employed, you can use *Worksheet 2.2* in Chapter 2 of Publication 505 to figure your deduction for one-half your expected self-employment tax.

Expected taxable income. Reduce your expected adjusted gross income by either your expected itemized deductions or your standard deduction and by a $2,500 deduction for each exemption. For information on the 1995 standard deduction amounts and a possible limit on your itemized deductions, see Publication 505 or the instructions for Form 1040–ES.

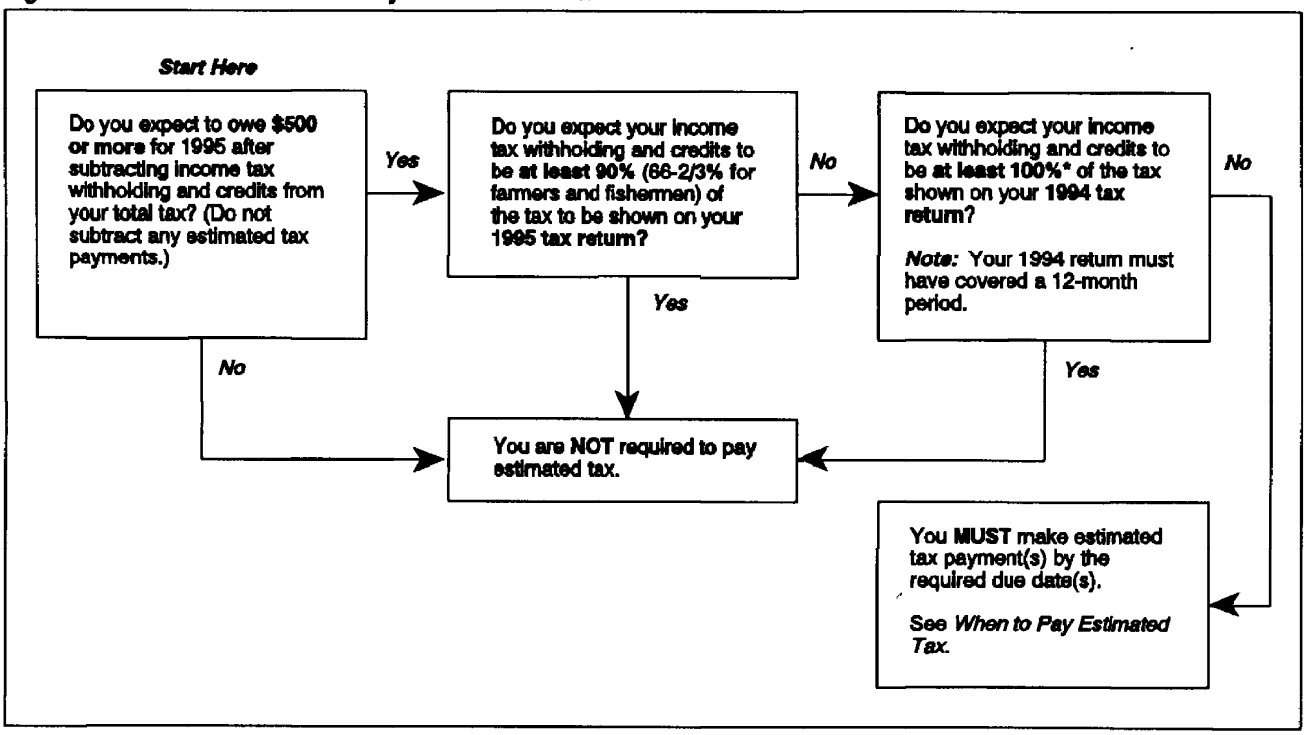
Expected taxes and credits. After you have figured your expected taxable income, figure your expected income tax. Use the 1995 Tax Rate Schedules near the end of Publication 505 or in the Form 1040–ES instructions. See Chapter 2 of Publication 505 for the special tax computation to use for a child under age 14 who has more than $1,300 of investment income.

Add your expected additional taxes from Form 4970, *Tax on Accumulation Distribution of Trusts,* and Form 4972, *Tax on Lump-Sum Distributions.* Subtract your expected credits. These are the credits shown on the 1994 Form 1040 that you included in the total on line 45. On the 1994 Form 1040A, these are the total credits on line 24c. If your credits are more than your taxes, use "–0–" as the result.

Add your expected self-employment tax and other taxes (see Chapter 2 of Publication 505). Other taxes are those shown on lines 48, 49 (other than from Form 8828), and 51 of the 1994 Form 1040, plus advance earned income credit payments on line 52 and any write-in amounts on line 53. Do not include uncollected social security, Medicare, or railroad retirement tax. On the 1994 Form 1040A, include as "other tax" any advance earned income credit payments on line 26.

Finally, subtract your expected earned income credit and fuel tax credit (from Form 4136). The result is your expected total tax for 1995.

Figure 5-B. Do You Have To Pay Estimated Tax?



*110% if less than two-thirds of your gross income for 1994 or 1995 is from farming or fishing and your 1994 adjusted gross income was more than $150,000 ($75,000 if your filing status for 1995 is married filing a separate return)

Required annual payment. You figure the total amount you must pay for 1995 through withholding and estimated tax payments on lines 14a through 14c of the 1995 Estimated Tax Worksheet. The result is your required annual payment. It is the ***smaller*** of:

1) 90% of your total expected tax for 1995, or

2) 100% of the total tax shown on your 1994 return. (Your 1994 tax return must cover all 12 months.)

Exceptions. If you are a farmer or fisherman, or your 1994 adjusted gross income was more than $150,000 ($75,000 if your filing status for 1995 is married filing a separate return), your required annual payment may be different. See *Required Annual Payment* in Chapter 2 of Publication 505.

Total tax for 1994. Your 1994 total tax on Form 1040 is the amount on line 53 reduced by the total of the amounts on lines 50 and 56, any credit from Form 4136 included on line 59, any uncollected social security, Medicare, or railroad retirement tax included on line 53, any tax from Form 5329 (other than the tax on early distributions) included on line 51, and any tax from Form 8828 included on line 49. On Form 1040A, it is line 27 reduced by line 28c. On Form 1040EZ, it is line 9 reduced by line 7.

Total estimated tax payments. Figure the total amount you must pay for 1995 through estimated tax payments on lines 15 and 16 of the 1995 Estimated Tax Worksheet. Subtract your expected withholding from your required annual payment. You usually must pay this difference in four equal installments. (See *When to Pay Estimated Tax* and *How to Figure Each Payment,* later.)

If your total expected tax on line 13c, minus your expected withholding on line 15, is less than $500, you do not need to make estimated tax payments.

Withholding. Your expected withholding for 1995 includes the income tax you expect to be withheld from all sources (wages, pensions and annuities, etc.). It also includes excess social security and railroad retirement tax you expect to be withheld from your wages.

For information on excess social security or tier 1 railroad retirement tax withholding for 1995, see Publication 505.

When to Pay Estimated Tax

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. If you do not pay enough tax by the due date of each of the payment periods, you may be charged a penalty even if you are due a refund when you file your income tax return. The following chart gives the payment periods and due dates for 1995 estimated tax payments.

For the period:	Due date:
Jan. 1* through Mar. 31	April 15
April 1 through May 31	June 15
June 1 through Aug. 31	September 15
Sept. 1 through Dec. 31	January 15 next year**

*If your tax year does not begin on January 1, see *Fiscal year taxpayers,* later.

**See *January payment,* later.

Saturday, Sunday, holiday rule. If the due date for making an estimated tax payment falls on a Saturday, Sunday, or legal holiday, the payment will be on time if you make it on the next day that is not a Saturday, Sunday, or legal holiday. For example, a payment due April 15, 1995, will be on time if you make it by April 17, 1995.

January payment. If you file your 1995 return by January 31, 1996, and pay the rest of the tax you owe, you do not need to make your estimated tax payment that would be due on January 16, 1996.

Fiscal year taxpayers. If your tax year does not start on January 1, your payment due dates are:

The 15th day of the 4th month of your fiscal year,

The 15th day of the 6th month of your fiscal year,

The 15th day of the 9th month of your fiscal year, and

The 15th day of the 1st month after the end of your fiscal year.

You do not have to make the last payment listed above if you file your income tax return by the last day of the first month after the end of your fiscal year and pay all the tax you owe with your return.

When to Start

You do not have to make estimated tax payments until you have income on which you will owe the tax. If you have income subject to estimated tax during the first payment period, you must make your first payment by the due date for the first payment period. You can pay all your estimated tax at that time, or you can pay it in four installments. If you choose to pay in installments, make your first payment by the due date for the first payment period. Make your remaining installments by the due dates for the later periods.

If you first have income subject to estimated tax during a later payment period, you must make your first payment by the due date for that period. You can pay your entire estimated tax by the due date for that period, or you can pay it in installments by the due date for that period and the due dates for the remaining periods. The following chart shows when to make installment payments:

If you first have income on which you must pay estimated tax:	Make a payment by:	Make later installments by:
Before April 1	April 15	June 15 September 15 January 15 next year*
After March 31 and before June 1	June 15	September 15 January 15 next year*
After May 31 and before Sept. 1	September 15	January 15 next year*
After August 31	January 15 next year*	(None)

*See *January payment,* and *Saturday, Sunday, holiday rule* under *When to Pay Estimated Tax,* earlier.

After making your first estimated tax payment, changes in your income, adjustments, deductions, credits, or exemptions may make it necessary for you to refigure your estimated tax. Pay the unpaid balance of your amended estimated tax by the next payment due date after the change or in installments by that date and the due dates for the remaining payment periods.

To determine how much you should pay by each payment due date, see *How to Figure Each Payment,* next.

How to Figure Each Payment

You should pay enough estimated tax by the due date of each payment period to avoid a penalty for that period. If you do not pay enough each payment period, you may be charged a penalty even if you are due a refund when you file your tax return. See *Underpayment Penalty,* later in this chapter.

Regular Installment Method

If you must pay estimated tax beginning with the payment due April 17, 1995, you can figure your required payment for each period by dividing your total estimated tax payments (line 16 of the 1995 Estimated Tax Worksheet) by 4. Use this method only if your required annual payment stays the same throughout the year. (Under certain circumstances, your required payment may be less. See *Annualized Income Installment Method,* later.)

Amended estimated tax. If you refigure your estimated tax during the year, or if your

first payment is due after April 17, 1995, figure your required payment for each remaining payment period using the following worksheet.

1. Amended total estimated tax payments ..... _____
2. Multiply line 1 by:
   .50 if next payment is due June 15, 1995.
   .75 if next payment is due September 15, 1995.
   1.00 if next payment is due January 16, 1996. ..... _____
3. Estimated tax payments for all previous periods ..... _____
4. **Next required payment:** Subtract line 3 from line 2 and enter the result (but not less than zero) here and on your payment-voucher for your next required payment ..... _____

If the payment on line 4 is due January 16, 1996, **stop here.** Otherwise, go on to line 5.

5. Add lines 3 and 4 ..... _____
6. Subtract line 5 from line 1 and enter the result (but not less than zero) .... _____
7. **Each following required payment:** If the payment on line 4 is due June 15, 1995, enter one-half of the amount on line 6 here and on the payment-vouchers for your payments due September 15, 1995, and January 16, 1996. If the amount on line 4 is due September 15, 1995, enter the full amount on line 6 here and on the payment-voucher for your payment due January 16, 1996 ..... _____

Example. Early in 1995, you figure your estimated tax is $1,800. You make estimated tax payments on April 17 and June 15 of $450 each ($1,800 ÷ 4).

On July 10, you sell investment property at a gain. Your refigured estimated tax is $3,600. Your required estimated tax payment for the third payment period is $1,800, figured as follows.

1. Amended total estimated tax payments $3,600
2. Multiply line 1 by:
   .50 if next payment is due June 15, 1995.
   .75 if next payment is due September 15, 1995.
   1.00 if next payment is due January 16, 1996. 2,700
3. Estimated tax payments for all previous periods 900
4. **Next required payment:** Subtract line 3 from line 2 and enter the result (but not less than zero) here and on your payment-voucher for your next required payment $1,800

If the payment on line 4 is due January 16, 1996, **stop here.** Otherwise, go on to line 5.

5. Add lines 3 and 4 2,700
6. Subtract line 5 from line 1 and enter the result (but not less than zero) 900
7. **Each following required payment:** If the payment on line 4 is due June 15, 1995, enter one-half of the amount on line 6 here and on the payment-vouchers for your payments due September 15, 1995, and January 16, 1996. If the amount on line 4 is due September 15, 1995, enter the full amount on line 6 here and on the payment-voucher for your payment due January 16, 1996 ..... $900

If your estimated tax does not change again, your required estimated tax payment for the fourth payment period will be $900.

Note. If your estimated tax payment for a previous period is less than one-fourth of your amended estimated tax, you may be charged a penalty for underpayment of estimated tax for that period when you file your tax return. To avoid the penalty, you must show that the total of your withholding and estimated tax payment for the period was at least as much as your annualized income installment. Complete Form 2210 and Schedule AI — *Annualized Income Installment Method,* and attach the form and Schedule AI to your tax return. See *Form 2210,* later, under *Underpayment Penalty,* for more information.

Annualized Income Installment Method

If you do not receive your income evenly throughout the year (for example, your income from a repair shop you operate is much larger in the summer than it is during the rest of the year), your required estimated tax payment for one or more periods may be less than the amount figured using the regular installment method.

To see if you can pay less for any period, complete the *1995 Annualized Estimated Tax Worksheet (Worksheet 2.12)* in Chapter 2 of Publication 505.

Note. If you use the annualized income installment method to figure your estimated tax payments, you ***must*** attach to your tax return a completed Form 2210 and Schedule AI (Form 2210). See *Form 2210* under *Underpayment Penalty,* later.

Estimated Tax Payments Not Required

You do not have to make estimated tax payments if your withholding in each payment period is at least one-fourth of your required annual payment or at least your required annualized income installment for that period. You also do not have to make estimated tax payments if you will pay enough through withholding to keep the amount you owe with your 1995 return under $500.

How to Pay Estimated Tax

There are two ways to make estimated tax payments:

1) By crediting an overpayment on your 1994 return to your 1995 estimated tax, and
2) By sending in your payment with a payment-voucher from **Form 1040–ES.**

Crediting an Overpayment

When you file your Form 1040 or Form 1040A for 1994 and you have an overpayment of tax, you can apply part or all of it to your estimated tax for 1995. On line 63 of Form 1040, or line 31 of Form 1040A, write the amount you want credited to your estimated tax rather than refunded. The amount you have credited should be taken into account when figuring your estimated tax payments. You can use all the credited amount toward your first payment, or you can spread it out in any way you choose among any or all of your payments.

If you ask that an overpayment be credited to your estimated tax for the next year, the payment is considered to have been made on the due date of the first estimated tax installment (April 15 for calendar year taxpayers). You cannot have any of that amount refunded to you after that due date. You also cannot use that overpayment in any other way after that date.

Using the Payment-Vouchers

Each payment of estimated tax must be accompanied by a payment-voucher from Form 1040–ES. If you made estimated tax payments last year, you should receive a copy of the 1995 Form 1040–ES in the mail. It will have payment-vouchers preprinted with your name, address, and social security number. Using the preprinted vouchers will speed processing, reduce the chance of error, and help save processing costs.

If you did not pay estimated tax last year, you will have to get a copy of Form 1040–ES from the IRS. Do so by calling toll-free 1–800–TAX–FORM (1–800–829–3676). After you make your first payment, the IRS will mail to you a Form 1040–ES package with preprinted vouchers. Follow the instructions in the package to make sure you use the vouchers correctly.

Use the addressed envelopes that came with your Form 1040–ES package. If you use your own envelope, make sure you mail your payment-vouchers to the address shown in the Form 1040–ES instructions for the place where you live. ***Do not*** use the address shown in the Form 1040 or Form 1040A instructions.

Change of address. You must notify the IRS if you are making estimated tax payments and you changed your address during the year. You must send a clear and concise written statement to the IRS Service Center where you filed your last return and provide all of the following:

1) Your full name (and your spouse's full name),
2) Your signature (and spouse's signature),
3) Your old address (and spouse's old address if different),
4) Your new address, and
5) Your social security number (and spouse's social security number).

You can use Form 8822, *Change of Address,* for this purpose.

You can continue to use your old preprinted payment-vouchers until the IRS sends you new ones. However, ***DO NOT*** correct the address on the old voucher or the address on the envelope.

Credit for Withholding and Estimated Tax

When you file your 1994 income tax return, take credit for all the income tax and excess social security or railroad retirement tax withheld from your salary, wages, pensions, etc. Also, take credit for the estimated tax you paid for 1994. These credits are subtracted from your tax. You should file a return and claim these credits even if you do not owe tax.

If you had two or more employers and were paid wages of more than $60,600 during 1994, too much social security or railroad retirement tax may have been withheld from your wages. See *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld* in Chapter 36.

Withholding

If you had income tax withheld during 1994, you should receive a statement by January 31, 1995, showing your income and the tax withheld. Depending on the source of your income, you will receive:

Form W–2, *Wage and Tax Statement,*

Form W–2G, *Certain Gambling Winnings,* or

A form in the 1099 series.

Forms W–2 and W–2G. You file these forms with your income tax return. You should get at least two copies of each form you receive. Attach Copy B to the front of your federal income tax return. Copy C is for your records. You should also receive copies to file with your state and local returns.

Form W–2

Your employer should give you a Form W–2 for 1994 by January 31, 1995. You should receive a separate Form W–2 from each employer you worked for.

If you stop working before the end of the year, your employer can give you your Form W–2 at any time after you leave your job. However, your employer must give it to you by January 31 of the following year (or the next day that is not a Saturday, Sunday, or holiday if January 31 is a Saturday, Sunday, or holiday). If you ask for the form, your employer must give it to you within 30 days after receiving your written request or within 30 days after your final wage payment, whichever is later.

If you have not received your Form W–2 by January 31, 1995, you should ask your employer for it. If you do not receive it by February 15, call the IRS toll-free telephone number for your area. The number is listed in the Form 1040, Form 1040A, and Form 1040EZ instructions. You will be asked to give your employer's name, address, and telephone number, and, if known, your employer's identification number. You will also be asked for your address, social security number, daytime telephone number, dates of employment, and your best estimate of your total wages and federal income tax withheld.

Form W–2 shows your total pay and other compensation and the income tax, social security tax, and Medicare tax that was withheld during the year. Take credit for the federal income tax withheld on:

Line 54 if you file Form 1040,

Line 28a if you file Form 1040A, or

Line 6 if you file Form 1040EZ.

Form W–2 is also used to report any taxable sick pay you received and any income tax withheld from your sick pay.

Form W–2G

If you had gambling winnings, the payer may have withheld 28% as income tax. If tax was withheld, the payer will give you a Form W–2G showing the amount you won and the amount of tax withheld. Report the amounts you won on line 21 of Form 1040. Take credit for the tax withheld on line 54 of Form 1040. If you had gambling winnings, you must use Form 1040; you cannot use Form 1040A or Form 1040EZ. See *Deductions Not Subject To the 2% Limit* in Chapter 30 for information on how to deduct gambling losses.

The 1099 Series

Most forms in the 1099 series are not filed with your return. You should receive these forms by January 31, 1995. Keep these forms for your records. There are several different forms in this series, including:

Form 1099–B, *Proceeds From Broker and Barter Exchange Transactions,*

Form 1099–DIV, *Dividends and Distributions,*

Form 1099–G, *Certain Government Payments,*

Form 1099–INT, *Interest Income,*

Form 1099–MISC, *Miscellaneous Income,*

Form 1099–OID, *Original Issue Discount,*

Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,*

Form SSA–1099, *Social Security Benefit Statement,* and

Form RRB–1099, *Payments by the Railroad Retirement Board.*

For some types of income reported on forms in the 1099 series, you may not be able to use Form 1040A or Form 1040EZ. See the instructions to these forms for details.

Form 1099–R. Attach Form 1099–R to your return if Box 4 shows federal income tax withholding. Include the amount withheld in the total on line 54 of Form 1040 or line 28a of Form 1040A. Check the box next to the total.

Backup withholding. If you were subject to backup withholding on income you received during 1994, include the amount withheld, as shown on your Form 1099, in the total on line 54 of Form 1040, or line 28a of Form 1040A. Check the box next to this total.

Form Not Correct

If you receive a form with incorrect information on it, you should ask for a corrected form. The corrected Form W–2G or Form 1099 you receive will be marked ''CORRECTED.'' A special form, Form W–2c, *Statement of Corrected Income and Tax Amounts,* is used to correct a Form W–2.

Form Received After Filing

If you file your return and you later receive a form for income that you did not include on your return, you should report the income and take credit for any income tax withheld by filing Form 1040X, *Amended U.S. Individual Income Tax Return.* See *Amended Returns and Claims for Refund* in Chapter 1.

Separate Returns

If you are married but file a separate return, you can take credit only for the tax withheld from your own income. Do not include any amount withheld from your spouse's income. However, different rules may apply if you live in a community property state.

Community property states. Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin are community property states. If you live in a community property state and file a separate return, you and your spouse must each report half of all community income in addition to your own separate income. Each of you takes credit for half of all taxes withheld on the community income. If you were divorced during the year, each of you generally must report half the community income and can take credit for half the withholding on that community income for the period before the divorce.

For more information on these rules, and some exceptions, see Publication 555, *Federal Tax Information on Community Property.*

Fiscal Years

If you file your tax return on the basis of a fiscal year (a 12-month period ending on the last day of any month except December), you must follow special rules, described below, to determine your credit for federal income tax withholding.

During your fiscal year, one calendar year will end and another will begin. You can claim credit on your tax return only for the tax withheld during the calendar year ending in your fiscal year. You cannot claim credit for any of the tax withheld during the calendar year beginning in your fiscal year. You will be able to claim credit for that withholding on your return for next year.

However, if income tax has been withheld from your income under the backup withholding rule, take credit for it on your tax return for the fiscal year in which you received the payment.

For a more detailed discussion of how to take credit for withholding on a fiscal year return, see *Fiscal Years* in Chapter 3 of Publication 505.

Estimated Tax

Take credit for all your estimated tax payments for 1994 on line 55 of Form 1040 or line 28b of Form 1040A. Include any overpayment from 1993 that you had credited to your 1994 estimated tax. You must use Form 1040 or Form 1040A if you paid estimated tax. You cannot use Form 1040EZ.

Name changed. If you changed your name, and you made estimated tax payments using your old name, attach a brief statement to the front of your tax return indicating:

1) When you made the payments,
2) The amount of each payment,
3) Which IRS address you sent the payments to, and
4) Your name when you made the payments and your social security number.

The statement should cover payments you made jointly with your spouse as well as any you made separately.

Separate Returns

If you and your spouse made separate estimated tax payments for 1994 and you file separate returns, you can take credit only for your own payments.

If you made joint estimated tax payments, you must decide how to divide the payments between your returns. One of you can claim all of the estimated tax paid and the other none, or you can divide it in any other way you agree on. If you cannot agree, you must divide the payments in proportion to each spouse's individual tax as shown on your separate returns for 1994.

Divorced Taxpayers

If you made joint estimated tax payments for 1994, and you were divorced during the year, either you or your former spouse can claim all of the joint payments, or you each can claim part of them. If you cannot agree on how to divide the payments, you must divide them in proportion to each spouse's individual tax as shown on your separate returns for 1994.

If you claim any of the joint payments on your tax return, enter your former spouse's social security number in the space provided on the front of Form 1040 or Form 1040A. If you divorced and remarried in 1994, enter your present spouse's social security number in that space and write your former spouse's social security number, followed by ''DIV,'' to the left of line 55, Form 1040, or line 28b, Form 1040A.

Underpayment Penalty

If you did not pay enough tax either through withholding or by making estimated tax payments, you will have an underpayment of estimated tax and you may have to pay a penalty. However, you will ***not*** generally have to pay a penalty for 1994 if any of the following situations apply to you.

- The total of your withholding and estimated tax payments was at least as much as your 1993 tax, you are not subject to the special rule limiting use of prior year's tax, and you paid all required estimated tax payments on time.
- The tax balance on your return is no more than 10% of your total 1994 tax, and you paid all required estimated tax payments on time.
- Your total 1994 tax minus your withholding is less than $500.
- You did not owe tax for 1993.

Special rules apply if you are a farmer or fisherman. See *Farmers and Fishermen* in Chapter 4 of Publication 505 for more information.

IRS can figure the penalty for you. If you think you owe the penalty but you do not want to figure it yourself when you file your tax return, you may not have to. Generally, the IRS will figure the penalty for you and send you a bill. However, you must complete Form 2210 and file it with your return if you check any of the boxes in Part I of the form. See *Reasons for filing* later in this section.

General Rule

In general, you may owe a penalty for 1994 if the total of your withholding and estimated tax payments did not equal at least the ***smaller*** of:

1) 90% of your 1994 tax, or
2) 100% of your 1993 tax. (Your 1993 tax return must cover a 12-month period.)

Exceptions. There are exceptions to the general rule for farmers and fishermen and for certain higher income taxpayers.

Farmers and fishermen. If at least two-thirds of your gross income for 1993 or 1994 is from farming or fishing, substitute 66⅔% for 90% in (1) above.

See *Farmers and Fishermen* in Chapter 4 of Publication 505 for more information.

Higher income taxpayers. If less than two-thirds of your gross income for 1993 or 1994 is from farming or fishing and your adjusted gross income (AGI) for 1993 was more than $150,000 ($75,000 if your filing status is married filing a separate return in 1994), substitute 110% for 100% in (2) above.

For 1993, AGI is the amount shown on Form 1040 – line 31; Form 1040A – line 16; and Form 1040EZ – line 4.

Penalty figured for each period. Because the penalty is figured separately for each payment period, you may owe a penalty for an earlier payment period even if you later paid enough to make up the underpayment. If you did not pay enough tax by the due date of each of the payment periods, you may owe a penalty even if you are due a refund when you file your income tax return.

Example. You did not make estimated tax payments during 1994 because you thought you had enough tax withheld from your wages. Early in January 1995, you made an estimate of your total 1994 tax. You then realized that your withholding was $2,000 less than the amount needed to avoid a penalty for underpayment of estimated tax.

On January 11, you made an estimated tax payment of $3,000, the difference between your withholding and your estimate of your total tax. Your final return shows your total tax to be $50 less than you originally figured, so you are due a refund.

You do not owe a penalty for your payment due January 17, 1995. However, you will owe a penalty through January 11 for your underpayments for the earlier payment periods.

Minimum required each period. You will owe a penalty for any 1994 payment period for which your estimated tax payment plus your withholding for the period and overpayments for previous periods was less than the ***smaller*** of:

1) 22.5% of your 1994 tax, or
2) 25% of your 1993 tax. (Your 1993 tax return must cover a 12-month period.)

Note. If you are subject to the rule for higher income taxpayers, discussed earlier, substitute 27.5% for 25% in (2) above.

When penalty is charged. If you miss a payment or you paid less than the minimum required in a period, you may be charged an underpayment penalty from the date the amount was due to the date the payment is made.

Change from 1993 separate returns to 1994 joint return. If you file a joint return with your spouse for 1994, but you filed separate returns for 1993, your 1993 tax is the total of the tax shown on your separate returns. You filed a separate return in 1993 if you filed as single, head of household, or married filing separately.

Change from 1993 joint return to 1994 separate return. If you file a separate return for 1994, but you filed a joint return with your spouse for 1993, your 1993 tax is your share of the tax on the joint return. You filed a separate return in 1994 if you filed as single, head of household, or married filing separately. To figure your share, first figure the tax both you and your spouse would have paid had you filed separate returns for 1993, using the same filing status as in 1994. Then multiply your joint tax liability by the following fraction:

$$\frac{\text{Your separate tax liability}}{\text{Both spouses' separate tax liabilities}}$$

Example. Lisa and Chris filed a joint return for 1993 showing taxable income of $48,000 and a tax of $8,650. Of the $48,000 taxable income, $40,000 was Lisa's and Chris was responsible for the rest. In 1994, they file married filing separately. Lisa figures her share of the tax on the 1993 joint return as follows:

Tax on $40,000 based on a separate return	$ 8,809
Tax on $8,000 based on a separate return	1,204
Total	$10,013
Lisa's portion of total ($8,809 ÷ $10,013)	88%
Lisa's share of 1993 joint return tax ($8,650 × 88%)	$ 7,612

Form 2210. In most cases, you do not need to file Form 2210. The IRS will figure the penalty for you and send you a bill. If you want to figure your penalty, complete Part I, Part II, and either Part III or Part IV of Form 2210. ***Do not*** file Form 2210 unless you must file it, as explained later under *Reasons for filing.* If you use Form 2210, you cannot file Form 1040EZ.

On Form 1040, enter the amount of your penalty on line 65. If you owe tax on line 64, add the penalty to your tax due and show your total payment on line 64. If you are due a refund, subtract the penalty from the overpayment you show on line 61.

On Form 1040A, enter the amount of your penalty on line 33. If you owe tax on line 32, add the penalty to your tax due and show your total payment on line 32. If you are due a refund, subtract the penalty from the overpayment you show on line 29.

Reasons for filing. You may be able to lower or eliminate your penalty if you file Form 2210. You ***must*** file Form 2210 with your return if any of the following applies.

1) You request a waiver. (See *Waiver of Penalty,* later.)
2) You use the annualized income installment method.
3) You use your actual withholding for each payment period for estimated tax purposes.
4) You base any of your required installments on the tax shown on your 1993 return and you filed or are filing a joint return for either 1993 or 1994 but not for both years.

For help in completing Form 2210, including illustrated examples, see Chapter 4 of Publication 505.

Annualized income installment method. If you did not receive your income evenly throughout the year (for example, your income from a repair shop you operated was much larger in the summer than it was during the rest of the year), you may be able to lower or eliminate your penalty by figuring your underpayment using the ***annualized income installment method.*** Under this method, your required installment for one or more payment periods may be less than one-fourth of your required annual payment.

To figure your underpayment using this method, complete Schedule AI of Form 2210. Also check the box on line 1b in Part I of Form 2210. You must file the form and Schedule AI with your return. This method is explained in Chapter 4 of Publication 505.

Actual withholding method. Instead of using one-fourth of your withholding to figure your payments, you can choose to establish how much was actually withheld on or before the due dates and use those amounts. You can make this choice separately for the tax withheld from your wages and for all other withholding.

Using your actual withholding may result in a smaller penalty if most of your withholding occurred early in the year.

If you use your actual withholding, you must check the box on line 1c, Part I of the Form 2210. Complete Form 2210 and file it with your return.

Short method for figuring the penalty. You may be able to use the short method in Part III of Form 2210 to figure your penalty for underpayment of estimated tax. If you qualify to use this method, it will result in the same penalty amount as the regular method, but with fewer computations.

You can use the short method ***only*** if you meet one of the following requirements.

1) You made no estimated tax payments for 1994. It does not matter whether you had income tax withholding.
2) You paid estimated tax on all four due dates in equal installments. You must have paid the same amount on each of the following dates:

   April 15, 1994,

   June 15, 1994,

   September 15, 1994, and

   January 17, 1995.

If you do not meet either requirement, figure your penalty using the regular method in Part IV, Form 2210.

Note. If you use the short method in Part III, you cannot use the annualized income installment method or the actual withholding method.

Exceptions

Generally, you do not have to pay an underpayment penalty if either of the following conditions apply:

- Your total tax due is less than $500, or
- You had no tax liability last year.

Less Than $500 Due

You do not owe a penalty if the total tax shown on your return minus the amount you paid through withholding (including excess social security and railroad retirement tax withholding) is less than $500.

Total tax for 1994. For 1994, your total tax on Form 1040 is the amount on line 53 reduced by the total of the following amounts:

1) Any recapture of a federal mortgage subsidy from Form 8828 included on line 49,
2) Any social security or Medicare tax on tips not reported to your employer on line 50,
3) Any tax on an IRA or a qualified retirement plan from Form 5329 (other than the tax on early distributions) included on line 51,
4) Any uncollected social security, Medicare, or railroad retirement tax included on line 53,
5) Any earned income credit on line 56, and
6) Any credit for federal tax on fuels from Form 4136 included on line 59.

Your total tax on Form 1040A for 1994 is the amount on line 27 minus the amount on line 28c. Your total tax on Form 1040EZ for 1994 is the amount on line 9 reduced by line 7.

No Tax Liability Last Year

You do not owe a penalty if you had no tax liability last year and you were a U.S. citizen or resident for the whole year. For this rule to apply, your tax year must have included all 12 months of the year.

You had no tax liability for 1993 if your total tax was zero or you did not need to file an income tax return.

Example. Ray, who is single and age 50, was unemployed for most of 1993. He earned $2,700 in wages before he was laid off, and he received $2,500 in unemployment compensation afterwards. He had no other income. Even though he had gross income of $5,200, he did not have to pay income tax because his gross income was less

than the filing requirement for a single person under age 65 ($6,050 for 1993). He filed a return only to have his withheld income tax refunded to him.

In 1994, Ray began regular work as an independent contractor. Ray made no estimated tax payments in 1994. Even though he did owe tax at the end of the year, Ray does not owe the underpayment penalty for 1994 because he had no tax liability in 1993.

Total tax for 1993. For 1993, your total tax on Form 1040 is the amount on line 53 reduced by the total of the following amounts:

1) Any recapture of a federal mortgage subsidy from Form 8828 included on line 49,
2) Any social security or Medicare tax on tips not reported to your employer on line 50,
3) Any tax on an IRA or a qualified retirement plan from Form 5329 (other than the tax on early distributions) included on line 51,
4) Any uncollected social security, Medicare, or railroad retirement tax included on line 53,
5) Any earned income credit on line 56, and
6) Any credit for federal tax on fuels from Form 4136 included on line 59.

Your total tax on Form 1040A for 1993 is the amount on line 27 minus the amount on line 28c. Your total tax on Form 1040EZ for 1993 is the amount on line 8.

Waiver of Penalty

The IRS can waive the penalty for underpayment if:

1) You did not make a payment because of a casualty, disaster, or other unusual circumstance, and it would be inequitable to impose the penalty, or
2) You retired (after reaching age 62) or became disabled during the tax year a payment was due or during the preceding tax year, and both the following requirements are met:
   a) You had reasonable cause for not making the payment, and
   b) Your underpayment was not due to willful neglect.

To claim either of these waivers, follow the procedures explained in the instructions for Form 2210.

Part Two.

Income

The eight chapters in this part discuss many kinds of income. They explain which income is and is not taxed. See Part Three for information on gains and losses you report on Schedule D (Form 1040) and for information on selling your home.

6.

Wages, Salaries, and Other Earnings

Important Reminders

Employer-provided educational assistance. The exclusion from gross income and wages of qualified employer-provided educational assistance is extended through December 31, 1994. For more information, see Chapter 5 of Publication 535, *Business Expenses.*

Employer-provided transportation. The value of employer-provided transportation, such as a vanpool, transit pass, or qualified parking, can be excluded from an employee's gross income up to certain limits. For more information on fringe benefits, see *Fringe Benefits,* later.

Introduction

This chapter discusses wages, salaries, fringe benefits, and other compensation received for services as an employee. The topics include:

- Bonuses and awards
- Unemployment compensation
- Disability income
- Special rules for certain employees
- Military

The chapter also explains what income is included in the employee's gross income and what is not included.

Useful Items

You may want to see:

Publication

- ❑ **503** Child and Dependent Care Expenses
- ❑ **505** Tax Withholding and Estimated Tax
- ❑ **525** Taxable and Nontaxable Income
- ❑ **917** Business Use of a Car

Employee Compensation

This section explains many types of employee compensation. The subjects are arranged in alphabetical order followed by *Fringe Benefits, Disability Income,* and *Pension and Annuity Contributions,* which are explained in greater detail.

Advance commissions and other earnings. If you receive advance commissions or other amounts for services to be performed in the future, and you are a cash method taxpayer, you must include these amounts in your income in the year you receive them.

If you repay unearned commissions or other amounts in the same year in which you received them, reduce the amount to include in your income by the repayment. However, if you repay the unearned commissions or other amounts in a later tax year, you can deduct the repayment as an itemized deduction on your Schedule A (Form 1040), or you may be able to take a credit for that year. See *Repayments* in Chapter 13.

Back pay awards. Amounts you are awarded in a settlement or judgment for back pay, including unpaid life insurance premiums and unpaid health insurance premiums, are included in your gross income. They should be reported to you by your employer on Form W–2, *Wage and Tax Statement.*

Bonuses and awards. Amounts paid to you for outstanding work, such as bonuses or awards, are income shown on your Form W–2. These include prizes such as vacation trips for meeting sales goals. If a prize or award is in goods or services, you must include the fair market value of the goods or services in your income. However, if your employer merely promises to pay you a bonus or award at some future time, it is not taxable until you receive it or it is made available to you. If you receive an award for length of service or safety achievement, see *Employee achievement awards* in Chapter 13.

Child-care providers. If you provide child care, either in the child's home or in your home or other place of business, the pay you receive must be included in your income. If you provide the care in the child's home, you may be an employee. If you provide the care in your home or other place of business, you may or may not be an employee. You are an employee if you are subject to the will and control of your employer as to what you are to do and how you are to do it.

Babysitting. The rules for child-care providers also apply to anyone who periodically babysits for relatives or neighborhood children.

If you are an employee, you should receive a Form W–2 if your pay is subject to social security and Medicare taxes or would be subject to the withholding of income tax if one exemption were claimed. Include your pay on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ, even if you do not receive a Form W–2.

If you are not an employee, you are probably self-employed and must include the payments you receive on Schedule C (Form 1040), *Profit or Loss From Business,* or Schedule C–EZ (Form 1040), *Net Profit From Business,* if you qualify.

Government cost-of-living allowances. These allowances are generally not included in the income of federal civilian employees, including federal court employees stationed in Alaska, Hawaii, or outside the 48 contiguous states or the District of Columbia.

Allowances and differentials that increase your basic pay as an incentive for taking a less desirable post of duty are part of your compensation and must be included in your income. For example, your compensation includes Foreign Post, Foreign Service, and Overseas Tropical salary differentials. For more information, get Publication 516, *Tax Information for U.S. Government Civilian Employees Stationed Abroad.*

Holiday gifts. If your employer gives you a turkey, ham, or other item of nominal value at Christmas or other holidays, the value of the gift is not income. However, if your employer gives you cash, a gift certificate, or similar item that you can easily exchange for cash, the value of the gift is extra salary or wages regardless of the amount involved.

Interview expenses. If an employer asks you to appear for an interview and pays you an allowance, or reimburses you for your transportation and other travel expenses, you include in your income on line 21, Form 1040, only the amount you receive that is more than your actual expenses.

Property purchased from employer. If your employer allows you to buy property below its fair market value as compensation for your services, you must include in your income as wages the difference between the property's fair market value and the amount you paid for it.

Property received for services. If you receive property for your services, you generally must include its value in your gross income as wages. Property for services includes shares of corporate stock you receive from your employer. You must include the fair market value of this property in the year you receive it. However, you may not have to include the value of the property in your income in the year received, if the property is both nontransferable and subject to a substantial risk of forfeiture. For details, see *Restricted Property Received for Services* in Publication 525.

Dividends you receive on restricted stock are extra compensation to you. Restricted stock is stock you received from your employer and did not include in your income because it was nontransferable and subject to forfeiture. Your employer should include these payments on your Form W–2.

Dividends you receive on stock you chose to include in your income in the year transferred are treated the same as any other dividends. Report them on line 9, Form 1040. For a discussion of dividends, see Chapter 9.

Get Publication 525 for information on how to treat dividends reported on both your Form W–2 and Form 1099–DIV.

Severance pay. Amounts you receive as severance pay are taxable. A lump-sum payment for cancellation of your employment contract is income in the tax year you receive it and must be reported with your other salaries and wages.

Accrued leave payment. If you are a federal employee and receive a lump-sum payment for accrued annual leave when you retire or resign, this amount will be included on your Form W–2.

If you resign from one agency and are reemployed by another agency, you may have to repay part of your lump-sum annual leave payment to the second agency. You can reduce gross wages by the amount you repaid in the same tax year in which you received it. You should attach to your tax return a copy of the receipt or statement furnished by the agency to which repayment is made to explain the difference between the wages on the return and the wages on your Forms W–2.

Employer provided outplacement services. If you receive employer-provided outplacement services, such as training in resumâe writing and interview techniques, in lieu of higher severance pay, you must include the amount of the unreduced severance pay in income.

Sick pay. Amounts you receive from your employer while you are sick or injured are part of your salary or wages. Report the amount you receive on line 7, Form 1040; line 7, Form 1040A; or line 1, Form 1040EZ. You must include in your income payments made by any of the following:

1) Your employer.
2) A welfare fund.
3) A state sickness or disability fund.
4) An association of employers or employees.
5) An insurance company, if your employer paid for the plan.

However, if you paid the premiums on an accident or health insurance policy, the benefits you receive under the policy are not taxable.

Railroad sick pay. If you receive sick pay under the Railroad Unemployment Insurance Act, these payments are taxable and you must include them in your income. However, you do not include them in your income to the extent they are for an on-the-job injury.

If you received income because of a disability, see *Disability Income,* later.

Social security and Medicare taxes paid by employer. If you and your employer have an agreement that your employer pays your social security and Medicare taxes without deducting them from your gross wages, you must report the amount of tax paid for you as taxable wages on your tax return. You must also treat the payments as wages for figuring your social security and Medicare taxes and your social security and Medicare benefits. However, these payments are not treated as social security and Medicare wages if you are a household worker or a farm worker.

Stock appreciation rights. If your employer grants you a stock appreciation right, do not include it in your income until you exercise the right. When you exercise (use) the right, you are entitled to a cash payment equal to the amount by which the fair market value of the corporation's stock on the date of exercise has increased over the fair market value on the date the right was granted. You include the cash payment in your income in the year you exercise the right.

Stock options. You usually have taxable income when you receive or exercise a nonstatutory option to buy stock (or other property) as payment for your services. However, if your option is a statutory stock option (an incentive stock option or an option granted under an employee stock purchase plan) special rules generally delay the tax until you sell or exchange your shares of stock. For details, get Publication 525.

Unemployment compensation. You must include in your income all unemployment compensation you receive. You should receive a Form 1099–G showing the unemployment compensation paid to you. Generally, you enter unemployment compensation on line 12, Form 1040A, or line 19, Form 1040. You may be liable for estimated tax if you receive unemployment compensation. For more information on estimated tax, see Chapter 5.

Types of unemployment compensation. Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or of a state. It includes:

1) Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
2) Unemployment insurance benefits.
3) Railroad unemployment compensation benefits.
4) Disability payments from a government program paid as a ***substitute*** for unemployment compensation (amounts received as workers' compensation for injuries or illness are ***not*** unemployment compensation).
5) Trade readjustment allowances under the Trade Act of 1974.
6) Benefits under the Airline Deregulation Act of 1978.
7) Unemployment assistance under the Disaster Relief Act Amendments of 1974.

Governmental program. If you contribute to a governmental unemployment compensation program, and your contributions are not deductible, amounts you receive under the program are not included as unemployment compensation until you recover your contributions.

Supplemental unemployment benefits. Benefits received from a company-financed fund (to which the employees did not contribute) are not unemployment compensation. They are taxable as wages subject to income tax withholding but not subject to social security, Medicare, or federal unemployment taxes. Report these payments on line 7 of Form 1040 or Form 1040A.

You may have to repay some of your supplemental unemployment benefits to qualify for trade readjustment allowances under the Trade Act of 1974. If you repay supplemental unemployment benefits in the same year you receive them, reduce the total benefits by the amount you repay. However, if you repay the benefits in a later year, you must include the full amount of the benefits received in your income for the year you received them.

Deduct the repayment in the later year as an adjustment to gross income. Include the repayment on line 30, Form 1040, and put ''Sub-pay TRA'' and the amount on the dotted line next to line 30. If the amount you repay in a later year is more than $3,000, you may be able to take a credit against your tax for the later year instead of deducting the amount repaid. For more information on this, see the discussion on *Repayments* in Chapter 13.

Private unemployment fund. Unemployment benefit payments from a private fund to which you voluntarily contribute are

taxable only if the amounts you receive are more than your total payments into the fund. Report the taxable amount on line 21, Form 1040.

Payments by a union. Benefits paid to you as an unemployed member of a union out of regular union dues are included in your gross income on line 21, Form 1040.

Guaranteed annual wage. Payments you receive from your employer during periods of unemployment, under a union agreement that guarantees you full pay during the year, are taxable as wages.

State employees. Payments can be made by a state to its employees who are not covered by the state's unemployment compensation law. If the payments are similar to benefits under that state law, they are fully taxable. Report these payments on line 21, Form 1040.

Fraud. Fraudulently obtained unemployment compensation is fully taxable and you report it on line 21, Form 1040.

Repayment of unemployment compensation benefits. If you repaid in 1994 unemployment compensation benefits you received in 1994, subtract the amount you repaid from the total amount you received and enter the difference on line 19, Form 1040, or on line 12, Form 1040A. Also, enter ''Repaid'' and the amount you repaid on the dotted line next to line 19 or next to line 12. If, in 1994, you repaid unemployment compensation that you included in gross income in an earlier year, you may deduct the amount repaid on Schedule A (Form 1040), line 22. See *Repayments* in Chapter 13.

Union benefits and dues. Amounts deducted from your pay for union dues, assessments, contributions, or other payments to a union cannot be excluded from your salary or wages. You must include them in your income as wages.

You may be able to deduct some of these payments as a miscellaneous deduction subject to the 2% limit if they are related to your job and if you itemize your deductions on Schedule A (Form 1040). You may deduct them whether you paid them directly to the union or had them deducted from your pay. See *Union Dues and Expenses* in Chapter 30.

Strike and lockout benefits. Benefits paid to you by a union from union dues as strike or lockout benefits, including both cash and the fair market value of other property, are usually included in your income as wages. You can exclude these benefits from your income only when the facts show that the union intended them as gifts to you.

Withholding. Amounts withheld from your pay for income tax, social security tax, Medicare tax, or savings bonds are considered received by you. They will be included in your wages on Form W–2. The same generally is true of amounts withheld for taxable fringe benefits, pensions, insurance, union dues, and other assessments. For more information on withholding, get Publication 505.

If your employer uses your wages to pay your debts, or if your wages are attached or garnisheed, the full amount is considered received by you. Also included in your wages are fines or penalties withheld from your pay.

Fringe Benefits

The value of fringe benefits you receive from your employer is taxable and must be included in your income as compensation, unless the benefits are specifically excluded by law or you pay fair market value for them.

Some of the benefits you must report in your income include your personal use of an employer-provided car or aircraft or a membership in a country club.

Generally, your employer determines the amount of your fringe benefits and includes this amount on your Form W–2. For more information on how an employer determines taxable fringe benefits, see Publication 535, *Business Expenses.*

Transportation

The value of employer-provided transportation, such as a vanpool, transit pass, or qualified parking, can be excluded from an employee's gross income up to certain limits. A qualified transportation fringe is:

1) Transportation in a commuter highway vehicle between the employee's home and work place,
2) A transit pass, or
3) Qualified parking.

Cash reimbursement by the employer for these expenses under a bona fide reimbursement arrangement is also excludable. However, cash reimbursement for a transit pass is allowed only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution to the employee.

Exclusion limit. The exclusion for commuter highway vehicle transportation and transit pass fringe benefits cannot exceed a total of $60 a month, regardless of the total value of both benefits.

The exclusion for the qualified parking fringe benefit cannot exceed $155 a month, regardless of its value.

If the benefits have a value in excess of these limits, the excess must be included in the employee's income.

Commuter highway vehicle. This is a highway vehicle that seats at least six adults (not including the driver). At least 80% of the vehicle's mileage must reasonably be expected to be for transporting employees between their homes and work place and at least half of the vehicle's seating capacity must be (not including the driver's) occupied by employees.

Transit pass. This is any pass, token, farecard, voucher, or similar item entitling a person to ride mass transit (whether public or private) free or at a reduced rate or in a commuter highway vehicle operated by a person in the business of transporting persons for compensation.

Qualified parking. This is parking provided to an employee on or near the employer's place of business. It also includes parking provided on or near a location from which the employee commutes to work in a commuter highway vehicle or carpool. It does not include parking on or near the employee's residence.

More information. For more information on fringe benefits, see Publication 535, *Business Expenses.*

Group Life Insurance Premiums

Generally, the cost of up to $50,000 of group-term life insurance coverage that is provided to you by your employer is not included in your income. However, you must include in your income the cost of insurance that is more than the cost of $50,000 of insurance, reduced by the amount you pay towards the purchase of the insurance.

Form W–2. The amount included in your income is reported as part of your wages on Form W–2 and is shown separately on the form. See *Your payment,* later.

Retired employees. If you are retired, you must generally include in income the cost of payments for insurance coverage that are for more than $50,000. However, certain retired employees do not have to include these amounts in income. For more information, get Publication 525.

Group-term life insurance. This insurance is term life insurance protection (insurance for a fixed period of time) that:

1) Provides a general death benefit that is excluded from income,
2) Is provided to a group of employees,
3) Is provided under a policy carried by the employer, and
4) Provides an amount of insurance for each employee based on a formula that prevents individual selection.

Your payment. If you pay any part of the cost of the insurance, your entire payment reduces, dollar for dollar, the amount your employer would otherwise include in your income. However, you cannot reduce the amount to include in your income by:

1) Payments for coverage in a different tax year, or
2) Payments not taxed to you because of the exceptions discussed below.

Permanent benefits. If your group-term life insurance policy includes permanent benefits, such as a paid-up or cash surrender value, you must include in your income, as wages, the cost of the permanent benefits, reduced by the amount you pay for them. Your employer should be able to tell you the amount to include in your income.

Accidental or other death benefits. If you receive accidental or other death benefits from a policy that does not provide general death benefits (travel insurance, for example), these benefits are not included as group-term life insurance coverage.

Exceptions. You are not taxed on the cost of group-term life insurance if any of the following apply:

1) You are disabled and have ended your employment;

2) Your employer is the beneficiary of the policy for the entire period the insurance is in force during the tax year; or

3) The only beneficiary is a qualified charitable organization (defined in Chapter 26) for the entire period the insurance is in force during the tax year. You are not entitled to a deduction for a charitable contribution by naming a charitable organization as the beneficiary of your policy.

Entire cost taxed. You are taxed on the entire cost of group-term life insurance protection provided by your employer through a qualified employees' trust, such as a pension trust or a qualified annuity plan.

You are also taxed on the entire cost of the group-term life insurance coverage provided by your employer if you are a key employee and your employer's plan discriminates in favor of key employees.

Life insurance agents. Full-time life insurance agents who are considered employees for social security and Medicare tax withholding purposes are treated as employees in applying the provisions relating to group-term life insurance under a policy carried by their employer.

One employer. If you have only one employer and you were insured at any time during the tax year for more than $50,000 under a group-term life insurance policy, your income from this source is shown as other compensation on the Form W–2 you receive.

Two or more employers. If two or more employers provide you group-term life insurance coverage totaling more than $50,000, you must figure how much to include in your income for the cost of all coverage that is more than $50,000. You must include the cost of life insurance provided to you during the tax year, regardless of when your employers paid the premiums.

You figure the cost for each month of coverage by multiplying the number of thousands of dollars of insurance coverage, less $50,000 of insurance (both figured to the nearest tenth), by the cost from the following table. You must prorate the cost if less than a full month of coverage is involved.

COST PER $1,000 OF PROTECTION FOR ONE MONTH

Age	Cost
Under 30	8 cents
30 through 34	9 cents
35 through 39	11 cents
40 through 44	17 cents
45 through 49	29 cents
50 through 54	48 cents
55 through 59	75 cents
60 through 64	$1.17
65 through 69	$2.10
70 and older	$3.76

Example. You are 51 years old and work for Employers A and B. Both employers provide group-term life insurance coverage for you. Your coverage with Employer A is 35,000, and your coverage with Employer B is $45,000. You pay premiums of $50 a year under the Employer B group plan. You figure the amount to include in your income as follows:

Employer A coverage (in thousands)	$ 35
Employer B coverage (in thousands)	45
Total coverage (in thousands)	$ 80
Minus: Exclusion (in thousands)	50
Excess amount (in thousands)	$ 30
Multiply by cost per $1,000 per month, age 51 (from table)	.48
Cost of excess insurance for 1 month	$ 14.40
Multiply by number of full months coverage at this cost	12
Cost of excess insurance for tax year	$172.80
Minus: Premiums you paid	50.00
Cost to include in your income as wages	$122.80

For information on employer payments for group-term life insurance, get Publication 535.

How To Report Fringe Benefits

The amount of your taxable fringe benefits is shown on your Form W–2.

Employer-provided car. If your employer provides a car (or other highway motor vehicle) to you, your personal use of the car is usually a taxable noncash fringe benefit.

Your employer must determine the actual value of this fringe benefit to include in your income. Your employer determines this value by either of the following methods:

1) The actual value of your personal use of the car, or

2) The actual value of the car as if you used it entirely for personal purposes (100% income inclusion).

If your employer includes 100% of the value in your income, you may deduct the value of your business use of the car as long as you itemize your deductions. You figure the value of this business use on Form 2106, *Employee Business Expenses.*

Certain employer-provided transportation can be excluded from gross income. See the discussion on *Transportation,* earlier.

Accounting period. You must use the same accounting period your employer uses to report your taxable fringe benefits and to claim any related deductions. Your employer has the option to report taxable fringe benefits by using either of the following rules:

1) The general rule: value the benefit for a full calendar year (January 1–December 31), or

2) The special accounting period rule: treat the value of benefits provided during the last two months of the calendar year (or any shorter period) as paid during the following calendar year.

   a) Under this rule, each year your employer includes the value of benefits provided the last 2 months of the prior year and the first 10 months of the current year.

   b) If your employer uses this rule to determine the amount to include in your income, you must use the same accounting period to claim an employee business deduction (for use of a car, for example).

Your employer does not have to use the same accounting period for each fringe benefit, but is required to use the same period for all employees who receive a particular benefit.

Form W–2. Your employer reports your taxable fringe benefits in box 1 (Wages, tips, other compensation) and, if applicable, box 3 (Social security wages) and box 5 (Medicare wages) of Form W–2. The total value of your fringe benefits should also be shown in box 12. The value of your fringe benefits may be added to your other compensation on one Form W–2, or you may receive a separate Form W–2 showing just the value of your fringe benefits in box 1 with a notation in box 12.

Disability Income

Generally, if you retire on disability you must report your pension or annuity as income. There is a tax credit for people who are permanently and totally disabled. For information on this credit and the definition of permanent and total disability, see Chapter 34.

Disability pensions. Generally, you must report as income any amount you receive for your disability through an accident or health insurance plan paid for by your employer. If both you and your employer pay for the plan, only the amount you receive for your disability that is due to your employer's payments is reported as income. However, certain payments may not be taxable. Your employer should be able to give you specific details about your pension plan and tell you the amount you paid for your disability pension. In addition to disability pensions and annuities, you may be receiving other payments for sickness and injury. See *Other Sickness and Injury Benefits* in Chapter 13.

Cost paid by you. If you pay the entire cost of a health or accident insurance plan, do not include any amounts you receive for your disability as income on your tax return. If your plan reimbursed you for medical expenses you deducted in an earlier year, you may have to include some, or all, of the reimbursement in your income. See *Reimbursement in a later year* in Chapter 23.

Accrued leave payment. If you retire on disability, any lump-sum payment you receive for accrued annual leave is a salary payment. The payment is not a disability payment. You must report it as wages in the tax year you receive it.

Retirement and profit-sharing plans. Any payments you receive from a retirement or profit-sharing plan that does not provide for disability retirement are not payments from an accident or health plan. Therefore, do not report them as disability income. The payments are taxable and should be reported as a pension or annuity. See *Disability Income* in Chapter 11.

Military disability pensions. Generally, you must report these disability pensions as income. But certain military and government disability pensions are not taxable. For more information, see *Military and Certain Government Disability Pensions* in Chapter 11.

How to report. If you retired on disability, payments you receive are taxed as wages until you reach minimum retirement age. Minimum retirement age generally is the age at which you can first receive a pension or annuity were you not disabled. You must report your taxable disability payments on line 7, Form 1040, or on line 7, Form 1040A, until you reach minimum retirement age.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension. Report the payments on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. The rules for reporting pensions are explained in *How to Report* in Chapter 11.

Pension and Annuity Contributions

Generally, you cannot exclude from income amounts you pay into a pension plan through payroll deductions.

Contributions to Federal Thrift Savings Fund. Federal employees can choose to make contributions, from their salaries, to the Federal Thrift Savings Fund. Contributions are not included in income. Your salary before contributions are taken out is used for purposes of figuring social security and Medicare taxes and benefits. Payments from the fund are taxable as a distribution from a qualified pension or annuity plan.

Employer's contributions to qualified plan. Generally, your employer's contributions to a qualified pension plan for you are not included in income at the time contributed. However, employer contributions that are made out of funds that would otherwise have been paid to you as salary, except that you entered into a salary reduction agreement with your employer (elective deferral), are excluded from income only up to a limit.

For 1994, you cannot set aside more than a total of $9,240 for all elective deferrals. If you set aside more than $9,240, the excess is included in your gross income that year. Contributions to tax-sheltered annuities are subject to a higher limit. Get Publication 571, *Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations,* for more information.

The cost of life insurance coverage included in an employer's plan may be income if the proceeds of the policy are payable directly or indirectly to your beneficiary. See *Group Life Insurance Premiums,* earlier, under *Fringe Benefits.*

Amounts actually distributed or made available to you generally are taxable, unless they are eligible for a tax-free rollover and are rolled over (within 60 days after receipt) to another qualified plan or to an individual retirement account or annuity. If you elect an eligible rollover distribution to be paid directly to you (even if you plan to roll over the distribution), the payer must withhold part of the distribution for income tax. You can avoid withholding if you choose a direct transfer to another qualified retirement plan. Your employer may be able to tell you how the amount you received is taxed. See Chapters 11 and 18.

Employer's contributions to nonqualified plan. If your employer pays into a nonqualified plan for you, you generally must include the contributions in your income as wages for the tax year in which the contributions are made. Report this income on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. However, if your interest is not transferable and is subject to a substantial risk of forfeiture (you have a good chance of losing it), you need not include the amount of the contribution or premium in your income. When your interest becomes transferable or is no longer subject to a substantial risk of forfeiture, you must include the value in your income.

Railroad retirement annuities. If you received railroad retirement tier 1 benefits that are more than the ''social security equivalent benefit,'' or tier 2 or vested dual benefits, these payments are treated as pension or annuity income and are taxable under the rules explained in Chapter 11.

Special Rules for Certain Employees

This section deals with special rules for people in certain types of employment. It includes members of the clergy, people working for foreign employers, military personnel, veterans, ACTION and Peace Corps volunteers, and statutory employees.

Clergy

If you are a member of the clergy, you must include in your income offerings and fees you receive for marriages, baptisms, funerals, masses, etc., in addition to your salary. If the offering is made to the religious institution, it is not taxable to you.

If you are a member of a religious organization and you give your outside earnings to the organization, you still must include the earnings in your income. However, you may be entitled to a charitable contribution deduction for the amount paid to the organization.

Rental value of a home. You do not include in your income the rental value of a home (or utility expenses) provided to you as part of your pay for your duties as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home, and related allowances, as earnings from self-employment on Schedule SE (Form 1040) if you are subject to the self-employment tax.

Housing allowance. A housing allowance paid to you as part of your salary is not income to the extent you use it, in the year received, to provide a home or to pay utilities for a home with which you are provided. The amount of the housing allowance that you can exclude from your income cannot be more than the reasonable compensation for your services as a minister. The church or organization that employs you must officially designate the payment as a housing allowance before the payment is made. A definite amount must be designated; the amount of the housing allowance cannot be determined at a later date.

If you are employed and paid by a local congregation, a resolution by a national church agency of your denomination does not effectively designate a housing allowance for you. The local congregation must officially designate the part of your salary that is to be a housing allowance. However, a resolution of a national church agency can designate your housing allowance if you are directly employed by the agency. If no part has been officially designated, you must include your total salary in your income.

Expenses of providing a home include rent, house payments, furniture payments, costs for a garage, and utilities. They do not include the cost of food or servants.

Homeowner. If you own your home, or are buying it, you can exclude your housing allowance from your income if you spend it for the down payment on the home, for mortgage payments, or for interest, taxes, utilities, repairs, etc. However, you cannot exclude more than the fair rental value of the home plus the cost of utilities, even if a larger amount is designated as a housing allowance. Fair rental value of a home includes the fair rental value of furnishings in it.

Interest and taxes on your home. You can deduct the qualified mortgage interest and real estate taxes you pay on your home even if you use nontaxable housing allowance funds to make the payments. See Chapters 24 and 25.

Teachers or administrators. If you are a minister employed as a teacher or administrator by a church school, college, or university, you are, for purposes of the housing exclusion, performing ministerial services. However, if you perform services as the head of a religious department, or as a teacher or administrator on the faculty of a nonchurch college, and if your specific duties involve no religious functions, you cannot exclude from your income a housing allowance or the value of a home that is provided to you.

If you live in qualified campus housing as an employee of an educational institution, do not include the value of that housing in your income if you pay rent equal to or greater than the fair rental value of the housing.

If you serve as a ''minister of music'' or ''minister of education,'' or serve in an administrative or other function of your religious organization, but are not authorized to perform all of the religious duties of an ordained minister in your church, even though you are commissioned as a ''minister of the gospel,'' you cannot exclude from your income a housing allowance or the value of a home provided to you.

Theological students. You cannot exclude a housing allowance from your income if you are a theological student serving a required internship as an assistant pastor, unless you are ordained, commissioned, or licensed as a minister.

Traveling evangelists. You can exclude amounts received from out-of-town churches for evangelistic services if you are an ordained minister, if those amounts are designated as a housing allowance, and you actually use them to maintain your permanent home.

Retired members of the clergy. The rental value of a home provided rent free by your church for your past services is not income if you are a retired minister. In addition, a housing allowance paid to you is not income to the extent you spend it for utilities, maintenance, repairs, and similar expenses that are directly related to providing a home.

The general convention of a national religious denomination can designate a housing allowance for retired ministers, if the local congregations authorize the general convention to establish and maintain a unified pension system for all retired clergy members of the denomination for their past services to the local churches.

A surviving spouse of a retired minister cannot exclude a housing allowance from income. If these payments were reported to you on Form 1099–R, include them on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A. Otherwise, include them on line 21, Form 1040.

Pension. A pension or retirement pay for a member of the clergy is usually treated the same as any other pension or annuity. (See Chapter 11.) If you are not expected to perform any further services, payments from the congregation may be gifts. If the payments are gifts, they are not taxable if they are based solely on your financial needs and the financial capacity of the congregation. If these payments are made under a legal agreement, an established plan, or because of past practice, they do not qualify as nontaxable gifts.

Members of religious orders. If you are a member of a religious order who has taken a vow of poverty, the amounts you earn for services you perform which you renounce and turn over to the order may or may not be included in your income.

Services performed for the order. If you are performing the services as an agent of the order in the exercise of duties required by the order, you do not include in your income the amounts you turn over to the order.

If your order directs you to perform services for another agency of the supervising church or an associated institution, you are considered to be performing the services as an agent of the order. Any wages you earn as an agent of an order that you turn over to the order are not included in your gross income.

Example. You are a member of a church order and have taken a vow of poverty. You renounce any claims to your earnings and turn over to the order any salaries or wages you earn. You are a registered nurse, so your order assigns you to work in a hospital that is an associated institution of the church. However, you remain under the general direction and control of the order. You are considered to be an agent of the order and, therefore, any wages you earn at the hospital that you turn over to your order are not included in your gross income.

Services performed outside the order. If you are directed to work outside the order, the work will not constitute the exercise of duties required by the order unless the services you perform meet both of the following requirements:

1) The services are the kind that are ordinarily the duties of members of the order, and

2) The services are part of the duties that are required to be exercised for, or on behalf of, the religious order as its agent.

If the legal relationship of employer and employee exists between you and a third party, the services you perform for the third party will not be considered directed or required of you by the order. Amounts you receive for these services are included in your gross income, even if you have taken a vow of poverty.

Example. Mark Brown is a member of a religious order and has taken a vow of poverty. He renounces all claims to his earnings and turns over his earnings to the order.

Mark is a school teacher. He was instructed by the superiors of the order to get a job with a private tax-exempt school. Mark became an employee of the school, and, at his request, the school made the salary payments directly to the order.

Because Mark is an employee of the school, he is performing services for the school rather than as an agent of the order. Therefore, the wages Mark earns working for the school are included in his gross income.

Foreign Employer

Special rules apply if you work for a foreign employer.

U.S. citizen. If you are a U.S. citizen who works for a foreign government, an international organization, a foreign embassy, or any foreign employer, you must include your salary in your income.

Social security and Medicare taxes. You are exempt from social security and Medicare taxes if you are employed in the United States by an international organization or a foreign government. However, you must pay self-employment tax on your earnings from services performed in the United States, even though you are not self-employed. This rule also applies if you are an employee of a qualifying wholly-owned instrumentality of a foreign government.

Non-U.S. citizen. If you are not a U.S. citizen, or if you are a U.S. citizen but also a citizen of the Philippines, and you work for an international organization in the United States, your salary from that source is exempt from tax. If you work for a foreign government in the United States, your salary from that source is exempt from tax if your work is like the work done by an employee of the United States in that foreign country and if the foreign government gives an equal exemption for the salary of the U.S. employee.

Alien status. If you are an alien and give up your right to this exemption (by filing a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status), you are not entitled to the exemption from the date you give it up, unless you get the exemption from a treaty, consular agreement, or international agreement.

Pensions. This exemption applies only to employees' wages, salaries, and fees. Pensions received by former employees living in this country do not qualify for this exemption.

Employment abroad. For information on income earned abroad, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.*

Military

Payments you receive as a member of a military service generally are taxable except for certain allowances. Allowances generally are not taxed. For additional information on military pay, see Publication 3, *Tax Information for Military Personnel (Including Reservists Called to Active Duty).*

Taxable Income

Taxable income includes the following items ***unless*** the pay is for service in a combat zone declared by an Executive Order of the President.

- Basic pay for such items as:
  - Active duty,
  - Attendance at a designated service school,
  - Back wages,
  - Drills,
  - Reserve training, and
  - Training duty.
- Special pay for such items as:
  - Aviation career incentives,
  - Diving duty,
  - Foreign duty (for serving outside the 48 contiguous states and the District of Columbia),
  - Hazardous duty,
  - Imminent danger,
  - Medical and dental officers,
  - Nuclear-qualified officers, and
  - Special duty assignment pay.
- Bonuses for such items as:
  - Enlistment, and
  - Re-enlistment.
- Payments for such items as:
  - Accrued leave,
  - Mustering-out payments received after November 4, 1990,
  - Personal money allowances paid to high-ranking officers,
  - Scholarships such as the Armed Forces Health Professions Scholarship Program (AFHPSP), and similar programs, granted after August 16, 1986, and
  - Student loan repayment from programs such as the General Educational Loan Repayment Program.

Military retirement pay. If this retirement pay is based on age or length of service, it is taxable and must be included on lines 16a and 16b of Form 1040, or on lines 11a and 11b of Form 1040A.

Nontaxable Income

The items in the following list are not included in taxable income. This applies whether the item is furnished in-kind, or is a reimbursement or allowance.

- Living allowances for:
  - BAQ (Basic Allowance for Quarters). You can deduct mortgage interest and real estate taxes on your home even if you pay these expenses with money from your BAQ,
  - BAS (Basic Allowance for Subsistence),
  - Housing and cost-of-living allowances abroad whether paid by the U.S. Government or by a foreign government, and
  - VHA (Variable Housing Allowance).
- Family allowances for:
  - Certain educational expenses for dependents,
  - Emergencies,
  - Evacuation to a place of safety, and
  - Separation.
- Death allowances for:
  - Burial services,
  - Death gratuity payments to eligible survivors (not more than $3,000), and
  - Travel of dependents to burial site.
- Moving allowances for:
  - Dislocation,
  - Moving household and personal items,
  - Moving trailers or mobile homes,
  - Storage, and
  - Temporary lodging.
- Travel allowances for:
  - Annual round trip for dependent students,
  - Leave between consecutive overseas tours,
  - Reassignment in a dependent-restricted status, and
  - Transportation for you or your dependents during ship overhaul or inactivation.
- Other payments for:
  - Defense counseling,
  - Disability,
  - Group-term life insurance,
  - Mustering-out payments received before November 5, 1990,
  - Professional education,
  - ROTC educational and subsistence allowances,
  - Survivor and retirement protection plan premiums,
  - Uniform allowances paid to officers, and
  - Uniforms furnished to enlisted personnel.
- In-kind military benefits such as:
  - Legal assistance,
  - Space-available travel on government aircraft,
  - Medical/dental care,
  - Commissary/exchange discounts.

Note. Personal use of a vehicle cannot be excluded from income as a qualified military benefit.

Combat zone exclusion. If you are a member of the U.S. Armed Forces who serves in a combat zone, you may exclude certain pay from your income. For more information, get Publication 945, *Tax Information for Those Affected by Operation Desert Storm.*

Veterans

Veterans' benefits under any law, regulation, or administrative practice that was in effect on September 9, 1986, and administered by the Department of Veterans Affairs (VA), are not included in gross income. The following amounts paid to veterans or their families are not taxable:

- Education, training, or subsistence allowances.
- Disability compensation and pension payments for disabilities.
- Grants for homes designed for wheelchair living.
- Grants for motor vehicles for veterans who lost their sight or the use of their limbs.
- Veterans' pensions paid either to the veterans or to their families.
- Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including proceeds of a veteran's endowment policy paid before death.
- Interest on insurance dividends you leave on deposit with the VA.

Rehabilitative program payments. VA payments to hospital patients and resident veterans for their services under the VA's therapeutic or rehabilitative programs are included as income other than wages on line 21, Form 1040.

Volunteers

The tax treatment of amounts you receive as a volunteer worker for the Peace Corps, ACTION, or similar agency is covered in the following discussions.

Peace Corps

If you are a Peace Corps volunteer or volunteer leader, some amounts you receive may be exempt from tax.

Taxable allowances. Any taxable allowances you receive must be included in your income and reported as wages. These include:

- Cash allowances received during training.
- Allowances paid to your spouse and minor children while you are training in the United States.

- The part of living allowances designated by the President, under the Peace Corps Act, as basic compensation.
- Allowances for personal items such as domestic help, laundry and clothing maintenance, entertainment and recreation, transportation, and other miscellaneous expenses.
- Leave allowances.
- Readjustment allowances or ''termination payments.'' These are considered received by you when credited to your account.

Example. Gary Carpenter, a Peace Corps volunteer, gets $175 a month during his period of service, to be paid to him in a lump sum at the end of his tour of duty. Although the allowance is not available to him until the end of his service, Gary must include it in his income on a monthly basis as it is credited to his account.

ACTION

ACTION participants perform services in antipoverty programs and Older American volunteer programs. Some amounts these participants receive are taxable and others are exempt from tax.

VISTA. If you are a VISTA volunteer, you must include meals and lodging allowances paid to you in your income as wages.

University Year for Action program. If you receive a stipend as a full-time student for service in the University Year for Action program, you must include the stipend in your income as wages.

Older American programs. Do not include in your income amounts you receive for supportive services or reimbursements for out-of-pocket expenses from the following programs:

- Retired Senior Volunteer Program (RSVP),
- Foster Grandparent Program, and
- Senior Companion Program.

Other Volunteer Programs

If you receive amounts for supportive services or are reimbursed for out-of-pocket expenses under either of the following volunteer programs, you do not include these amounts in your gross income:

- Service Corps of Retired Executives (SCORE), and
- Active Corps of Executives (ACE).

Volunteer tax counseling. You do not include in your income any reimbursements you receive for transportation, meals, and other expenses you have in training for, or actually providing, volunteer federal income tax counseling for the elderly (TCE).

You can deduct as a charitable contribution your unreimbursed out-of-pocket expenses in taking part in the volunteer income tax assistance (VITA) program.

Statutory Employees

Statutory employees are considered self-employed independent contractors for purposes of reporting income and expenses on their tax returns. If you are a statutory employee, get Publication 525 for more information.

7.

Tip Income

Introduction

This chapter discusses the tax rules for people who receive tips, such as waiters, waitresses, other food service employees, hairdressers, cab drivers, and casino dealers. It includes:

- What records of tips you should keep,
- When and how to report tips to your employer,
- What taxes your employer must withhold from your tips,
- How to treat tips you did not report to your employer, and
- Whether tip allocation affects you and how to report your tips if your employer allocates tips.

All tips you receive are taxable income and are subject to federal income tax. You must include in gross income tips you receive directly from customers, tips from charge customers that are paid to you by your employer, and your share of any tips you receive under a tip-splitting arrangement.

Withholding tax on tips. Cash tips of $20 or more that you receive in a month while working for any one employer are subject to withholding of income tax, social security or railroad retirement tax, and Medicare tax. Report the tips you receive to your employer so that the correct amount of these taxes can be determined. This is explained under *Withholding on Tips by Employer,* later in this chapter.

Social security or railroad retirement benefits. Your tips and other pay are used to determine the amount of social security or railroad retirement benefits you or your family may receive if you retire, become disabled, or die. Also, your tip income will be considered in determining your eligibility for Medicare benefits at age 65 or if you become disabled. You can get information about these benefits from Social Security offices or Railroad Retirement Board offices. Noncash tips are not counted as wages for social security purposes.

Your future benefits can be figured correctly only if the Social Security Administration (SSA) has your correct information. To make sure that you have received credit for all your earnings, you should request a statement of your earnings from SSA at least every other year. You can get information on how to receive a statement of your earnings by calling 1–800–SSA–1213, or for the hearing impaired with access to TDD equipment, 1–800–325–0778. When you get the statement from SSA, you should check it to be sure it includes all of your earnings.

Useful Items

You may want to see:

Publication

- ❑ **531** Reporting Tip Income
- ❑ **1244** Employee's Daily Record of Tips and Report to Employer

Form (and Instructions)

- ❑ **4137** Social Security and Medicare Tax on Unreported Tip Income

Reporting Tips

You must report all tips as wages on Form 1040, Form 1040A, or Form 1040EZ. This includes the value of tips not paid in cash, such as passes, tickets, goods, or services. If you received tips of $20 or more in a month and you did not report all of them to your employer, you must file Form 1040 and Form 4137. You cannot file Form 1040A or Form 1040EZ. If you are a railroad employee and you did not report tips of $20 or more, contact your employer.

Service charges. A club, hotel, or restaurant may require customers who use its dining or banquet rooms to pay a service charge, which is given to the waiters or waitresses and other employees. Your share of this service charge is not a tip, but it is part of your wages paid by the employer. You should not include your share of the service charge in your report of tips to your employer. Your employer should not include your share of the service charge in tips paid to you, but should include it in your wages.

Tip splitting. If you split tips with fellow employees (such as waiters giving a part of their tips to busboys), include only your share of the tips in your report to your employer. ''Tip splitting'' may be referred to also as ''tip sharing'' or ''tip pooling.''

Daily Record of Tips

You must keep a ***daily record*** or ***other documentation*** to prove the amount of tip income you report on your return.

Daily record. Your daily record must show the following.

- Your name and address,
- Your employer's name, and
- The establishment's name.

Also show for each workday:

- The amount of cash tips you receive directly from customers or from other employees,
- Tips from credit card charge customers when paid to you by your employer,
- The amount of tips you paid out to other employees through tip splitting, etc., and
- The names of the other employees to whom you paid tips.

Make the entries in your daily record on or near the date you receive the tip income. Your records should also show the date each entry is made.

Other documentation. If you do not keep a daily record of tips, you must maintain other documentation of the tip income you receive. This other documentation must be as credible and reliable as a daily record. This other documentation can be:

- Documentary records that show tips added to checks by customers and paid over to you, or
- Amounts paid for food or beverages on which you generally would receive a tip.

Examples of other documentary records are copies of:

- Restaurant bills,
- Credit card charges, or
- Charges under any other arrangement containing amounts added by customers as tips.

Which form to use. You can use ***Form 4070–A***, *Employee's Daily Record of Tips,* to record your tips.

Form 4070–A can be found only in Publication 1244, *Employee's Daily Record of Tips and Report to Employer.* You can get Publication 1244 from the IRS or your employer.

Your personal records. You should keep your daily tip record and a copy of the written reports you give your employer with your personal records.

When to Report Tips to Employer

You must give your employer a written report of your tips for each month by **the 10th day** of the next month. This report is required for each month that you receive tips of $20 or more while working for that employer.

Saturday, Sunday, holiday rule. If the 10th day of the month falls on a Saturday, Sunday, or legal holiday, you can give your employer the report on the next day that is not a Saturday, Sunday, or legal holiday.

Example. You must report tips of $20 or more you receive during May 1995 to your employer by Monday, June 12, 1995.

How to Report Tips to Employer

The following discussions refer only to tips paid by cash, credit card, and check.

Less than $20 in tips in one month. If you receive less than $20 in tips while working for one employer during a month, you do not

have to report them to that employer. But you must include the tips in gross income on your income tax return. You do not have to pay social security tax, Medicare tax, or railroad retirement tax on these tips.

$20 or more in tips in one month. If you receive tips of $20 or more in a month while working for any one employer, you must report the total amount of your tips to that employer.

Example 1. You work for Watson's Restaurant during the month and receive $75 in tips. Because your tips are more than $20 for the month, you must report the $75 to your employer.

Example 2. You work for Watson's Restaurant during the month and receive $17 in tips. In that same month you work for Parkview Restaurant and get $14 in tips. Even though your tips total $31, you do not have to report tips to either employer because you did not receive $20 or more in tips from either job. However, you should keep a record of the $31 because you must report it as income on your tax return.

When to report tips to your employer. Your tip report to your employer should cover only one calendar month. But, your employer may require you to report your tips more often than once a month. For example, you may be required to report your tips weekly. In this case, you must make your report on the dates set by your employer.

When you stop working for your employer, you should report your tips of $20 or more to your employer at that time. If you do not report the tips when you stop working, you must give a statement to your employer either before your final payday or by the 10th day following the month you receive the tips, whichever is earlier.

Date tips are treated as paid. Tips are treated as paid to you when you make the written report to your employer. However, if you make no report to your employer, tips are treated as paid to you when you receive them.

Example 1. During December 1994, you received $300 in tips. On January 10, 1995, you reported the tips to your employer. Your December 1994 tips will be treated as paid to you in January 1995, the time you made the report to your employer. You must report the $300 on your 1995 income tax return.

Example 2. If during December 1994 your tips were only $18, you would not have to make a report to your employer. In this case your tips are treated as paid in December 1994, the time you actually received them. You must report the $18 on your 1994 income tax return.

Information you must report. To report tips to your employer, you can use **Form 4070,** *Employee's Report of Tips to Employer.* This form, available only in Publication 1244, tells you what information you must report. If you do not use Form 4070, your report should include the following.

- The amount of tips,
- Your employer's name and address,
- Your name, social security number, and address,
- The month (or shorter period) covered,
- Your signature, and
- The date of the report.

Withholding on Tips by Employer

Your employer must withhold income tax, social security or railroad retirement tax, and Medicare tax on the tips you report. Your employer usually deducts the withholding due on tips from your regular wages. However, you do not have to have income tax withheld if you can claim exemption from withholding. You can claim exemption only if you had no income tax liability last year and expect none this year. See *Exemption From Withholding* in Chapter 5 for more information.

Employer's recordkeeping. Your employer may withhold an estimated amount from your wages to cover the tax on your tips. Your employer also may require your written tip reports more than once a month and deduct the taxes due on your reported tips even though they do not yet total $20. If this is done, your employer must adjust the amount of taxes withheld from time to time, based on the actual amount of tips you report.

Form W–2. The Form W–2, *Wage and Tax Statement,* which you get from your employer, includes your reported tips.

- Box 1 includes your total wages, other compensation, and the tips you reported.
- Box 3 is your social security wages not including tips.
- Box 7 is your social security tips, the tips you reported to your employer.
- Box 5 is your Medicare wages and tips, which for most persons will be the sum of boxes 3 and 7. Your Medicare wages and tips total will be higher if your wages and tips are more than $60,600.

Any tips that are allocated to you (discussed later) are shown in box 8. Allocated tips are not included in boxes 1, 5, and 7. Any errors you find in these amounts should be brought to your employer's attention as soon as possible so you can obtain a corrected form.

Giving your employer money for taxes. Your regular pay may not be enough for your employer to withhold all the tax due on your regular pay plus reported tips. You can give your employer money to pay this withholding tax up to the close of the calendar year.

If your wages and any money you provide are not enough to pay all of your withholding taxes, the amounts will be applied in the following order. Your employer will first withhold from your wages all taxes due on your regular wages. This includes withholding for state and local income tax. Next, your employer will withhold from the balance of your wages taxes due on your reported tips. Social security and Medicare tax on reported tips will be withheld before any income tax will be withheld. Any taxes that remain unpaid should be collected by the employer out of your next paycheck.

You may pay estimated tax instead of giving your employer extra money. See Chapter 5 for information on estimated tax.

Uncollected employee social security and Medicare tax on tips. Box 13 (code A) on your Form W–2 will show the amount of social security tax on tips that your employer was unable to withhold and for which you did not give your employer extra money to pay the tax.

Box 13 (code B) will show the amount of Medicare tax on tips that your employer was unable to withhold and for which you did not give your employer extra money to pay the tax.

You must file Form 1040 to report the amount of uncollected tax on tips from Box 13 (code A and B), Form W–2, and pay it with your return, even if you do not otherwise have to file a return. Include the amount of uncollected tax in the total on line 53 of Form 1040. On the dotted line next to line 53, write "Uncollected Tax" and show the amount.

Limit on social security and railroad retirement tax. There are limits on the amount of social security and railroad retirement tax that your employer withholds from your wages and reported tips. If you worked for two or more employers in 1994, and you earned more than $60,600 ($45,000 if you are a railroad employee), you may have overpaid one or more of these taxes. You may be eligible for a credit for excess social security tax or railroad retirement tax, discussed in Chapter 36.

Note. Beginning in 1994, your entire wages and reported tips are subject to Medicare tax.

No limit for withholding of income tax. Unlike the social security and railroad retirement taxes, there is no dollar limit on the income tax withheld on wages and tips. The income tax withheld by your employer will either decrease what you owe at the end of the year or increase your refund when you file your return.

Tips Not Reported to Employer

If you received tips of $20 or more in any month while working for one employer, but did not report all of them to your employer, you must figure your social security and Medicare tax on the tips not reported. You

should use **Form 4137** and attach it to Form 1040. See *Social Security and Medicare Tax on Unreported Tip Income (Form 4137),* later.

Employees subject to the Railroad Retirement Act. If you received tips of $20 or more in any month while working for a railroad employer and did not report them to your employer, do not use Form 4137. Instead, see *Employees subject to the Railroad Retirement Act,* in Publication 531.

Penalty for failure to report tips. If you do not report tips to your employer as required, you may be subject to a penalty equal to 50% of the employee social security or railroad retirement tax and Medicare tax, in addition to the tax that you owe.

Reasonable cause. You can avoid this penalty if you can show reasonable cause for not reporting these tips to your employer. To do so, attach a statement to your return explaining why you did not report them.

Tip Allocation

Large food or beverage establishments are required to report certain additional information about tips to the IRS.

To make sure that employees are correctly reporting tips, employers must keep records to verify amounts reported by employees. Certain employers must allocate tips if the percentage of tips reported by employees falls below a required minimum percentage of gross sales. To ''allocate tips'' means to assign an additional amount as tips to each employee whose reported tips are below the required percentage.

How the rules work. If the rules on tip allocation apply to your employer's establishment, your employer must allocate the difference between 8% of total sales (or some lower acceptable percentage) and the amount of reported tips among all tipped employees. However, no allocation will be made to you if you report tips at least equal to your share of 8% of total sales.

If the customers do not tip 8% on the average, either your employer or a majority of the directly-tipped employees may petition to have the allocation percentage reduced from 8%. However, it cannot be reduced below 2%.

Allocated tips on Form W-2. Your employer will report the amount of tips allocated to you on your Form W–2 (in box 8), separately from your wages and reported tips. Your employer bases withholding only on wages and reported tips. Your employer ***should not withhold*** income, social security, railroad retirement, or Medicare taxes from the allocated amount. Any incorrectly withheld taxes should be refunded to you by your employer.

Allocated tips you must report as income. You must report as income on Form 1040, line 7, at least the amount of allocated tips shown on your Form(s) W–2 unless you have adequate records that prove you received a smaller amount. If you have records, you **must** report as income the amount of tips your records show you actually received, even if this amount is more or less than the allocated tips. The IRS may determine that you received a larger amount of tip income than reflected by the tip allocation.

For more information on these requirements, see *Tip Allocation* in Publication 531.

Social Security and Medicare Tax on Unreported Tip Income (Form 4137)

Report on line 1 of Form 4137 ***all*** of the tips you received. This includes tips you reported to your employer, unreported tips, and allocated tips that you must report as income. Report on line 2 the amount of tips you reported to your employer and on line 4 the amount of tips you did not report because the total was less than $20 in a calendar month. These amounts are subtracted from the amount on line 1. The balances on lines 9 and 5 are the unreported tips subject to social security and Medicare tax figured on Form 4137.

Note: Only include cash, check, and charge tips when completing Form 4137. The value of tips not paid in cash or by check or charge card are not counted as wages for social security and Medicare tax purposes.

Be sure to complete Schedule U on the bottom of Form 4137. Schedule U is used by the Social Security Administration to credit your social security and Medicare accounts.

Attach Form 4137 to Form 1040. Enter the tax on line 50 of Form 1040. You may not use Form 1040EZ or Form 1040A.

Note: Do not include on line 50, Form 1040, any amount of uncollected social security tax and Medicare tax due on tips you **did** report to your employer. This amount, if any, is shown in Box 13 on Form W–2. Instead, see *Uncollected employee social security and Medicare tax on tips* under *Withholding on Tips by Employer* for the method of paying these taxes.

8.

Interest Income

Important Reminders

Market discount rules changed for certain taxable bonds. Bonds issued before July 19, 1984, are subject to the rules for market discount bonds if you purchased them after April 30, 1993. For more information, see *Market discount bonds* later in this chapter.

Market discount rules changed for certain tax-exempt bonds. When you redeem or dispose of tax-exempt bonds that you bought after April 30, 1993, any gain from market discount is taxable as ordinary income. For tax-exempt bonds that you bought before May 1, 1993, the gain from market discount is capital gain. For more information, see *Market discount bonds* later in this chapter.

Tax exemption continued for qualified mortgage bonds and qualified small issue bonds. The interest on qualified mortgage bonds and qualified small issue bonds was scheduled to become taxable on bonds issued after June 30, 1992. Instead, the exemption from tax on these bonds has been extended, and interest on these bonds continues to be exempt from tax. For more information about tax-exempt bonds, see *State or Local Government Obligations* later in this chapter.

Education Savings Bond Program. You may be able to exclude from income interest on qualified U.S. savings bonds that you redeem if you pay qualified higher educational expenses. These are expenses for tuition and required fees at an eligible educational institution (college or eligible vocational school) for you, your spouse, or your dependent. A "qualified U.S. savings bond" is a Series EE savings bond that is ***issued after December 31, 1989,*** to an individual 24 years of age or older.

Reporting tax-exempt interest. You must show on your tax return the amount of any tax-exempt interest you received or accrued during the tax year. This is an information-reporting requirement and does not convert tax-exempt interest to taxable interest. For more information, see *How to Report Interest Income* later in this chapter.

Introduction

This chapter discusses:

- Different types of interest income,
- What interest is taxable and what interest is nontaxable,
- When to report interest income, and
- How to report interest income on your tax return.

In general, any interest that you receive or that is credited to your account and can be withdrawn is taxable income. (It does not have to be entered in your passbook.) Exceptions to this rule are discussed later in this chapter.

As an important part of your records, you should keep a list showing sources and amounts of interest received during the year.

You may be able to deduct expenses you have in earning this income on Schedule A (Form 1040) if you itemize your deductions. See Chapter 30.

Useful Items

You may want to see:

Publication

- ❑ **525** Taxable and Nontaxable Income
- ❑ **537** Installment Sales
- ❑ **550** Investment Income and Expenses
- ❑ **925** Passive Activity and At-Risk Rules
- ❑ **1212** List of Original Issue Discount Instruments

Form (and Instructions)

- ❑ **Schedule B (Form 1040)** Interest and Dividend Income
- ❑ **Schedule 1 (Form 1040A)** Interest and Dividend Income for Form 1040A Filers
- ❑ **1099** 1994 Instructions for Forms 1099, 1098, 5498, and W–2G
- ❑ **3115** Application for Change in Accounting Method
- ❑ **8815** Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989
- ❑ **8818** Optional Form To Record Redemption of Series EE U.S. Savings Bonds Issued After 1989

General Information

A few items of general interest are covered here.

Passive activity income and losses. There are tax rules which limit the amount of losses and tax credits from passive activities that you can claim. Generally, you can use losses from passive activities only to offset income from passive activities. You generally cannot use passive activity losses to offset your other income, such as your wages or your ***portfolio income*** (that is, any gross income from interest, dividends, etc., that is not derived in the ordinary course of a trade or business). For more information about determining and reporting income and losses from passive activities, see Publication 925.

Tax on investment income of a child under age 14. Part of a child's investment income may be taxed at the parent's tax rate. This may happen if the child is under age 14, has more than $1,200 of investment income (such as taxable interest and dividends) and is required to file a tax return, and either parent is alive at the end of the year. If these requirements are met, **Form 8615,** *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,200,* must be completed and attached to the child's tax return. If these requirements are not met, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, the parent can choose to include the child's interest and dividends on the parent's return if certain requirements are met. Use **Form 8814,** *Parents' Election To Report Child's Interest and Dividends,* for this purpose.

For more information about the tax on investment income of children and the parents' election, see Chapter 32.

Beneficiary of an estate or trust. Interest, dividends, or other investment income you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a **Schedule K–1** (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.,* from the fiduciary. Your copy of Schedule K–1 and its instructions will tell you where to report the items on your Form 1040.

Backup withholding. To ensure that income tax is collected on interest and other types of income that generally are not subject to withholding, backup withholding will apply in certain circumstances.

Under backup withholding, when you open a new account you must certify under penalties of perjury that your social security number is correct and that you are not subject to backup withholding. If you fail to make this certification, backup withholding may begin immediately on your new account or investment, and 31% of the interest paid on your account will be withheld. Your payer will give you a **Form W–9,** *Request for Taxpayer Identification Number and Certification,* or a similar form, to make this certification. Backup withholding may also be required if the Internal Revenue Service (IRS) has determined that you underreported your interest or dividend income. For more information, see *Backup Withholding* in Chapter 5.

Social security number. You must give your name and social security number to any person required by federal tax law to make a

return, statement, or other document that relates to you. This includes payers of interest. If you are married and the funds in a joint account belong to you, you should give your social security number to the payer of the interest. If the funds in the account belong to both you and your spouse, you may give either your number or your spouse's number. But the number you provide must correspond with the name listed first on the account. You must give the payer the correct social security number if the number being used is wrong.

Penalty. If you do not give your social security number to the payer of interest, you may have to pay a penalty. See *Penalty for failure to supply social security number* under *Penalties* in Chapter 1. Backup withholding also may apply. See *Backup Withholding* in Chapter 5.

Joint accounts. In a joint account, two or more persons, such as you and your spouse, hold property as ***joint tenants, tenants by the entirety, or tenants in common.*** That property can include a savings account or bond. Each person receives a share of any interest from the property. Each person's share is determined by local law.

Income from property given to a child. Property you give as a parent to your child under the Model Gifts of Securities to Minors Act, the Uniform Gifts to Minors Act, or any similar law, is a true gift for federal gift tax purposes.

Income from property transferred under these laws is taxable to the child unless it is used in any way to satisfy a legal obligation of support of that child. The income is taxable to the person having the legal obligation to support the child (parent or guardian) to the extent that it is used for the child's support.

Savings account with parent as trustee. Interest income derived from a savings account opened for a child who is a minor, but placed in the name and subject to the order of the parents as trustees, is taxable to the child, if, under the law of the state in which the child resides:

1) The savings account legally belongs to the child, and
2) The parents are not legally permitted to use any of the funds to support the child.

Form 1099–INT. Interest income is generally reported to you on Form 1099–INT, *Interest Income,* or a similar statement, by banks, savings and loans, and other payers of interest. This form shows you the interest you received during the year. Keep this form for your records. You do not have to attach it to your tax return.

Report on your tax return the total amount of interest income that is shown on any Form 1099–INT that you receive for the tax year. You must also report all of your interest income for which you do not receive a Form 1099–INT.

Reporting backup withholding. If backup withholding is deducted from your interest income, the payer must give you a Form 1099–INT that indicates the amount withheld. The Form 1099–INT will show any backup withholding as ''Federal income tax withheld.''

Nominees. Generally, if someone receives interest as a nominee for you, that person will give you a Form 1099–INT showing the interest they received on your behalf.

If you receive a Form 1099–INT that includes amounts belonging to another person, see the discussion on nominee distributions, later, under *How to Report Interest Income.*

Incorrect amount. If you receive a Form 1099–INT that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The new Form 1099–INT you receive will be marked ''CORRECTED.''

Interest on Form 1099–OID. Reportable interest income may also be shown on Form 1099–OID, *Original Issue Discount.* For more information about amounts shown on this form, see *Original Issue Discount (OID),* later in this chapter.

Individual Retirement Arrangements (IRAs). Interest that you earn on an IRA is tax-deferred. You generally do not include it in your income until you make withdrawals from the IRA. Nor is it included in the amount to be reported as tax-exempt interest. See Chapter 18.

Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information reporting requirement,* next.) You will receive a notice from the mutual fund telling you the amount of the tax-exempt interest dividends that you received. Exempt-interest dividends are not shown on Form 1099–DIV or Form 1099–INT.

Information reporting requirement. Although exempt-interest dividends are not taxable, you must show them on your tax return if you are required to file. This is an information reporting requirement and does ***not*** convert the exempt-interest dividend to taxable income. See *How to Report Interest Income,* later.

Note: Exempt-interest dividends may be treated as tax-exempt interest on specified private activity bonds, which is a ''tax preference item'' that may be subject to the alternative minimum tax. See *Alternative Minimum Tax* in Chapter 31 for more information. Publication 550 contains a discussion on private activity bonds, under *State or Local Government Obligations.*

Interest income on frozen deposits. A frozen deposit is an account from which you are unable to withdraw funds because:

1) The financial institution is bankrupt or insolvent, or
2) The state where the financial institution is located has placed limits on withdrawals because other banks in the state are bankrupt or insolvent.

Exclude from your gross income interest credited during 1994 on frozen deposits that you could not withdraw by the end of 1994.

Amount to exclude. The amount of interest you must exclude from gross income in 1994 is the interest that was credited on the frozen deposits minus the sum of:

1) The net amount you withdrew from these deposits during 1994, and
2) The amount you could withdraw as of the end of 1994 (not reduced by any penalty for premature withdrawals of a time deposit).

If you receive a Form 1099–INT for interest income on deposits that were frozen at the end of 1994, see *Frozen deposits* later under *How to Report Interest Income,* for information about reporting this interest income exclusion on your 1994 tax return.

The interest you excluded from your income in 1994 must be reported in the later tax year when you can withdraw it from your account.

Example. $100 of interest was credited on your frozen deposit during the year. You withdrew $80 but could not withdraw any more as of the end of the year. Your net amount withdrawn was $80. You must exclude $20. You must include $80 in your income for the year.

Interest on VA dividends. Interest on insurance dividends that you leave on deposit with the Department of Veterans Affairs (VA) is ***not*** taxable. This includes interest paid on dividends on converted United States Government Life Insurance and on National Service Life Insurance policies.

Taxable Interest

Taxable interest includes interest you receive from bank accounts, loans you make to others, and interest from most other sources. The following are some other sources of taxable interest.

Dividends that are actually interest. Certain distributions commonly referred to as dividends are actually interest. You must report as interest so-called ''dividends'' on deposits or on share accounts in:

- Cooperative Banks
- Credit Unions
- Domestic Building and Loan Associations
- Domestic Savings and Loan Associations
- Federal Savings and Loan Associations
- Mutual Savings Banks

Money market funds. Generally, amounts you receive from money market funds should be reported as dividends, not as interest.

Money market certificates, savings certificates, and other deferred interest accounts. If you open any of these accounts, and interest is paid at fixed intervals of one year or less during the term of the account, you must include this interest in your income when you actually receive it or are entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in one year or less and give a single payment of interest at maturity. If interest is deferred for more than one year, see *Original Issue Discount (OID),* later.

Money borrowed to invest in money market certificate. The interest you pay on money borrowed from a bank or savings institution to meet the minimum deposit required for a money market certificate from the institution and the interest you earn on the certificate are two separate items. You must report the total interest you earn on the certificate in your income. You may deduct the interest you pay, as investment interest subject to certain limits, only if you itemize deductions. The limits are discussed in Chapter 3 of Publication 550 under *Limit on Investment Interest.*

Example. You deposit $5,000 with a bank and borrow $5,000 from the bank to make up the $10,000 minimum deposit required to buy a 6–month money market certificate. The certificate earns $575 at maturity in 1994, but you receive only $265, which represents the $575 you earned minus $310 interest charged on your $5,000 loan. The bank gives you a Form 1099–INT for 1994 showing the $575 interest you earned. The bank also gives you a statement showing that you paid $310 interest for 1994. You must include the $575 in your income. You may deduct up to $310 on Schedule A (Form 1040) if you itemize your deductions, subject to the investment interest expense limit.

Gift for opening account. The fair market value of ''gifts'' or services you receive for making long-term deposits or for opening accounts in savings institutions is interest. Report it in income in the year you receive it.

Example. In 1994, you open a savings account at your local bank. The account earns $20, which is credited as interest. You also receive a $10 calculator. If no other interest is credited to your account during 1994, the Form 1099–INT you receive would show $30 interest income for 1994.

Interest on insurance dividends. Interest on insurance dividends that you leave on deposit with an insurance company, that is credited annually, and that can be withdrawn annually, is taxable to you when the interest is credited to your account. However, if you can only withdraw it on the anniversary date of the policy (or other specified date), the interest is taxable in the year in which that date occurs.

Prepaid insurance premiums. Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for you to withdraw. Your insurance company must give you a Form 1099–INT showing the interest you earned for the year if you had $10 or more of interest income from that company.

U.S. obligations. Interest on U.S. obligations, such as U.S. Treasury bills, notes, and bonds, issued by any agency or instrumentality of the United States, is taxable for federal income tax purposes, but is exempt from all state and local income taxes.

Treasury bills are issued at a discount and generally have 13–week, 26–week, and 52–week maturity periods. The difference between the discounted price you pay for the bills and the face value you receive at maturity is interest income. Report this interest income when the bill is paid at maturity.

Treasury notes range in maturity periods from 1 to 10 years. Maturity periods for Treasury bonds are longer than 10 years. Both notes and bonds generally pay interest every 6 months. Report this interest for the year paid. For more information, see *U.S. Treasury Bills, Notes, and Bonds* in Publication 550.

For information on Series EE and Series HH Savings Bonds, see *U.S. Savings Bonds,* later.

Interest on tax refunds. Interest you receive on tax refunds is taxable income.

Interest on condemnation award. If the condemning authority pays you interest to compensate you for a delay in paying an award, the interest is taxable.

Installment sale payments. Certain deferred payments you receive under a contract for the sale or exchange of property provide for interest that is taxable. If little or no interest is provided for in certain contracts with payments due more than one year after the date of sale, each payment due more than 6 months after the date of sale will be treated as containing interest. These unstated interest rules apply to certain payments received on account of a ***seller-financed*** sale or exchange of property. See *Unstated Interest* in Publication 537, *Installment Sales.*

Interest on annuity contract. Accumulated interest on an annuity contract you sell before its maturity date is taxable.

Usurious interest. Usurious interest is taxable unless state law automatically changes it to a payment on the principal. Usurious interest is interest charged at an illegal rate.

Accrued interest on bonds. If you sell bonds between interest payment dates, the accrued interest paid to you is taxable. See *Bonds Sold Between Interest Dates,* later.

Bonds traded flat. If you purchase bonds when interest has been defaulted or when the interest has accrued but has not been paid, that interest is not income and is not taxable as interest if later paid. Such payments are returns of capital which reduce the remaining cost basis. Interest which accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued. See *Bonds Sold Between Interest Dates,* later, for more information.

Interest on below-market loans. A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. See *Below-Market Loans* in Publication 550 for more information.

U.S. Savings Bonds

You may earn interest on U.S. Savings Bonds in one of two ways. On some bonds, interest is paid at stated intervals by interest checks or coupons. Other bonds are issued at a discount and pay all interest at redemption or maturity. The interest on the latter is the difference between what you pay for the bond and its redemption or maturity value.

This section provides information on different types of U.S. Savings Bonds, how to report the interest income on these bonds, and how to treat transfers of these bonds.

Cash-basis taxpayers. If you use the cash method of accounting, as most individual taxpayers do, you generally report the interest on U.S. Savings Bonds when you receive it. The cash method of accounting is explained in Chapter 1 under *Accounting Methods.*

Accrual-basis taxpayers. If you use an accrual method of accounting, you must report interest on U.S. Savings Bonds each year as it accrues. You cannot postpone reporting interest until you receive it or the bonds mature. Accrual methods of accounting are explained in Chapter 1 under *Accounting Methods.*

Series HH Bonds. These bonds are issued at face value. Interest is paid twice a year by check or by direct deposit to your bank account. If you are a cash-basis taxpayer, you must report interest on these bonds as income in the year you receive it.

Series HH Bonds were first offered in 1980. Before 1980, ***Series H Bonds*** were issued. Series H Bonds are treated the same as Series HH Bonds. If you are a cash-basis taxpayer, you must report the interest when you receive it.

Series EE Bonds. These bonds are issued at a discount. You pay less than the face value for the bonds. The face value is payable to you at maturity. The difference between the purchase price and the redemption value is taxable interest.

Series EE Bonds were first offered in 1980. Before 1980, ***Series E Bonds*** were issued. If you own either Series EE or Series E Bonds and use the cash method of reporting income, you can:

1) Postpone reporting the interest until the earlier of the year you cash the bonds or the year in which they finally mature (***method 1***), or
2) Choose to report the increase in redemption value as interest each year (***method 2***).

Change from method 1. If you want to change your method of reporting the interest from method (1) to method (2), you can do so without permission from the IRS. However, in the year of change you must report all interest accrued to date and not previously reported for all such bonds.

Once you choose to report the interest each year, you must continue to do so for all Series EE or Series E Bonds you own and for any you get later, unless you request permission to change, as discussed next.

Change from method 2. To change from method (2) to method (1), complete **Form 3115,** *Application for Change in Accounting Method,* and attach it to your income tax return for the year of change. Type or print at the top of page 1 of the Form 3115 ''*Filed Under Rev. Proc. 89–46.*'' You must file your return by the due date (including extensions). You must identify the savings bonds for which you are requesting this change in accounting method.

Permission for the change is automatically granted if you attach to Form 3115 a statement that you agree to report all interest on the bonds acquired:

1) During the year of change and for all subsequent tax years, when the interest is realized upon disposition, redemption, or final maturity, whichever is earlier, and
2) Before the year of change, when the interest is realized upon disposition, redemption, or final maturity, whichever is earlier, with the exception of any interest income previously reported in prior tax years.

Note. If you plan to redeem Series EE bonds in the same year that you pay for higher education expenses, you ***should*** use method (1). See *Education Savings Bond Program* later for more information.

Bonds held beyond maturity. If you hold the bonds beyond the original maturity period, and if you have chosen to report the interest each year, you must continue to do so unless you get permission to change your method of reporting. If you have chosen to postpone reporting the interest, you need not include the interest in income for the year of original maturity. Report it in the year you redeem the bonds or the year in which the extended maturity period ends, whichever is earlier. The original maturity period has been extended on all Series E Bonds.

The extended maturity period of Series E Bonds issued between May 1941 and November 1965 ends 40 years from their issue dates. The Department of the Treasury has announced that no further extension will be given to these bonds. Therefore, if you have postponed reporting interest on Series E Bonds purchased in 1954, you must report the interest on your 1994 return, unless you trade your Series E Bonds for Series HH Bonds.

Co-owners. If you buy a U.S. Savings Bond issued in your name and another person's name as co-owners, such as you and your child or you and your spouse, interest on the bond is generally taxable to the co-owner who bought the bond. If you used your funds to buy the bond, you must pay the tax on the interest. This is true even if you let the other co-owner redeem the bond and keep all the proceeds. Under these circumstances, since the other co-owner will receive a Form 1099–INT at the time of redemption, the other co-owner must provide you with another Form 1099–INT showing the amount of interest from the bond that is taxable to you. The co-owner who redeemed the bond is a ''nominee.'' See *Nominee distributions and accrued interest (Form 1040),* later, under *How to Report Interest Income,* for more information about how a person who is a nominee reports interest income belonging to another person.

If you and the other co-owner each contribute part of the purchase price, interest on the bond is generally taxable to each of you, in proportion to the amount each of you paid.

If you and your spouse live in a community property state and hold bonds as community property, one-half of the interest is considered received by each of you. If you file separate returns, each of you must report one-half the bond interest. For more information about community property, see Publication 555, *Federal Tax Information on Community Property.*

These rules are also contained in *Table 8–1.*

Ownership transferred. If you bought Series EE or Series E Bonds ***entirely with your own funds*** and have them reissued in your co-owner's name or beneficiary's name alone, you must include in your gross income for the year of reissue all interest that you earned on such bonds and have not previously reported. But, if the bonds were reissued in your name alone, you do not have to report the interest accrued at that time. This same rule applies when bonds are transferred between spouses incident to divorce.

Purchased jointly. If you buy Series EE or Series E Bonds ***jointly*** with a co-owner and have them reissued in the co-owner's name alone, you must include in your gross income for the year of reissue your share of all the interest earned on the bonds that you have not previously reported. At the time of reissue, the former co-owner does not have to include in gross income his or her share of the interest earned that was not reported before the transfer. This interest, however, as well as all interest earned after the reissue, is income to the former co-owner.

This income reporting rule also applies when the bonds are reissued in the name of your former co-owner and a new co-owner. But the new co-owner will report only his or her share of the interest earned after the transfer.

If bonds that you and a co-owner bought ***jointly*** are reissued to each of you separately in the same proportion as your contribution to the purchase price, neither you nor your co-owner has to report at that time the interest earned before the bonds were reissued.

Example. You and your spouse each spent an equal amount to buy a $1,000 Series EE Savings Bond. The bond was issued to you as co-owners. You both postpone reporting interest on the bond. You later have the bond reissued as two $500 bonds, one in your name and one in your spouse's name. At that time neither you nor your spouse has to report the interest earned to the date of reissue. But if you bought the $1,000 bond entirely with your own funds, you must report half the interest earned to the date of reissue. This is the previously postponed interest earned on the $1,000 bond that is attributable to the $500 bond issued to your spouse.

Transfer to a trust. If you own Series EE or Series E Bonds and transfer them to a trust, giving up all rights of ownership, you must include in your income for that year the interest earned to the date of transfer, if you have not

Table 8-1. **Who Pays Tax on U.S. Savings Bond Interest**

How Bond Is Purchased	Who Must Pay Tax on Bond Interest
You use your funds to buy a bond in your name and the name of another person as co-owners.	You
You buy a bond in the name of another person, who is the sole owner of the bond.	The person for whom you bought the bond
You and another person buy a bond as co-owners, each contributing part of the purchase price.	Each of you, in proportion to the amount you and the other co-owner each paid
You and your spouse, who live in a community property state, buy a bond that is community property.	If you file separate returns, each of you generally pays tax on one-half.

already reported it. However, if you are considered the owner of the trust and if the increase in value both before and after the transfer continues to be taxable to you, you can continue to postpone reporting the interest earned each year. You must include the total interest in your income when the bonds are cashed or finally mature, whichever is earlier.

The same rules apply to previously unreported interest on Series EE or Series E Bonds if the transfer to a trust consisted of Series HH or Series H Bonds you got in a trade for the Series EE or Series E Bonds. See *Savings bonds traded,* later.

Decedents. The manner of reporting interest income on Series EE or Series E Bonds, after the death of the owner, depends on the accounting and income reporting method previously used by the decedent. If the bonds transferred because of death were owned by a person who used an accrual method, or who used the cash method and had chosen to report the interest each year, the interest earned in the year of death up to the date of death must be reported on that person's final return. The person who acquires the bonds includes in income only interest earned after the date of death.

If the transferred bonds were owned by a decedent who used the cash method, who had not chosen to report the interest each year, and who bought the bonds entirely with his or her own funds, all interest earned before death must be reported in one of the following ways:

1) The surviving spouse or personal representative (executor, administrator, etc.) who files the final income tax return of the decedent can choose to include on that return all of the interest earned on the bonds before the decedent's death. The person who acquires the bonds then includes in income only interest earned after the date of death, or

2) If the choice in (1) is not made, the interest earned up to the date of death is income in respect of a decedent. It should not be included in the decedent's final return. All of the interest earned both before and after the decedent's death is income to the person who acquires the bonds. If that person uses the cash method and does not choose to report the interest each year, he or she can postpone reporting any of it until the bonds are cashed or finally mature, whichever is earlier. In the year that person reports the interest, he or she can claim a deduction for any federal estate tax paid that was for the part of the interest included in the decedent's estate.

For more information on income in respect of a decedent, see Chapter 4.

Savings bonds traded. If you traded Series E Bonds for Series H Bonds, or traded Series EE or Series E Bonds for Series HH Bonds, you did not realize taxable income unless you received cash in the trade. Any cash you received is income to the extent of the interest earned on the bonds traded. When your Series HH or Series H Bonds mature, or if you dispose of them before maturity, you report as interest the difference between their redemption value and your cost. Your cost is the sum of your cost of the traded Series EE or Series E Bonds plus any amount you had to pay at the time of the trade.

Example. You trade Series E Bonds with a redemption value of $2,723 for Series HH Bonds. You get $2,500 in Series HH Bonds and $223 in cash. You must report the $223 as taxable income in the year of the trade to the extent that you did not report interest on the Series E Bonds you traded.

$500 minimum value. Series EE or Series E Bonds that you want to trade must have a current redemption value of $500 or more. To figure the current redemption value of the bonds to be traded, you must add the accrued interest to their original purchase price.

Choice to report interest in year of trade. You can choose to treat all of the accrued interest on the Series EE or Series E Bonds traded for Series HH Bonds as income in the year of the trade.

Form 1099–INT for U.S. Savings Bonds interest. When you cash a bond, the bank or other payer that redeems it must give you a Form 1099–INT if the interest part of the payment you receive is $10 or more. Box 3 of your Form 1099–INT should show the interest as the difference between the amount you received and the amount paid for the bond. However, your Form 1099–INT may show more interest than you are required to include on your income tax return. For example, this may happen if:

1) You chose to report the increase in the redemption value of the bond each year. The interest shown on your Form 1099–INT will not be reduced by amounts previously included in income.

2) You received a bond from a decedent. The interest shown on your Form 1099–INT will not be reduced by any interest reported by the decedent before death, or on the decedent's final return, or by the estate on the estate's income tax return.

3) Ownership of a bond was transferred. The interest shown on your Form 1099–INT will not be reduced by interest that accrued prior to the transfer.

4) You redeemed a bond on which you were named as a co-owner but for which you did not use your funds to buy the bond. (See *Co-owners,* earlier in this chapter, for more information about the reporting requirements.)

5) You received a taxable distribution of bonds from a retirement or profit-sharing plan. The interest shown on your Form 1099–INT will not be reduced by the interest portion of amounts taxable as a distribution from a retirement or profit-sharing plan and not taxable as interest. (These amounts are generally shown on Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*)

For information on including the correct amount of interest on your return for (1), (2), (3), and (4) above, see *How to Report Interest Income,* later. Publication 550 includes examples showing how to report these amounts.

If you received a taxable distribution of bonds from a retirement or profit-sharing plan ((5), above), see *Interest from U.S. Savings Bonds* under *How to Report Interest Income* in Publication 550 for information on how to report the interest.

Note. U.S. Savings Bond interest is exempt from state and local taxes. The Form 1099–INT you receive will indicate the amount that is for U.S. Savings Bond interest in Box 3. Do not include this amount on your state or local income tax return.

Education Savings Bond Program. You may be able to exclude from income all or part of the interest you receive on the redemption of qualified U.S. Savings Bonds during the year if you pay qualified higher educational expenses during the same year. This exclusion is known as the *Education Savings Bond Program.*

Married taxpayers who file separate returns ***do not*** qualify for this exclusion.

Qualified U.S. Savings Bonds. A qualified U.S. Savings Bond is a Series EE U.S. Savings Bond ***issued after December 31, 1989.*** The bond must be issued either in your name (sole owner) or in your and your spouse's name (co-owners). You must be at least 24 years old before the bond's issue date.

The date a bond is issued may be earlier than the date the bond is purchased because bonds are issued as of the first day of the month in which they are purchased. You may designate any individual (including a child) as a beneficiary of the bond (payable on death).

Eligible expenses. Qualified higher educational expenses are tuition and fees required for you, your spouse, or your dependent (for whom you can claim an exemption) to attend an eligible educational institution. Eligible expenses do not include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree program.

Eligible educational institutions. These institutions include most public and nonprofit universities and colleges and certain vocational schools that are eligible for federal assistance.

Amount excludable. If the total proceeds (interest and principal) from the qualified U.S. Savings Bonds you redeem during the year are not more than your qualified higher educational expenses for the year,

you can exclude all of the interest. If the proceeds are more than the expenses, you will be able to exclude only part of the interest.

To determine the excludable amount, multiply the interest part of the proceeds by a fraction. The numerator (top part) of the fraction is the qualified higher educational expenses you paid during the year. The denominator (bottom part) of the fraction is the total proceeds you received during the year.

Example. In April 1994, Mark and Joan, a married couple, cashed qualified Series EE U.S. Savings Bonds they bought in November 1990. In 1994, they helped pay for their daughter's college tuition. They received proceeds of $5,800, representing principal of $5,000 and interest of $800. The qualified higher educational expenses they paid during 1994 totaled $4,000. They can exclude $552 ($800 × ($4,000 ÷ $5,800)) of interest in 1994.

Exclusion reduced for certain benefits. Before you figure your interest exclusion, you must reduce your qualified higher educational expenses by certain benefits the student may have received. These benefits include qualified scholarships that are exempt from tax and any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses, such as veterans' educational assistance benefits and employer-provided educational assistance benefits. See Publication 520, *Scholarships and Fellowships,* for more information on qualified scholarships.

Modified adjusted gross income limit. The interest exclusion is phased out if your modified adjusted gross income (modified AGI) is:

- $41,201 to $56,200 for taxpayers filing single, head of household, or qualifying widow(er) with dependent child, and
- $61,851 to $91,850 for married taxpayers filing jointly.

You do not qualify for the interest exclusion if your modified AGI is equal to or more than the upper limit for your filing status.

Modified AGI, for purposes of this exclusion, is adjusted gross income (line 16 of Form 1040A or line 31 of Form 1040) figured ***before*** the interest exclusion, and modified by adding back any:

1) Foreign earned income exclusion,
2) Foreign housing exclusion or deduction,
3) Exclusion for income from certain U.S. possessions, and
4) Exclusion for income from sources within Puerto Rico.

If you do not have any of these items, your modified AGI is your adjusted gross income before the interest exclusion.

If you have investment interest expense attributable to royalty income, see *Education Savings Bond Program* in Publication 550.

Form 8815. Use Form 8815, *Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989,* to figure your exclusion and to compute your modified AGI.

Recordkeeping. If you claim the interest exclusion, you must keep a written record of the Series EE U.S. Savings Bonds issued after 1989 that you redeem. Your written record must include the serial number, issue date, face value, and redemption proceeds of each bond. You may use **Form 8818,** *Optional Form To Record Redemption of Series EE U.S. Savings Bonds Issued After 1989,* to keep this information.

You should also keep bills, receipts, canceled checks, or other documentation that shows you paid qualified higher educational expenses during the year.

Verification by IRS. Only Series EE U.S. Savings Bonds issued after December 31, 1989, qualify for this exclusion. If you claim the exclusion, IRS will check it by using bond redemption information from Department of the Treasury records.

Bonds Sold Between Interest Dates

When bonds are sold between interest dates, part of the sales price represents interest accrued to the date of sale. The seller must report this interest in gross income. The purchaser must treat this amount as a capital investment and deduct it from the next interest payment as a return of capital. To do this, the purchaser must:

1) Report the total interest payment as taxable interest on line 1 of Schedule B (Form 1040), and
2) Show the accrued interest separately and subtract it from the total interest reported.

See *Nominee distributions and accrued interest (Form 1040),* later under *How to Report Interest Income,* for information about making this adjustment.

If the bond is an original issue discount (OID) debt instrument, see *Original Issue Discount (OID),* later, to determine the OID you must include in income. Also, see *Original issue discount (OID),* under *How to Report Interest Income,* for information on how to report OID on your income tax return.

If the bond has market discount, see *Market discount bonds,* later under *Original Issue Discount (OID),* for information about the accrued market discount that must be recognized as interest income.

Insurance

Life insurance proceeds paid to you as beneficiary of the insured person are not taxable unless the policy was turned over to you for a price. This is true even if the proceeds were paid under an accident or health insurance policy or an endowment contract.

If you receive life insurance proceeds in installments, you can exclude a part of each installment from your income. If you die before you receive all of the installments, a second beneficiary can also exclude a part of each installment.

For more information about insurance proceeds received in installments, see Publication 525.

Annuity. If you buy an annuity with life insurance proceeds, the annuity payments you receive are taxed as pension and annuity income, not as interest income. See Publication 939, *Pension General Rule (Nonsimplified Method),* for information on taxation of pension and annuity income.

Original Issue Discount (OID)

Original issue discount (OID) is a form of interest. You report OID as it accrues, whether or not you receive any payments from the bond issuer.

A long-term debt instrument, such as a bond, note, or other evidence of indebtedness, generally has OID when the instrument is issued for a price that is less than its stated redemption price at maturity (principal amount). The amount of OID is the difference between the principal amount and the issue price of the instrument.

All long-term debt instruments that pay no interest prior to maturity are presumed to be issued at a discount. Zero-coupon bonds are one example of such instruments.

The OID rules do not apply to short-term obligations (those with a fixed maturity date of one year or less from date of issue). See *Discount on Short-Term Obligations* in Publication 550.

De minimis OID. You can disregard the discount and treat it as zero if it is less than one-fourth of 1% (.0025) of the stated redemption price at maturity, multiplied by the number of full years from the date of original issue to maturity. This small discount is known as "de minimis OID."

Example 1. You bought a 10–year bond, with a stated redemption price at maturity of $1,000, issued at $980 and having OID of $20. One-fourth of 1% of $1,000 (stated redemption price) times 10 (number of full years from the date of original issue to maturity) equals $25. Because the $20 discount is less than $25, you can disregard reporting the OID.

Example 2. Assume the same facts as in Example 1, except that the bond was issued at $950. The OID is $50. Because the $50 discount is not less than the $25 figured in Example 1, you must report the OID.

If a subsequent holder buys a debt instrument with de minimis OID at a premium, the OID is not includible in income. If a subsequent holder buys a debt instrument with de minimis OID at a discount, the discount is reported under the rules for *Market Discount Bonds* discussed in Chapter 1 of Publication 550.

Form 1099–OID. The issuer of the debt instrument (or your broker, if you held the instrument through a broker) should give you Form 1099–OID, *Original Issue Discount,* or a similar statement, if the total OID for the

calendar year is $10 or more. Form 1099–OID shows the amount of OID for the period in 1994 that you held the bond. It also will show the stated interest that you must include in your income. A copy of Form 1099–OID will be sent to the IRS. Do not file your copy with your return. Keep it for your records. See *Recomputation of OID shown on Form 1099–OID,* later in this discussion and also *Original issue discount (OID)*, later under *How to Report Interest Income,* for more information.

Nominee. If someone is the holder of record (the registered owner) of an OID instrument that belongs to you and receives a Form 1099–OID on your behalf, that person must give you a Form 1099–OID.

Debt instrument bought at premium. If you bought at a premium a debt instrument that was originally issued at a discount, you do not have to report any OID as ordinary income. You buy a debt instrument at a ***premium*** if its adjusted basis immediately after purchase is greater than the total of all amounts payable on the instrument after the purchase date, other than qualified stated interest (defined in Publication 1212 under *Computation of reportable OID).* When you sell or redeem an instrument bought at a premium, the difference between the sale or redemption price and your purchase price is a capital gain or loss.

Premium is not the same as ''acquisition premium,'' discussed later.

Exceptions to the OID rules. The OID rules discussed in this chapter for publicly offered, long-term instruments do not apply to the following debt instruments:

1) Tax-exempt obligations (however, see *Stripped tax-exempt obligations* under *Stripped Bonds and Coupons* in Publication 550),
2) U.S. Savings Bonds,
3) Short-term debt instruments (those which have fixed maturity dates of not more than one year from the date of issue),
4) Obligations issued by an individual before March 2, 1984, and
5) Loans between individuals, if:
   a) The lender is not in the business of lending money,
   b) The amount of the loan, plus the amount of any outstanding prior loans, is $10,000 or less, and
   c) Avoiding any federal tax is not one of the principal purposes of the loan.

Debt instruments issued after 1954 and before May 28, 1969 (or before July 2, 1982, if a government instrument). For these instruments, you pay no tax on the OID until the year you sell, exchange, or redeem the instrument. If a gain results, and if the instrument is a capital asset, the amount of the gain equal to the OID is taxed as ordinary interest income. The balance of the gain is capital gain. If there is a loss on the sale of the instrument, the entire loss is a capital loss and no reporting of OID is required.

Corporate debt instruments issued after May 27, 1969, and before July 2, 1982. If you hold these debt instruments as capital assets, you must include a part of the discount in your gross income each year that you own the instruments. Your basis in the instrument is increased by the amount of OID that you include in your gross income.

Include in your gross income the total OID from Form 1099–OID. Box 1 shows the OID on the debt instrument for the part of the year you owned it. In certain cases, you cannot use the amount in Box 1. Instead, you must figure the correct OID to report. See *Recomputation of OID shown on Form 1099–OID,* later, for more information.

Debt instruments issued after July 1, 1982, and before January 1, 1985. If you hold these debt instruments as capital assets, you must include a part of the discount in your gross income each year and increase your basis by the amount included.

Include in your gross income the OID from Box 1 of Form 1099–OID. In certain cases, you cannot use the amount in Box 1. Instead, you must figure the correct OID to report. See *Recomputation of OID shown on Form 1099–OID,* later.

Debt instruments issued after December 31, 1984. If you hold these debt instruments, the OID reporting rules, in general, are similar to those for debt instruments issued after July 1, 1982. However, you report the total applicable OID (based on the number of days in the accrual period) regardless of whether you hold that debt instrument as a capital asset. Your basis in the instrument is increased by the amount of OID that you include in your gross income. The method for determining the reportable discount on any OID instrument issued after 1984 is generally based on an accrual period of 6 months. However, debt instruments issued after April 3, 1994 may have variable accrual periods. For more information about determining reportable OID for these debt instruments, see *Debt Instruments Issued After December 31, 1984,* in Publication 1212.

Recomputation of OID shown on Form 1099–OID. You must recompute the OID shown in Box 1 of Form 1099–OID if any of the following apply:

1) You bought the debt instrument after its original issue and paid a premium (as explained earlier in this section) or an acquisition premium (as explained under *Acquisition premium,* later),
2) The debt instrument is a stripped bond or a stripped coupon (these include certain zero coupon instruments), or
3) You received the Form 1099–OID as a ''nominee'' recipient.

For each of these situations, see Publication 1212 for detailed information and examples on figuring the amount of OID to report on your income tax return. The rules for figuring OID are broken down in Publication 1212 to reflect the specific computations that apply to corporate long-term OID debt instruments issued before July 2, 1982, and to all long-term OID debt instruments issued after July 1, 1982.

If you bought the debt instrument at a market discount, see *Market discount bonds,* later, for information about including market discount in income.

Reporting correct amount of OID. If you are reporting OID in an amount greater or less than the amount shown on Form 1099–OID, see *Original issue discount (OID)* at the end of this chapter, for information about reporting the correct amount of OID on Schedule B (Form 1040).

Acquisition premium. You purchase a debt instrument at an acquisition premium, if its adjusted basis immediately after purchase (including purchase at original issue), is:

1) Less than or equal to the total of all amounts payable on the instrument after the purchase date, other than qualified stated interest, and
2) Greater than its adjusted issue price.

Acquisition premium reduces the amount of discount includible in your income. See *Computation of reportable OID* in Publication 1212 for information about figuring this reduction including the definitions of qualified stated interest and adjusted issue price.

REMIC regular interests. If you own a regular interest in a real estate mortgage investment conduit (REMIC), you will receive a Form 1099–OID and an additional written statement from your broker. Form 1099–OID shows the amount of OID and interest, if any, that accrued to you for the period you held the regular interest. You will not need to make any adjustments to the amounts reported even if you held the regular interest for only a portion of the calendar year. The additional written statement should also contain enough information to enable you to figure your accrual of market discount or amortizable bond premium. See *REMICs* in Publication 550 for more information.

If a Form 1099–OID is not received. If you had OID for 1994 but did not receive a Form 1099–OID, see Publication 1212 which lists total OID on certain debt instruments. If your debt instrument is not listed in Publication 1212, consult the issuer for information about the OID that accrued for 1994.

Recomputation of periodic interest shown on Form 1099–OID. If you disposed of a corporate debt instrument or acquired it from another holder during 1994, see *Bonds Sold Between Interest Dates,* earlier, for information about the treatment of periodic interest that may be shown in Box 2 of Form 1099–OID for that instrument. See *Nominee*

distributions and accrued interest (Form 1040) under *How to Report Interest Income,* later, for information about reporting the correct amount of interest on Schedule B (Form 1040).

Stripped bonds and stripped coupons. Special rules apply to the sale and purchase of stripped bonds and stripped coupons after July 1, 1982. These rules also cover the treatment of zero coupon U.S. Treasury-backed securities. See *Rules for Figuring OID on Stripped Bonds and Stripped Coupons* in Publication 1212 for more information.

Certificates of deposit (CDs) and similar deposit arrangements. If you purchase a CD or a similar deposit arrangement and the receipt of interest is postponed for more than one year, you must include in income each year a part of the total interest due and report it in the same way as other original issue discount (OID).

Examples of such deposit arrangements with banks, building and loan associations, etc., include:

Certificates of deposit

Time deposits

Bonus plans

Savings certificates

Deferred income certificates

Bonus savings certificates

Growth savings certificates

Interest subject to penalty for early withdrawal. If you deposit money in one of the arrangements listed above that has a term of one year or less, and you lose part of the interest because you withdraw funds before the end of the term, you must include all the interest in income at the end of the term. However, you can deduct the entire penalty, even if it exceeds your interest income, on line 28 of Form 1040.

Example. On October 1, 1993, you invested $10,000 in a savings certificate that was to pay you $10,600 on April 1, 1994. Because you withdrew part of the principal or interest before April 1, the bank charged you a penalty of $300. For 1994, you must report as income the entire $600 accrued interest. However, you can deduct the $300 penalty as an adjustment to gross income.

Bearer certificates of deposit. These are not issued in the depositor's name and, therefore, are transferable from one individual to another. They are issued by banks for a certain period, usually a number of years. Interest is not usually paid until the certificates are redeemed by the bank at the end of this period.

Banks are required to provide the IRS and the person redeeming the bearer certificate with a Form 1099–INT.

Certificates of deposit issued after 1982 are generally required to be in registered form. For more information about this requirement, see *Obligations issued in bearer form* in Chapter 15.

For more information about interest income from certificates of deposit, see *Original Issue Discount (OID)* in Publication 550.

Market discount bonds. A market discount bond is any bond having market discount except:

1) Short-term obligations (those with fixed maturity dates of up to one year from the date of issue),
2) Tax-exempt obligations that you bought before May 1, 1993,
3) U.S. Savings Bonds, and
4) Certain installment obligations.

Market discount arises when the value of a debt obligation decreases after its issue date, generally because of an increase in interest rates. If you buy a bond on the secondary market, it may have market discount.

If you dispose of a market discount bond, you generally must recognize the gain as taxable interest income up to the amount of the bond's ***accrued market discount,*** if:

1) The bond was issued after July 18, 1984, or
2) You purchased the bond after April 30, 1993.

The rest of the gain is capital gain if the bond was a capital asset. For more information about the tax treatment of market discount, see *Market Discount Bonds* in Publication 550.

Discount on short-term obligations. Certain holders of short-term obligations are required to accrue and include the discount on such obligations in current income. See *Discount on Short-Term Obligations* in Publication 550 for more information.

REMIC regular interests. If you are the holder of a regular interest in a real estate mortgage investment conduit (REMIC), or an interest in a collateralized debt obligation (CDO), that interest is considered to be a debt instrument for income tax purposes, whether or not it is in the form of a debt instrument. Accordingly, the OID, market discount, and income-reporting rules that apply to bonds and other debt instruments apply to such interests with certain modifications. For more information, see *REMICs and Other CDOs* in Publication 550.

State or Local Government Obligations

Generally, interest on obligations of state or local governments is tax exempt. This includes obligations of a state or one of its political subdivisions, the District of Columbia, a possession of the United States, or one of its political subdivisions, used to finance governmental operations. This includes interest on certain obligations issued after 1982 by an Indian tribal government treated as a state.

If you receive a Form 1099–INT for interest paid on a tax-exempt obligation, see *Tax-exempt interest income* under *How to Report Interest Income.*

Interest on arbitrage bonds issued by state or local governments after October 9, 1969, and interest on private activity bonds generally is ***taxable.***

For more information on whether such interest is taxable or tax exempt, see *State or Local Government Obligations* in Publication 550.

Information reporting requirement. If you received or accrued any tax-exempt interest income (such as interest on certain state and municipal bonds), you must show that interest on your tax return if you are required to file. This is an information reporting requirement and does not convert tax-exempt interest to taxable interest. See *How to Report Interest Income,* later.

When to Report Interest Income

When you report your interest income depends on whether you use the cash method or an accrual method of reporting income.

Cash method. If you use this method, you generally report your interest income in the year in which you actually or constructively receive it. Most individual taxpayers use this method. However, there are special rules for OID and certain U.S. Savings Bonds. See *U.S. Savings Bonds,* and *Original Issue Discount (OID),* earlier.

Example. On September 1, 1992, you loaned $2,000 at 12% a year. The note stated that principal and interest would be due on August 31, 1994. In 1994, you received $2,480 ($2,000 principal and $480 interest). If you use the cash method, you must include in income on your 1994 return the $480 interest you received in 1994.

Constructive receipt. You constructively receive income when it is credited to your account or made available to you. You do not need to have physical possession of it. For example, you are considered to receive interest, dividends, or other earnings on any deposit or account in a bank, savings and loan, or similar financial institution, or interest on life insurance policy dividends left to accumulate, when they are credited to your account and subject to your withdrawal. This is true even if they are not yet entered in your passbook.

You constructively receive income on the deposit or account even if you must:

1) Make withdrawals in multiples of even amounts,
2) Give a notice to withdraw before making the withdrawal,
3) Withdraw all or part of the account to withdraw the earnings, or

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PAYER'S name, street address, city, state, and ZIP code	Payer's RTN (optional)	OMB No. 1545-0112 **1994** **Interest Income**
PAYER'S Federal identification number / RECIPIENT'S identification number	1 Interest income not included in box 3 $	**Copy A For Internal Revenue Service Center** **File with Form 1096.**
RECIPIENT'S name	2 Early withdrawal penalty $	3 Interest on U.S. Savings Bonds and Treas. obligations $
Street address (including apt. no.)	4 Federal income tax withheld $	For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
City, state, and ZIP code	5 Foreign tax paid $	6 Foreign country or U.S. possession
Account number (optional) / 2nd TIN Not. ☐		

Form **1099-INT** Cat. No. 14410K Department of the Treasury - Internal Revenue Service

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4) Pay a penalty on early withdrawals, unless the interest you are to receive on an early withdrawal or redemption is substantially less than the interest payable at maturity.

You constructively receive interest when it is credited to your account under a long-term savings plan that does not let you withdraw interest until a specified date, if the plan lets you freely withdraw your deposits of principal.

Accrual method. If you use an accrual method, you report your interest income when you earn it, whether or not you have received it.

Example. If, in the previous example, you use an accrual method, you must include the interest in your income as you earn it. You would report the interest as follows: 1992, $80; 1993, $240; and 1994, $160.

Coupon bonds. Interest on coupon bonds is taxable in the year the coupon becomes due and payable. It does not matter when you mail the coupon for payment.

How to Report Interest Income

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

You cannot use Form 1040EZ if any of the following are true.

1) Your interest income is more than $400.
2) You are excluding interest under the Education Savings Bond Program.
3) You received interest as a nominee (that is, in your name but the interest actually belongs to someone else).
4) You received a Form 1099–INT for U.S. Savings Bond interest that includes amounts you reported before 1994. (See *Interest from U.S. Savings Bonds,* later, for how to report this interest.)

Instead, you must complete the schedules for Form 1040A or Form 1040, as described later. In addition, you must use Form 1040 under certain circumstances described later.

Form 1099–INT. Your taxable interest income, except for interest from U.S. Savings Bonds and Treasury obligations, is shown in Box 1 of Form 1099–INT. Add this amount to any other taxable interest income you received.

If you had any tax-exempt interest income, or exempt-interest dividends from a mutual fund, you should report the total of this tax-exempt income on line 8b of Form 1040A or Form 1040. If you file Form 1040EZ, write "TEI" in the space to the right of the words "Form 1040EZ" on line 2. After "TEI," show the amount of your tax-exempt interest, but do not add tax-exempt interest in the total on Form 1040EZ, line 2.

If you forfeited interest income because of the early withdrawal of a time deposit, the deductible amount will be shown on Form 1099–INT in Box 2 (early withdrawal penalty). If an amount appears in Box 2, you should file Form 1040 and report this amount on line 28 (penalty on early withdrawal of savings).

Box 3 of Form 1099–INT shows the amount of interest income you received from U.S. Savings Bonds, Treasury bills, Treasury notes, and Treasury bonds. Include the amount shown in Box 3 in your total taxable interest income, unless it includes an amount previously included in interest income. If you are redeeming U.S. Savings Bonds you bought after 1989 ***and*** you have qualified educational expenses, see *Form 8815,* later. If part of the amount shown in Box 3 was previously included in interest income, see *Interest from U.S. Savings Bonds,* next.

Box 4 of Form 1099–INT (federal income tax withheld) will contain an amount if you were subject to backup withholding. You may be subject to backup withholding if, for example, you did not furnish your social security number to a payer. Report the amount from Box 4 on Form 1040A, line 28a, or on Form 1040, line 54 (federal income tax withheld), and check the box on that line.

If there are entries in Boxes 5 and 6 of Form 1099–INT, you must file Form 1040. Report the amount shown in Box 5 (foreign tax paid) on **Form 1116,** *Foreign Tax Credit,* unless you deduct this amount on Schedule A of Form 1040 as "Other taxes." For more information on the credit and deduction, see Publication 514, *Foreign Tax Credit for Individuals.*

Interest from U.S. Savings Bonds. If you received a Form 1099–INT for U.S. Savings Bond interest, the form may show interest you are not required to report. See *Form 1099–INT for U.S. Savings Bonds interest,* earlier, under *U.S. Savings Bonds.*

If you have qualified education expenses (as discussed earlier under *Education Savings Bond Program*), see *Form 8815,* later, for information on your interest exclusion.

You should show on line 1, Part I of Schedule B (Form 1040), or on line 1, Part I of Schedule 1 (Form 1040A), all the interest shown on your Form 1099–INT.

If Form 1099–INT includes interest you previously reported, make the following adjustment. On Schedule B, several lines above line 2, enter a subtotal of all interest listed on line 1. If you use Form 1040A, enter this subtotal several lines above line 2, Part I of Schedule 1. Below the subtotal write ''U.S. Savings Bond Interest Previously Reported,'' and enter amounts previously reported or interest accrued prior to receiving the bond. (To figure the amount to enter for interest reported or being reported as a taxable distribution from a retirement or profit-sharing plan, see *Interest from U.S. Savings Bonds* in Publication 550.) Subtract these amounts from the subtotal and enter the result on line 2 of Schedule B (Form 1040) or on line 2, Part I of Schedule 1 (Form 1040A).

Form 8815. Use Form 8815, *Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989,* to figure your interest exclusion when you redeem bonds and pay qualified higher educational expenses during the same year.

For more information on the exclusion and qualified higher educational expenses, see the earlier discussion under *Education Savings Bond Program.*

You must show your total interest from Series EE Savings Bonds issued after 1989 that you cashed during 1994 on line 6 of Form 8815 and on line 1 of either Schedule 1 (Form 1040A) or Schedule B (Form 1040). After completing Form 8815, enter the result from line 14 (Form 8815) on line 3 of Schedule 1 (Form 1040A) or line 3 of Schedule B (Form 1040).

Form 1040A

You must complete Part I of Schedule 1 (Form 1040A), if you file Form 1040A and:

1) Your taxable interest income totals more than $400,
2) You are claiming the interest exclusion under the Education Savings Bond Program,
3) You received a Form 1099–INT for tax-exempt interest,
4) You received interest from a seller-financed mortgage and the buyer used the property as a personal residence, or
5) You received, as a nominee, interest that actually belongs to someone else. (See *Nominee distributions (Form 1040A)*, later, for how to report this interest.)

List each payer's name and the amount of interest income received from each payer. If you received a Form 1099–INT or Form 1099–OID from a brokerage firm, list the brokerage firm as the payer.

However, you must use Form 1040 instead of Form 1040A if:

- You are reporting OID in an amount more or less than the amount shown on Form 1099–OID,
- You received or paid accrued interest on securities transferred between interest payment dates,
- You acquired taxable bonds after 1987 and choose to reduce interest income from the bonds by any amortizable bond premium (see *Bond Premium Amortization* in Publication 550), or
- You forfeited interest income because of the early withdrawal of a time deposit.

Reporting interest on seller-financed mortgage. If an individual buys his or her home from you in a sale that you finance, you must report the buyer's name, address, and social security number on line 1 of Schedule 1 (Form 1040A). If you do not, you may have to pay a $50 penalty. The buyer may have to pay a $50 penalty if he or she does not give you this information.

The buyer must report your name, address, and social security number (or employer identification number) on Schedule A (Form 1040). You must give this information to the buyer. If you do not, you may have to pay a $50 penalty.

Nominee distributions (Form 1040A). If the total interest income you list on line 1, Part I of Schedule 1 (Form 1040A), includes any amount that you received as a nominee for the real owner, show that amount separately below a subtotal of all interest income listed. Identify the amount as ''Nominee Distribution,'' and subtract it from the interest income subtotal. Report the result on line 2, Part I of Schedule 1.

For more information, see *Nominee distributions and accrued interest* later under *Form 1040.*

Tax-exempt interest income (Form 1040A). If you received any tax-exempt interest, such as from state or local governmental obligations, do not include this income on line 8a. Instead, enter your tax-exempt interest on line 8b. Also include on line 8b any exempt-interest dividends received from a mutual fund or other regulated investment company. Remember that OID is a form of interest. You report OID as it accrues, whether or not you receive any payments from the bond issuer.

Interest earned on an individual retirement arrangement (IRA) is tax deferred rather than tax exempt. Do not include such amount in tax-exempt interest.

You should not have received a Form 1099–INT for tax-exempt interest. But if you did, you must fill in Schedule 1 (Form 1040A). See the *Form 1040A Instructions* for how to report this on Schedule 1. Be sure to show the tax-exempt interest on line 8b.

If you redeemed Series EE U.S. Savings Bonds and you have qualified educational expenses, complete and attach Form 8815. Enter the result from line 14 of Form 8815 on line 3 of Schedule 1. Subtract the amount on line 3 from the amount on line 2. Enter the result on line 4 of Schedule 1 and on line 8a of Form 1040A. See *Education Savings Bond Program* and *Form 8815* earlier for more information.

Frozen deposits (Form 1040A). Even if you receive a Form 1099–INT for interest on deposits that you could not withdraw at the end of 1994, you must exclude these amounts from your gross income, as explained earlier under *General Information.* Do not include this income on line 8a. If you are completing Part I of Schedule 1, include on line 1 the interest shown on Form 1099–INT. Several lines above line 2, put a subtotal of all interest income. Below this subtotal, write ''Frozen Deposits,'' and show the amount of interest that you are excluding. Subtract this amount from the subtotal and write the result on line 2 of Part I.

Form 1040

You must complete Part 1 of Schedule B (Form 1040) if you file Form 1040 and:

1) Your taxable interest income is more than $400.
2) You are claiming the interest exclusion under the Education Savings Bond Program.
3) You received interest from a seller-financed mortgage and the buyer used the property as a personal residence.
4) You received a Form 1099–INT for tax-exempt interest.
5) You received, as a nominee, interest that actually belongs to someone else. (See *Nominee distributions and accrued interest (Form 1040)*, later, for how to report this interest.)
6) You received a Form 1099–INT for interest on a bond that you bought between interest payment dates. (See *Nominee distributions and accrued interest (Form 1040)*, later, for how to report this interest.)
7) You are reporting OID in an amount more or less than the amount shown on Form 1099–OID. (See *Original issue discount (OID)*, later, for how to report your OID.)
8) You choose to reduce your interest income from a bond by the amount of amortizable bond premium. (For more information about this choice, see *Bond Premium Amortization* in Publication 550.)

On Schedule B, list each payer's name and the amount received from each.

First, report on line 1, Part I of Schedule B, any interest income from seller-financed

mortgages. (For more information about reporting this income, see *Reporting interest on seller-financed mortgage,* next.)

Next, report on line 1, Part I of Schedule B (Form 1040), all other taxable interest you received. Include the total amount of interest income that is shown in Box 1 and Box 3 of any Form 1099–INT or in Box 1 and Box 2 of any Form 1099–OID that you receive for the tax year, and other interest income received for which you did not receive a Form 1099. List each payer's name and the amount of interest received from each. If you received a Form 1099–INT or Form 1099–OID from a brokerage firm, list the brokerage firm as the payer. If you received more than $400 in taxable interest, you must also complete Part III of Schedule B (Form 1040). See *Foreign financial accounts and foreign trusts,* discussed in Chapter 1.

If you redeemed Series EE U.S. Savings Bonds and you have qualified educational expenses, complete and attach Form 8815. Enter the result from line 14 of Form 8815 on line 3 of Schedule B. See *Education Savings Bond Program* and *Form 8815* earlier for more information.

Reporting interest on seller-financed mortgage. If an individual buys his or her home from you in a sale that you finance, you must report the buyer's name, address, and social security number on line 1 of Schedule B (Form 1040). If you do not, you may have to pay a $50 penalty. The buyer may have to pay a $50 penalty if he or she does not give you this information.

The buyer must report your name, address, and social security number (or employer identification number) on Schedule A (Form 1040). You must give this information to the buyer. If you do not, you may have to pay a $50 penalty.

Tax-exempt interest income (Form 1040). If you received any tax-exempt interest income (such as interest on certain state and municipal bonds), you must report the total amount of that interest on line 8b of Form 1040. Also report on line 8b any exempt-interest dividends that you received from a mutual fund or other regulated investment company. Do not include this interest in your taxable interest income on line 8a. Remember that OID is a form of interest. You report OID as it accrues, whether or not you receive any payments from the bond issuer.

You should not have received a Form 1099–INT for tax-exempt interest. But if you did, you must fill in Schedule B (Form 1040). See the *Form 1040 Instructions* for how to report this on Schedule B. Be sure to also show the tax-exempt interest on Form 1040, line 8b.

Interest earned on an individual retirement arrangement (IRA) is tax deferred rather than tax exempt. Do not include such amount in tax-exempt interest.

Frozen deposits (Form 1040). Even if you receive a Form 1099–INT for interest on deposits that you could not withdraw at the end of 1994, you must exclude these amounts from your gross income, as explained earlier under *General Information.* Do not include this income on line 8a. If you are completing Part I of Schedule B, include the full amount of interest shown on your Form 1099–INT on line 1. Several lines above line 2, put a subtotal of all interest income. Below this subtotal, write ''Frozen Deposits,'' and show the amount of interest that you are excluding. Subtract this amount from the subtotal and write the result on line 2, Part I of Schedule B.

Nominee distributions and accrued interest (Form 1040). If the total interest income you list on line 1, Part I of Schedule B, includes any amount that you received as a nominee for the real owner or that reflects accrued interest paid on a bond that you bought between interest payment dates, show that amount separately below a subtotal of all interest income listed. Identify the amount as ''Nominee Distribution,'' or ''Accrued Interest,'' as appropriate, and subtract it from the interest income subtotal. Report the result on line 2, Part I of Schedule B.

Interest on a joint account. If you receive a Form 1099–INT which shows your taxpayer identification number and names two or more recipients or includes amounts belonging to another person, you must file a Form 1099–INT with the IRS to show the proper distributions of the amounts shown. Complete a Form 1099–INT and **Form 1096,** *Annual Summary and Transmittal of U.S. Information Returns,* and file both forms with your Internal Revenue Service Center. Give the other person(s) Copy B of the Form 1099–INT which you filed as a nominee. On Form 1099–INT and Form 1096, you should be listed as the ''Payer.'' Prepare one Form 1099–INT for each other owner and show that person as the ''Recipient.'' You are not required, however, to file Form 1099–INT to show payments for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see *1994 Instructions for Forms 1099, 1098, 5498, and W–2G.*

Example. You receive a Form 1099–INT for 1994 that shows a total of $1,500 of interest income earned on a savings account that you hold jointly with your sister. You each have agreed to share the yearly interest income in proportion to the amount that each of you has invested, even though your identification (social security) number was submitted to the bank for its recordkeeping purposes. Your sister has deposited 30% of the amount invested in this account. As a result, you received as a nominee the amount of interest income belonging to your sister. For 1994, this amount is $450, or 30% of the total interest of $1,500.

You must provide your sister with a Form 1099–INT no later than January 31, 1995, showing $450 of interest income that she earned for 1994. You must also send a copy of the nominee Form 1099–INT, along with Form 1096, to the Internal Revenue Service Center no later than February 28, 1995. Show your own name, address, and identification number as the ''Payer'' on the Form 1099–INT. Provide the same information for your sister in the blocks provided for identification of the ''Recipient.''

When you prepare your own 1994 federal income tax return, report the total amount of interest income, $1,500, on line 1, Part I of Schedule B (Form 1040), and identify the name of the bank which paid this interest. Show the amount belonging to your sister, $450, as a subtraction from the subtotal of all interest on Schedule B and identify this subtraction as a ''Nominee Distribution.'' (Your sister will report the $450 of interest income on her own tax return, if she is required to file a return, and identify you as the payer of that amount.)

Original issue discount (OID). If you are reporting OID in an amount greater or less than the amount shown on Form 1099–OID, or other written statement (such as for a REMIC regular interest), include the full amount of OID shown on your Form 1099–OID or other statement on line 1, Part I of Schedule B (Form 1040). If the OID to be reported is less than the amount shown on Form 1099–OID, follow the earlier reporting rules for nominee distributions or accrued interest, as applicable, so that you will report only the OID you are required to report. Below the subtotal, write ''OID Adjustment,'' and show the OID you are not required to report. If the OID to be reported is greater than the amount shown on Form 1099–OID, show the additional OID separately below a subtotal of all interest income listed. Identify the amount as ''OID Adjustment,'' and add it to the interest income subtotal.

Market discount. Report as interest any gain on the sale (or other disposition) of certain market discount bonds, to the extent of the accrued market discount. See *Market discount bonds,* under *Original Issue Discount (OID)* earlier.

Penalty on early withdrawal of savings. If you withdraw funds from a time savings account before maturity, you may be charged a penalty. You must report the gross amount of interest paid or credited to your account during the year, without subtracting the penalty. You deduct the penalty on line 28, Form 1040. Deduct the entire penalty even if it exceeds your interest income. The Form 1099–INT or similar statement given to you by the financial institution will show the gross amount of interest and the penalty.

Sample returns. The sample return in Chapter 38 has an example of reporting interest income on Form 1040A. The sample return in Chapter 39 has an example of reporting interest income on Form 1040.

9.

Dividends and Other Corporate Distributions

Important Reminder

Dividends received in January. Any dividend declared by a regulated investment company (mutual fund) or real estate investment trust (REIT) in October, November, or December and payable to you in such a month, but actually paid during January of the following calendar year, is treated as paid to you in the earlier year.

Introduction

This chapter discusses the tax treatment of:

- Dividend income,
- Capital gain distributions,
- Nontaxable distributions, and
- Other distributions you may receive from a corporation or a mutual fund.

This chapter also explains how to report dividend income on your tax return.

Dividends are distributions of money, stock, or other property paid to you by a corporation. You also may receive dividends through a partnership, an estate, a trust, or an association that is taxed as a corporation. However, some amounts you receive that are called dividends are actually interest income. See *Dividends that are actually interest* under *Taxable Interest* in Chapter 8.

Most distributions that you receive are paid in cash (or check). However, you may receive distributions such as additional stock, stock rights, other property, or services. These distributions are also discussed in this chapter.

Useful Items

You may want to see:

Publication

- ❑ **514** Foreign Tax Credit for Individuals
- ❑ **550** Investment Income and Expenses
- ❑ **564** Mutual Fund Distributions
- ❑ **925** Passive Activity and At-Risk Rules

Form (and Instructions)

- ❑ **Schedule B (Form 1040)** Interest and Dividend Income
- ❑ **Schedule 1 (Form 1040A)** Interest and Dividend Income for Form 1040A Filers
- ❑ **1099** 1994 Instructions for Forms 1099, 1098, 5498, and W–2G

General Information

This section discusses general rules on dividend income.

Passive activity income and losses. There are tax rules which limit the amount of losses and tax credits from passive activities that you can claim. Generally, you can use losses from passive activities only to offset income from passive activities. You generally cannot use passive activity losses to offset your other income, such as your wages or your portfolio income. ***Portfolio income*** is any gross income from interest, dividends, etc., that is not derived in the ordinary course of a trade or business. For more information about determining and reporting income and losses from passive activities, see Publication 925.

Tax on investment income of a child under age 14. Part of a child's investment income may be taxed at the parent's tax rate. This may happen if the child is under age 14, has more than $1,200 of investment income (such as taxable interest and dividends) and is required to file a tax return, and either parent is alive at the end of the year. If these requirements are met, **Form 8615,** *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,200,* must be completed and attached to the child's tax return. If these requirements are not met, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, parents can choose to include their child's gross income on their return if certain requirements are met. Use **Form 8814,** *Parents' Election To Report Child's Interest and Dividends,* for this purpose.

For more information about the tax on investment income of children and the parents' election, see Chapter 32.

Beneficiary of an estate or trust. Interest, dividends, or other investment income you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a **Schedule K–1** (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.,* from the fiduciary. Your copy of Schedule K–1 and its instructions will tell you where to report the items on your Form 1040.

Backup withholding. To ensure that income tax is collected on dividends and other types of income that generally are not subject to withholding, backup withholding will apply in certain circumstances.

Under backup withholding, when you open a new account you must certify under penalties of perjury that your social security number is correct and that you are not subject to backup withholding. If you fail to make this certification, backup withholding may begin immediately on your new account or investment, and 31% of the amount paid on your account or investment will be withheld. Your payer will give you a **Form W–9,** *Request for Taxpayer Identification Number and Certification,* or a similar form, to make this certification. Backup withholding may also be required if the Internal Revenue Service (IRS) has determined that you underreported your interest or dividend income. For more information, see *Backup Withholding* in Chapter 5.

Form 1099–DIV. Most corporations use Form 1099–DIV, *Dividends and Distributions,* to show you the distributions you received from them during the year. Keep this form with your records. You do not have to attach it to your tax return. Even if you do not receive Form 1099–DIV, you must report all of your taxable dividend income.

Reporting tax withheld. If tax is withheld from your dividend income, the payer must give you a Form 1099–DIV that indicates the amount withheld.

Nominees. If someone receives distributions as a nominee for you, that person will give you a Form 1099–DIV, which will show distributions they received on your behalf.

If you receive a Form 1099–DIV that includes amounts belonging to another person, see *Nominees,* later under *How to Report Dividend Income,* for more information.

Form 1099–MISC. Certain substitute payments in lieu of dividends or tax-exempt interest that are received by a broker on your behalf must be reported to you on Form 1099–MISC, *Miscellaneous Income,* or a similar statement. See *Reporting substitute payments* under *Short Sales* in Publication 550 for more information about reporting such substitute payments.

Incorrect amount. If you receive a Form 1099 that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The corrected Form 1099 you receive will be marked "CORRECTED."

Social security number. You must give your name and social security number to any person required by federal tax law to make a return, statement, or other document that relates to you. This includes payers of dividends. If you are married and the funds in a joint account belong to you, you should give your social security number to the payer of the dividends. If the funds in the account belong to both you and your spouse, you may give either your number or your spouse's number. But the number you provide must correspond with the name listed first on the account. You must give the payer the correct social security number if the number being used is wrong.

Penalty. If you do not give your social security number to the payer of dividends,

you may have to pay a penalty. See *Penalty for failure to supply social security number* under *Penalties* in Chapter 1. Backup withholding also may apply. See *Backup Withholding* in Chapter 5.

Dividends received in January. If a regulated investment company (mutual fund) or real estate investment trust (REIT) declares a dividend (including any exempt-interest dividend) in October, November, or December and that dividend is payable to you on a specified date in such month, you are considered to have received the dividend on December 31 even though the company or trust actually pays the dividend during January of the following calendar year. Therefore, you report the amount in the year of declaration.

Ordinary Dividends

Ordinary (taxable) dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are ordinary income to you. This means they are not capital gains. You can assume that any dividend you receive, whether on common or preferred stock, is an ordinary dividend unless the paying corporation tells you otherwise.

Money market funds. Report amounts you receive from money market funds as dividend income. These amounts generally are not interest income and should not be reported as interest.

Dividends on capital stock. Dividends on the capital stock of organizations, such as savings and loan associations, are ordinary dividends. They are not interest. You should report them with your dividend income.

Stock certificate in two or more names. If two or more persons, such as a husband and wife, hold stock as ***joint tenants, tenants by the entirety, or tenants in common,*** each person receives a share of any dividends from the stock. Each person's share is determined by local law.

Dividends used to buy more stock. The corporation in which you own stock may have a ***dividend reinvestment plan.*** This plan lets you choose to use your dividends to buy (through an agent) more shares of stock in the corporation instead of receiving the dividends in cash. If you are a member of this type of plan and you use your dividends to buy more stock at a price equal to its fair market value, you must report the dividends as income.

If you are a member of a dividend reinvestment plan that lets you buy more stock at a price less than its fair market value, you must report as income the fair market value of the additional stock on the dividend payment date.

You also must report as income any service charge subtracted from your cash dividends before the dividends are used to buy the additional stock. But you may be able to deduct the service charge. See Chapter 30 for more information about deducting expenses of producing income.

In some dividend reinvestment plans, you can invest more cash to buy shares of stock at a price less than fair market value. If you choose to do this, you must report as income the difference between the cash you invest and the fair market value of the stock you buy. When figuring this amount, use the fair market value of the stock on the dividend payment date.

Public utility stock reinvestment plans. If you own stock in a qualified domestic public utility and chose to receive your dividends in common stock, rather than in cash, you must include in your income the total value of such stock dividends.

Pre-1986 stock dividend exclusion. If after 1981 and before 1986, you chose to receive your dividends from the public utility stock in the form of more stock, you could choose to exclude the value of the dividend from your income. You had to make this choice on your return for the year in which you would have included the dividends in income.

If you excluded the value of stock dividends from income, your basis in that stock is zero.

Capital Gain Distributions

These distributions or dividends are paid by ***regulated investment companies, mutual funds, and real estate investment trusts.*** A Form 1099–DIV or the mutual fund statement will tell you the amount you are to report as a capital gain distribution. Report capital gain distributions as long-term capital gains on your tax return regardless of how long you have owned the stock in the mutual fund. Those distributions that are not derived in the ordinary course of a trade or business are treated as portfolio income and are not considered as income from a passive activity (see *Passive activity income and losses,* earlier).

Undistributed capital gains. In addition to the amounts you receive, you must report as long-term capital gains any amounts that the investment company or mutual fund credited to you as capital gain distributions, even though you did not actually receive them. (This income is not reported to you on Form 1099–DIV.)

Form 2439. You can take a credit on your return for any tax that the investment company or mutual fund has paid for you on the undistributed capital gains. The company or fund will send you Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains,* showing the amount of the undistributed long-term capital gain and the tax that was paid. Take this credit by entering the amount of tax paid and checking box a on line 59, Form 1040. Attach Copy B of Form 2439 to your return.

Basis adjustment. Increase your basis in the stock by the difference between the amount of undistributed capital gain that you report and the amount of the tax paid for you by the fund. Keep Copy C of Form 2439 as part of your records to show increases in the basis of your stock.

Note. You must report any undistributed gains shown on Form 2439 in addition to any capital gain distributions reported on Form 1099–DIV.

Real estate investment trusts (REITs). You will receive a Form 1099–DIV or similar statement from the REIT showing the capital gain distributions you must include in your income. You report the capital gain distributions as long-term capital gain regardless of how long you owned stock in the REIT.

Additional information. For more information on the treatment of distributions from mutual funds and regulated investment companies, see Publication 564, *Mutual Fund Distributions.*

Nontaxable Distributions

You may receive a return of capital or a tax-free distribution of more shares of stock or stock rights. These distributions are not treated the same as ordinary dividends or capital gain distributions.

Return of Capital

A return of capital is a distribution that is not paid out of the earnings and profits of a corporation. It is a return of your investment in the stock of the company. You should receive a Form 1099–DIV or other statement from the corporation showing you what part of the distribution is a return of capital. If you do not receive such a statement, you report the distribution as an ordinary dividend.

Basis adjustment. A return of capital reduces the basis of your stock. It is not taxed until your basis in the stock is fully recovered. If you buy stock in a corporation in different lots at different times, reduce the basis of your earliest purchases first.

When the basis of your stock has been reduced to zero, report any return of capital that you receive as a capital gain. Whether you report it as a long-term or short-term capital gain depends on how long you have held the stock. See *Holding Period* in Chapter 15.

Example. You bought stock in 1986 for $100. In 1988, you received a return of capital of $80. You did not include this amount in your income, but you reduced the basis of your stock. Your stock now has an adjusted basis of $20. You receive a return of capital of $30 in 1994. The first $20 of this amount

reduces your basis to zero. You report the other $10 as a long-term capital gain for 1994. You must report as a long-term capital gain any return of capital you receive on this stock in later years.

Liquidating distributions. Liquidating distributions, sometimes called liquidating dividends, are distributions you receive during a partial or complete liquidation of a corporation. These distributions are, at least in part, one form of a return of capital. They may be paid in one or more installments. You will receive a Form 1099–DIV from the corporation showing you the amount of the liquidating distribution.

Any liquidating distribution you receive is not taxable to you until you have recovered the basis of your stock. After the basis of your stock has been reduced to zero, you must report the liquidating distribution as a capital gain (except in certain instances with regard to collapsible corporations). Whether you report the gain as a long-term or short-term capital gain depends on how long you have held the stock. See *Holding Period* in Chapter 15.

Stock acquired at different times. If you acquired stock in the same corporation in more than one transaction, you own more than one block of stock in the corporation. If you receive distributions from the corporation in complete liquidation, you must divide the distribution among the blocks of stock you own in the following proportion: the number of shares in that block over the total number of shares you own. Divide distributions in partial liquidation among that part of the stock that is redeemed in the partial liquidation. After the basis of a block of stock is reduced to zero, you must report the part of any later distribution for that block as a capital gain.

Distributions less than basis. If the total liquidating distributions you receive are less than the basis of your stock, you may have a capital loss. You can report a capital loss only after you have received the final distribution in liquidation that results in the redemption or cancellation of the stock. Whether you report the loss as a long-term or short-term capital loss depends on how long you held the stock. See *Holding Period* in Chapter 15.

Distributions of Stock and Stock Rights

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as ''stock options'') are distributions by a corporation of rights to subscribe to the corporation's stock. Generally, stock dividends and stock rights are not taxable to you, and you do not report them on your return.

Taxable stock dividends and stock rights. Distributions of stock dividends and stock rights are taxable to you if:

1) You or any other shareholder has the choice to receive cash or other property instead of stock or stock rights,
2) The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders,
3) The distribution is in convertible preferred stock and has the same result as in (2),
4) The distribution gives preferred stock to some common stock shareholders and gives common stock to other common stock shareholders, or
5) The distribution is on preferred stock. (This requirement, however, does not apply if the distribution is made on convertible preferred stock solely to take into account a stock dividend, stock split, or a similar event that would otherwise result in reducing the conversion right.)

In addition, any transaction having the effect of increasing your proportionate interest in the corporation's assets or earnings and profits may be taxable to you, even though no stock or stock rights are actually distributed.

The term ''stock'' includes rights to acquire such stock, and the term ''shareholder'' includes a holder of rights or of convertible securities.

Basis. If you receive taxable stock dividends or stock rights, include their fair market value at the time of the distribution in your income. This amount is your basis in the stock or stock rights received. If you receive stock dividends or stock rights that are not taxable to you, see *Stocks and Bonds* under *Basis of Investment Property* in Chapter 4 of Publication 550 for information on how to figure their basis.

Fractional shares. You may not own enough stock in a corporation to receive a full share of stock if the corporation declares a stock dividend. However, with the approval of the shareholders, the corporation may set up a plan in which no fractional shares are issued, but are sold, and the cash proceeds are given to the shareholders. Any cash you receive for fractional shares under such a plan is treated as an amount realized on the sale of the fractional shares. You must determine your gain or loss and report it as a capital gain or loss on Schedule D (Form 1040). Your gain or loss is the difference between the cash you receive and the basis of the fractional shares sold.

Example. You own one share of common stock that you bought on January 3, 1990, for $100. The corporation declared a common stock dividend of 5% on June 30, 1994. The fair market value of your stock at the time the stock dividend was declared was $200. You were paid $10 for the fractional-share stock dividend under a plan described in the above paragraph. You figure your gain or loss as follows:

Fair market value of old stock	$200.00
Fair market value of stock dividend (cash received)	10.00
Fair market value of old stock and stock dividend	$210.00
Basis (cost) of old stock after the stock dividend (($200 ÷ $210) × $100)	$ 95.24
Basis (cost) of stock dividend (($10 ÷ $210) × $100)	4.76
Total	$100.00
Cash received	$ 10.00
Basis (cost) of stock dividend	4.76
Gain	$ 5.24

Because you had held the share of stock more than one year at the time the stock dividend was declared, your gain on the stock dividend is a long-term capital gain.

Other Distributions

You may receive any of the following distributions during the year.

Exempt-interest dividends. Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information reporting requirement,* next.) You will receive a notice from the mutual fund telling you the amount of the exempt-interest dividends you received. Exempt-interest dividends are not shown on Form 1099–DIV or Form 1099–INT. See *Gains and Losses* in Publication 564 for information about the loss treatment of mutual fund stock on which you received exempt-interest dividends.

Information reporting requirement. Although these dividends are not taxable, you must show them on your tax return if you are required to file. This is an information-reporting requirement and does not convert exempt-interest dividends to taxable income. See *How to Report Interest Income* in Chapter 8.

Also, exempt-interest dividends may be treated as tax-exempt interest from private activity bonds, which is a ''tax preference item'' that may be subject to the alternative minimum tax. See *Alternative Minimum Tax* in Chapter 31 for more information.

Dividends on insurance policies. Dividends you receive on insurance policies are a partial return of the premiums you paid. Do not include them in your gross income until they are more than the total of all net premiums you paid for the contract. However, you must report as taxable income the interest paid or credited on dividends that are left with an insurance company. See Chapter 8 for treatment of interest income.

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PAYER'S name, street address, city, state, and ZIP code		1a Gross dividends and other distributions on stock (Total of 1b, 1c, 1d, and 1e) $	OMB No. 1545-0110 **1994** **Dividends and Distributions**
		1b Ordinary dividends $	
PAYER'S Federal identification number	RECIPIENT'S identification number	1c Capital gain distributions $	2 Federal income tax withheld $
RECIPIENT'S name		1d Nontaxable distributions $	3 Foreign tax paid $
Street address (including apt. no.)		1e Investment expenses $	4 Foreign country or U.S. possession
City, state, and ZIP code		**Liquidation Distributions**	
Account number (optional)	2nd TIN Not. ☐	5 Cash $	6 Noncash (Fair market value) $

Copy A For Internal Revenue Service Center

File with Form 1096.

For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**

Form **1099-DIV** Cat. No. 14415N Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

Dividends on veterans' insurance. Dividends you receive on veterans' insurance policies are not taxable. In addition, do ***not*** report as taxable income interest on dividends left with the Department of Veterans Affairs. See *Veterans* in Chapter 6 for more information about veterans' benefits.

Patronage dividends. Patronage dividends you receive in money from a cooperative organization are generally included in your income.

Do not include in your income patronage dividends you receive on:

1) Property bought for your personal use, or
2) Capital assets or depreciable property bought for use in your business. But you must reduce the basis (cost) of the items bought. If the dividend is more than the adjusted basis of the assets, you must report the excess as income.

These rules are the same whether the cooperative paying the dividend is a taxable or tax-exempt cooperative.

Alaska Permanent Fund Dividends. Do not report these amounts as dividends. Instead, report these amounts on line 21 of Form 1040.

How to Report Dividend Income

Generally, you can use either Form 1040 or Form 1040A to report your dividend income. However, you must use Form 1040 if you receive capital gain distributions or return of capital distributions. You cannot use Form 1040EZ if you receive any dividend income.

Form 1099–DIV. If you owned stock on which you received $10 or more in gross dividends and other distributions, you should receive a Form 1099–DIV.

Box 1a of Form 1099–DIV shows the amount of gross dividends and other distributions you received on stock. Box 1a is the total of boxes 1b, 1c, 1d, and 1e.

Box 1b of Form 1099–DIV shows your ordinary dividends. This amount is included in box 1a. If you do not need to file Schedule B (Form 1040), or Schedule 1 (Form 1040A), add together the amounts shown in boxes 1b and 1e and enter the total on line 9 (Form 1040 or Form 1040A). Also see the paragraph later about box 1e.

Box 1c of Form 1099–DIV shows your capital gain distributions. If you enter the box 1a amount on line 5 of Schedule B, subtract the box 1c amount out on line 7 of Schedule B. You must also report these capital gains on line 14, Part II of Schedule D (Form 1040). However, if you do not need to complete Schedule D for any other capital transactions, report them directly on line 13 of Form 1040.

Box 1d of Form 1099–DIV shows your nontaxable distributions. If you enter the box 1a amount on line 5 of Schedule B (Form 1040), subtract the box 1d amount out on line 8 of Schedule B. Amounts shown in box 1d are usually a return of capital that reduces your basis in the stock. Once you have received an amount equal to your cost or other basis, these distributions are taxable to you as a capital gain even if the payer lists them as nontaxable.

If you own stock in a nonpublicly-offered regulated investment company, your pro rata share of that fund's allocable investment expenses is shown in box 1e of Form 1099–DIV. This amount is also included in box 1a of Form 1099–DIV. You must include this amount as income on your tax return. You can deduct these expenses as a miscellaneous itemized deduction subject to the 2% of adjusted gross income limit only if you itemize your deductions on Schedule A (Form 1040).

Box 2 of Form 1099–DIV shows the amount of "Federal income tax withheld" if you were subject to backup withholding. You may be subject to backup withholding if, for example, you failed to furnish your social security number to a payer. Report this amount on Form 1040A, line 28a, or on Form 1040, line 54, and check the box.

Box 3 of Form 1099–DIV shows the amount of foreign taxes withheld (paid) on dividends and other distributions, and box 4 identifies the foreign country or U.S. possession that did the withholding. If there are entries in these boxes, fill out Form 1040 and **Form 1116,** *Foreign Tax Credit.* However, do not complete Form 1116 if you claim this amount as "Other taxes" on Schedule A. For more information on the credit and deduction, see Publication 514, *Foreign Tax Credit for Individuals.*

Box 5 of Form 1099–DIV shows distributions of cash from corporations in partial or complete liquidation. Box 6 shows the fair market value of noncash distributions. If

there are entries in these boxes, see *Liquidating distributions* under *Nontaxable Distributions* in Publication 550.

Dividends received on restricted stock. Restricted stock is stock that you get from your employer for services you perform and that is nontransferable and subject to a substantial risk of forfeiture. You do not have to include the value of the stock in your income when you receive it. However, if you get dividends on the restricted stock, you must include them in your income as wages, not dividends.

Your employer should include these dividends in the wages shown on your Form W–2. If you also get a Form 1099–DIV for these dividends, list them on line 5, Part II of Schedule B (Form 1040), with any other dividends you received. Enter a subtotal of all your dividend income several lines above line 6. Below the subtotal, write ''Dividends on restricted stock reported as wages on line 7, Form 1040,'' and enter the amount of the dividends included in your wages on line 7, Form 1040. Subtract this amount from the subtotal and enter the result on line 6, Part II of Schedule B.

Election. You can choose to include in gross income the value of restricted stock as compensation for services. If you make this choice, the dividends are treated as any other dividends.

If you receive both a Form 1099–DIV and a Form W–2 showing these dividends, do not include the dividends in your wages reported on line 7, Form 1040. List the dividends on line 5, Part II of Schedule B, along with your other dividends (if the amount of dividends received from all sources is more than $400). Attach a statement to your Form 1040 explaining why the amount shown on line 7 of your Form 1040 is different from the amount shown on your Form W–2.

Dividends on stock sold. If stock is sold, exchanged, or otherwise disposed of after a dividend is declared, but before it is paid, the owner of record (usually the payee shown on the dividend check) must report the dividend. Even if the purchase price of the stock goes up because of the amount of the anticipated dividend, the owner of record must report such dividend.

Stock sold short. If you borrow stock to make a short sale, you may have to pay the lender an amount to replace the dividends distributed while you maintain your short position. Your treatment of the payment depends on the kind of distribution for which you are reimbursing the lender of the stock.

If your payment is made for a liquidating distribution or nontaxable stock distribution, or if you buy more shares equal to a stock distribution issued on the borrowed stock during your short position, you have a capital expense. You must add the payment to the cost of the stock sold short. See *Short Sales* in Publication 550 for more information about the tax treatment of short sales.

Expenses related to dividend income. You may deduct expenses related to dividend income only if you itemize your deductions on Schedule A (Form 1040). See Chapter 30 for general information about deducting expenses of producing income.

Form 1040A

Report your total dividends on line 9, Form 1040A. You also must list each payer's name and the amount of dividends received from each payer in Part II of Schedule 1 (Form 1040A) and attach it to your Form 1040A, if:

1) The amount on line 9 is more than $400, or
2) You received, as a nominee, dividends that actually belong to someone else. (See *Nominees (Form 1040A)*, next, for how to report these dividends.)

If you received a Form 1099–DIV from a brokerage firm, list the brokerage firm as the payer. However, you must use Form 1040 instead of Form 1040A if you had capital gain distributions or return of capital distributions.

Exempt-interest dividends, which are treated as interest, should be reported on line 8b. See *How to Report Interest Income* in Chapter 8.

Nominees (Form 1040A). If you received dividends as a nominee (that is, the dividends are in your name but actually belong to someone else), include them on line 5 of Schedule 1. Several lines above line 6, put a subtotal of all dividend income listed on line 5. Below this subtotal, write ''Nominee Distribution'' and show the amounts received as a nominee. Subtract the total of your nominee distributions from the subtotal. Enter the result on line 6 of Part II.

See *Nominees (Form 1040),* later, for more information.

Form 1040—Total Dividends of $400 or Less

Report only the total of your ordinary dividends from box 1b of Form 1099–DIV and any investment expenses from box 1e of Form 1099–DIV on line 9, Form 1040, if:

1) Your total dividends, including capital gain and nontaxable distributions, are $400 or less, and
2) You did not receive, as a nominee, dividends that actually belong to someone else.

Capital gain distributions. Report capital gain distributions (box 1c of Form 1099–DIV) on line 14, Part II of Schedule D (Form 1040). If you do not need Schedule D to report any other capital gains or losses, enter your capital gain distributions on line 13, Form 1040. Write ''CGD'' on the dotted line next to line 13.

Note: Use the *Capital Gain Tax Worksheet* in the Form 1040 instructions to figure your tax if your taxable income (Form 1040, line 37) is more than: $91,850 if married filing jointly or qualifying widow(er); $55,100 if single; $78,700 if head of household; or $45,925 if married filing separately.

Nontaxable (return of capital) distributions. Some distributions are nontaxable because they are a return of your cost. You report return of capital distributions (box 1d of Form 1099–DIV) only after your basis in the stock has been reduced to zero. If the basis of your stock is zero, report any return of capital distributions you receive on line 1, Part I of Schedule D, if you held the stock one year or less. Report them on line 9, Part II of Schedule D, if you held the stock for more than one year. Write ''Dividend R.O.C. Exceeding Basis'' in column (a) of Schedule D and the name of the company. Report your gain in column (g) of Schedule D. Your gain is the amount of the distribution in excess of your basis in the stock.

Form 1040—Total Dividends of More Than $400

You must fill in Part II of Schedule B and attach it to your return, if:

1) Your total dividends, including capital gain and nontaxable distributions, are more than $400, or
2) You received, as a nominee, dividends that actually belong to someone else. (See *Nominees (Form 1040)*, later, for how to report these dividends.)

If your total dividends are more than $400, you must also complete Part III of Schedule B.

You must report all of your dividend income (box 1a of Form 1099–DIV) on line 5, Part II of Schedule B. You must include on this line all the ordinary dividends, capital gain distributions, and return of capital distributions you receive. You should list the name of the payer and the amount of income for each distribution you receive. If your securities are held by a brokerage firm (in ''street name''), list the name of the brokerage firm that is shown on Form 1099–DIV as the payer. If your stock is held by a nominee who is the owner of record, and the nominee credits or pays you dividends on the stock, you should show the name of the nominee and the dividends you received or for which you were credited. You should enter on line 6 the total of the amounts listed on line 5. However, if you hold stock as a nominee, see *Nominees (Form 1040),* later.

Capital gain distributions. You enter on line 7, Part II of Schedule B, any amount shown on line 5 that is a capital gain distribution. You also enter this amount on line 14, Part II of Schedule D (Form 1040). If you do not need to use Schedule D to report any other gains or losses, do not use it. Instead, show your capital gain distributions on line

13, Form 1040. Write ''CGD'' on the dotted line next to line 13.

Note: Use the *Capital Gain Tax Worksheet* in the Form 1040 instructions to figure your tax if your taxable income (Form 1040, line 37) is more than: $91,850 if married filing jointly or qualifying widow(er); $55,100 if single; $78,700 if head of household; or $45,925 if married filing separately.

Nontaxable (return of capital) distributions. You enter on line 8, Part II of Schedule B, any amount from line 5 that you received as a return of capital distribution. However, after the basis of your stock has been reduced to zero, you must also show this amount on line 1, Part I of Schedule D, if you held the stock one year or less. Show it on line 9, Part II of Schedule D, if you held the stock for more than one year. Write ''Dividend R.O.C. Exceeding Basis'' in column (a) of Schedule D and the name of the company. Report your gain in column (g) of Schedule D. Your gain is the amount of the distribution in excess of your basis in the stock.

Completing Schedule B. Add the amounts shown on lines 7 and 8, and enter the total on line 9. Subtract the amount on line 9 from the amount on line 6. The difference, if any, is your taxable ordinary dividends. Enter this amount on line 10, Part II of Schedule B, and on line 9, Form 1040. If you had over $400 of dividends, you must also complete Part III of Schedule B. See *Foreign financial accounts and foreign trusts* under *Additional Schedules* in Chapter 1 for more information.

Nominees (Form 1040). Include on line 5, Part II of Schedule B (Form 1040), all dividends you received. This includes dividends you received, as a nominee, that actually belong to another person (such as your child), even if you later distributed some or all of this income to others. Enter a subtotal of all your dividend income listed on line 5 several lines above line 6. Below the subtotal, write ''Nominee Distribution,'' and show the amounts received as a nominee. Subtract these distributions from the subtotal, and enter the result on line 6.

If you receive a Form 1099–DIV on which your taxpayer identification number is shown, and two or more recipients are named, or amounts belonging to another person are included, you must file a Form 1099–DIV with the IRS to show the proper distributions of the amounts shown. Complete a **Form 1096,** *Annual Summary and Transmittal of U.S. Information Returns,* and file both forms with the Internal Revenue Service Center. Give the other person Copy B of the Form 1099–DIV that you filed as a nominee. On Form 1099–DIV and Form 1096, you should be listed as the ''Payer.'' On Form 1099–DIV, the other owner should be listed as the ''Recipient.'' You are not required, however, to file a Form 1099–DIV to show payments for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see *1994 Instructions for Forms 1099, 1098, 5498, and W–2G.*

Liquidating distributions. You will receive Form 1099–DIV from the corporation showing the amount of the liquidating distribution. Generally, this is treated as the sale or exchange of a capital asset and you should report it on Schedule D (Form 1040).

Sample returns. The sample return in Chapter 38 has an example of reporting dividend income on Form 1040A. The sample return in Chapter 39 has an example of reporting dividend income on Form 1040.

10.

Rental Income and Expenses

Important Change for 1994

Passive activity rules for rental activities. Prior to 1994, all rental activities (regardless of the level of the taxpayer's participation) were passive activities. Losses from such activities were limited.

Beginning in 1994, rental activities in which the taxpayer materially participates will no longer be passive activities if the taxpayer meets certain eligibility requirements. Losses from these activities are not limited by the passive activity rules.

Otherwise, there are still passive loss limits and at-risk rules that may affect the amount of rental loss you can claim on your return. See *Limits on Rental Losses,* later.

Introduction

This chapter discusses rental income and expenses. It covers the following topics:

- Rental income
- Rental expenses
- Vacation homes and other dwelling units
- Depreciation
- Limits on rental losses
- How to report your rental income and expenses

If you sell or otherwise dispose of your rental property, see Publication 527, *Residential Rental Property.*

If you have a loss from damage to, or from theft of, rental property, see Chapter 26 of Publication 334, *Tax Guide for Small Business.*

If you rent out a condominium or a cooperative apartment, some special rules apply to you even though you receive the same tax treatment as other owners of rental property. See Publication 527 for more information.

Useful Items

You may want to see:

Publication

- ❑ **334** Tax Guide for Small Business
- ❑ **527** Residential Rental Property
- ❑ **534** Depreciation
- ❑ **535** Business Expenses
- ❑ **544** Sales and Other Dispositions of Assets
- ❑ **925** Passive Activity and At-Risk Rules
- ❑ **946** How To Begin Depreciating Your Property

Form (and Instructions)

- ❑ **4562** Depreciation and Amortization
- ❑ **8582** Passive Activity Loss Limitations
- ❑ **Schedule E (Form 1040)** Supplemental Income and Loss

Rental Income

Rental income is any payment you receive for the use or occupation of property.

You generally must include in your gross income all amounts you receive as rent.

In addition to amounts you receive as normal rent payments, there are other amounts that may be rental income.

Advance rent. Advance rent is any amount you receive before the period that it covers. Include advance rent in your rental income in the year you receive it regardless of the period covered or the method of accounting you use.

Example. You sign a 10–year lease to rent your property. In the first year, you receive $5,000 for the first year's rent and $5,000 as rent for the last year of the lease. You must include $10,000 in your income in the first year.

Security deposits. Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. But, if during any year, you keep part or all of the security deposit because your tenant does not live up to the terms of the lease, include the amount you keep in your income for that year.

If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in your income when you receive it.

Payment for canceling a lease. If your tenant pays you to cancel a lease, the amount you receive is rent. Include the payment in your income for the year you receive it regardless of your method of accounting.

Expenses paid by tenant. If your tenant pays any of your expenses and these payments are in lieu of rent, then these payments are rental income. You must include them in your income. You can deduct those expenses if they are deductible rental expenses.

Property or services. If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income.

If the services are provided at an agreed upon or specified price, that price is the fair market value in the absence of evidence to the contrary.

Rental of property also used as a home. If you rent property that you also use as your home and you rent it for less than 15 days during the tax year, do not include the rent you receive in your gross income. You cannot deduct rental expenses. However, you can deduct allowable interest, taxes, and casualty and theft losses as itemized deductions on Schedule A of Form 1040. See *Personal Use of Vacation Homes and Other Dwelling Units,* later.

If you own a part interest in rental property, you must report your part of the rental income from the property.

Rental Expenses

This part discusses repairs and certain other expenses of renting property that you ordinarily can deduct from your gross rental income. It includes information on the expenses you can deduct if you rent part of your property, or if you change your property to rental use. Depreciation, which you can also deduct from your gross rental income, is discussed later.

If you own a part interest in rental property, you can deduct your part of the expenses that you paid.

When to deduct. You generally deduct your rental expenses in the year you pay or incur them.

Vacant rental property. If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses for managing, conserving, or maintaining the property while the property is vacant. However, you cannot deduct any loss of rental income for the period the property is vacant.

Pre-rental expenses. You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time you make it available for rent.

Expenses for rental property sold. If you sell property you held for rental purposes, you can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold.

Personal use of rental property. If you sometimes use your rental property for personal purposes, you must divide your expenses between rental and personal use. Also, your rental expense deductions may be limited. See *Personal Use of Vacation Homes and Other Dwelling Units,* later.

Repairs and Improvements

You can deduct the cost of repairs that you make to your rental property. You cannot deduct the cost of improvements. You recover

the costs of improvements by taking depreciation (explained later).

Separate the costs of repairs and improvements, and keep accurate records. You will need to know the cost of improvements when you sell or depreciate your property.

Repairs. A repair keeps your property in good operating condition. It does not materially add to the value of your property or substantially prolong its life. Repainting property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

If you make repairs as part of an extensive remodeling or restoration of your property, the whole job is an improvement.

Improvements. An improvement adds to the value of your property, prolongs its useful life, or adapts it to new uses. Putting a recreation room in an unfinished basement, paneling a den, adding a bathroom or bedroom, putting decorative grillwork on a balcony, putting up a fence, putting in new plumbing or wiring, putting in new cabinets, putting on a new roof, and paving a driveway are examples of improvements.

If you make an improvement to property before you begin renting it, add the cost of the improvement to the basis of the property. Basis is explained later under *Modified Accelerated Cost Recovery System (MACRS).*

Other Expenses

Other expenses you can deduct from your gross rental income include advertising, janitor and maid service, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation, and other expenses discussed below.

Salaries and wages. You can deduct reasonable salaries and wages you pay to your employees. You can also deduct bonuses you pay to your employees if, when added to their regular salaries or wages, the total is not more than reasonable pay.

You can deduct reasonable wages you pay to your dependent child if your child is your bona fide employee. However, you cannot deduct the cost of meals and lodging for the child.

Rental payments for property. You can deduct the rent you pay for property that you use for rental purposes. If you buy a leasehold for rental purposes, you can deduct an equal part of the cost each year over the term of the lease.

Rental of equipment. You can deduct the rent you pay for equipment that you use for rental purposes. However, in some cases, lease contracts are actually purchase contracts. If so, you cannot deduct these payments. You can recover the cost of purchased equipment through depreciation.

Insurance premiums. You can deduct insurance premiums you pay for rental purposes. If you pay the premiums for more than one year in advance, each year you can deduct the part of the premium payment that will apply to that year. You continue to deduct your premium in this manner for as long as the insurance is in effect. You cannot deduct the total premium in the year you pay it.

Local benefit taxes. Generally, you cannot deduct charges for local benefits that increase the value of your property, such as for putting in streets, sidewalks, or water and sewer systems. These charges are nondepreciable capital expenditures. You must add them to the basis of your property. You can deduct local benefit taxes if they are for maintaining, repairing, or paying interest charges for the benefits.

Charges for services. You can deduct charges you pay for services provided for your rental property, such as water, sewer, and trash collection.

Travel expenses. You can deduct the ordinary and necessary costs of traveling away from home if the primary purpose of the trip was to collect rental income or to manage, conserve, or maintain your rental property. You must properly allocate between rental and nonrental activities. For information on travel expenses, see Chapter 28.

To deduct travel expenses, you must keep records that follow the rules in Chapter 28.

Local transportation expenses. You can deduct your ordinary and necessary local transportation expenses if you incur them to collect rental income or to manage, conserve, or maintain your rental property.

Generally, if you use your personal car, pickup truck, or light van for rental activities, you can deduct local transportation expenses using one of two methods: actual expenses or the standard mileage rate. The standard mileage rate for 1994 is ***29 cents a mile*** for all business miles.

To deduct car expenses under either method, you must follow certain rules. These rules are discussed in Chapter 28.

In addition, you must complete Part V of Form 4562 and attach it to your tax return.

Tax return preparation. You can deduct, as a rental expense, the part of tax return preparation fees you paid to prepare Part I of Schedule E. You can also deduct, as a rental expense, any expense you paid to resolve a tax underpayment related to your rental activities. On your 1994 Schedule E (Form 1040), you can deduct fees paid in 1994 to prepare Part I of your 1993 Schedule E (Form 1040).

Renting Part of Your Property

If you rent part of your property, you must divide certain expenses between the part of the property used for rental purposes and the part of the property used for personal purposes as though you actually had two separate pieces of property.

You can deduct a part of some expenses, such as mortgage interest and property taxes, as a rental expense. You can deduct the other part, subject to certain limitations, only if you itemize your deductions. You can also deduct as a rental expense a part of other expenses that normally are nondeductible personal expenses, such as expenses for electricity, a second telephone line, or painting the outside of your house.

You do not have to divide the expenses that belong only to the rental part of your property. If you paint a room that you rent, or if you pay premiums for liability insurance in connection with renting a room in your home, your entire cost is a rental expense. You can deduct depreciation, discussed later, on the part of the property used for rental purposes as well as on the furniture and equipment you use for these purposes.

How to Divide Expenses

If an expense is for both rental use and personal use, such as mortgage interest or the heat for the entire house, you must divide the expense between the rental use and the personal use. You can use any reasonable method for dividing the expense. The two most common methods are one based on the number of rooms in your home and one based on the square footage of your home.

Allocating costs. Dividing certain expenses based on the number of people involved may be the proper method to use. For example, if you provide meals to tenants, the most accurate method of dividing food costs between rental and personal expenses may be one based on the total number of people eating the food. Or, if you rent an apartment and your tenants have unrestricted use of your second telephone line, dividing the monthly charge for that line by the number of people using it may be the best method to use.

Limits on Deductions for Rental Expenses

If you rent out part of your property and you also use that or another part of the same property for personal purposes during the year, your deductions for rental expenses for the property may be limited. See *Personal Use of Vacation Homes and Other Dwelling Units,* later, for more information.

Property Changed to Rental Use

If you change your home, apartment, or other property, or a part of it, to rental use at any time other than at the beginning of your tax year, you must divide yearly expenses, such as depreciation, taxes, and insurance, between rental use and personal use.

You can deduct as rental expenses only the part of the expense that is for the part of

the year the property was used or held for rental purposes.

You cannot deduct depreciation or insurance for any property or part of property held for personal use. However, you can deduct the allowable part of the interest and tax expenses for personal use as an itemized deduction on Schedule A (Form 1040).

Example. You moved from your home in May 1994 and started renting it out on June 1, 1994. You can deduct as rental expenses seven-twelfths of your yearly expenses, such as taxes and insurance.

You can deduct as rental expenses, starting with June, the amounts you pay for items generally billed monthly, such as utilities.

Information on depreciation. See *Personal home changed to rental use,* later, under *Modified Accelerated Cost Recovery System (MACRS)* for information about how to figure your deduction for depreciation.

Other limits. If you change property to rental use and later use part or all of it for personal purposes, there are other rules that apply to how much of your rental expenses you can deduct. These rules are explained later under *Personal Use of Vacation Homes and Other Dwelling Units.*

Not Rented For Profit

If your rental of a property is an activity that you do not carry on to make a profit, you can deduct your rental expenses only up to the amount of your rental income. You cannot carry forward any of your rental expenses that are more than your rental income. For more information about the rules for an activity not engaged in for profit, see Chapter 1 of Publication 535.

Where to report. Report your rental income on line 21, Form 1040. Deduct your mortgage interest, real estate taxes, and casualty losses on the appropriate lines of Schedule A (Form 1040).

You claim your other expenses, subject to the rules explained in Chapter 1 of Publication 535, as miscellaneous itemized deductions on line 22 of Schedule A. You can deduct these expenses only if they, together with certain other miscellaneous itemized deductions, total more than 2% of your adjusted gross income. For more information about miscellaneous deductions, see Chapter 30.

Personal Use of Vacation Homes and Other Dwelling Units

If you have any personal use of a vacation home or other dwelling unit that you rent out, you must divide your expenses between the rental use and the personal use. See *Figuring Days of Personal Use* and *How to Divide Expenses,* later.

If you use the dwelling unit as a home and you rent it for fewer than 15 days during the year, do not include any of the rent in your income and do not deduct any of the rental expenses. If you rent out the dwelling unit for 15 or more days, you must include the rent in your income and, if you have a net loss, you may not be able to deduct all of the rental expenses. See *How to Figure Your Income and Deductions,* later.

Dwelling unit. The rules in this section apply to vacation homes and other dwelling units. A dwelling unit includes a house, apartment, condominium, mobile home, boat, or similar property. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities. A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment.

Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

Example. You rent out a room in your home that is always available for short-term occupancy by paying customers. You do not use the room yourself, and you only allow paying customers to use the room. The room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

Dwelling Unit Used as Home

You use a dwelling unit as a home during the tax year if you use it for personal purposes more than the greater of:

1) 14 days, or
2) 10% of the total days it is rented to others at a fair rental price.

See *Figuring Days of Personal Use,* later.

If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, do not count that day as a day of rental in applying (2) above. Instead, count it as a day of personal use in applying both (1) and (2) above.

Example. You own a cottage at the shore. You rent it out at a fair rental price from June 1 through August 31, a total of 92 days. The tenant who rented the cottage for the month of July was unable to use it from July 4 through July 8. The tenant allowed you to use the cottage for those 5 days. The tenant did not ask for a refund of or a reduction in the rent. Your family used the cottage for 3 of those days.

To determine the number of days the cottage was rented at a fair rental price, do not count those 3 days you used it for personal purposes. The cottage was rented at a fair rental price for 89 days (92 – 3).

Fair rental price. A fair rental price for your property generally is an amount that a person who is not related to you would be willing to pay. The rent you charge is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property.

Ask yourself the following questions when comparing another property with yours.

Is it used for the same purpose?

Is it approximately the same size?

Is it in approximately the same condition?

Does it have similar furnishings?

Is it in a similar location?

If any of the answers are no, the properties probably are not similar.

Examples. The following examples show how to determine whether you used your rental property as a home.

Example 1. You converted the basement of your home into an apartment with a bedroom, a bathroom, and a small kitchen. You rent the apartment at a fair rental price to college students during the regular school year. You rent to them on a 9–month (273 days) lease.

During the summer, your brothers stay with you for a month (30 days) and live in the apartment rent free.

Your basement apartment is used as a home because you use it for personal purposes for 30 days. That is more than the greater of 14 days or 10% of the total days it is rented.

Example 2. You rent out the guest bedroom in your home at a fair rental price during the local college's homecoming, commencement, and football weekends (a total of 27 days). Your sister-in-law stays in the room, rent free, for the last three weeks (21 days) in July.

The room is used as a home because you use it for personal use for 21 days. That is more than the greater of 14 days or 10% of the total days it is rented.

Figuring Days of Personal Use

A day of personal use of a dwelling unit is any day that it is used by:

1) You or any other person who has an interest in it, unless you rent it to another owner as his or her main home under a shared equity financing agreement (defined later),
2) A member of your family or a member of the family of any other person who has an interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price. Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.),
3) Anyone under an arrangement that lets you use some other dwelling unit, or
4) Anyone at less than a fair rental price.

Main home. If the other owner or member of the family in (1) or (2) above has more than one home, his or her main home is the one lived in most of the time.

Shared equity financing agreement. This is an agreement under which two or more persons acquire undivided interests for more than 50 years in an entire dwelling unit, including the land, and one or more of the co-owners is entitled to occupy the unit as his or her main home upon payment of rent to the other co-owner or owners.

Donation of use of property. You use a dwelling unit for personal purposes if:

- You donate the use of the unit to a charitable organization,
- The organization sells the use of the unit at a fund-raising event, and
- The purchaser uses the unit.

Examples

The following examples show how to determine days of personal use.

Example 1. You and your neighbor are co-owners of a condominium at the beach. You rent the unit out to vacationers whenever possible. The unit is not used as a main home by anyone. Your neighbor uses the unit for two weeks every year.

Because your neighbor has an interest in the unit, both of you are considered to have used the unit for personal purposes during those two weeks.

Example 2. You and your neighbors are co-owners of a house under a shared equity financing agreement. Your neighbors live in the house and pay you a fair rental price.

Even though your neighbors have an interest in the house, the days your neighbors live there are not counted as days of personal use by you. This is because your neighbors rent the house as their main home under a shared equity financing agreement.

Example 3. You own a rental property that you rent to your son. Your son has no interest in this dwelling unit. He uses it as his main home. He pays you a fair rental price for the property.

Your son's use of the property is not personal use by you because your son is using it as his main home, he has no interest in the property, and he is paying you a fair rental price.

Example 4. You rent your beach house to Marcia. Marcia rents her house in the mountains to you. You each pay a fair rental price.

You are using your house for personal purposes on the days that Marcia uses it because your house is used by Marcia under an arrangement that allows you to use her house.

Example 5. You rent an apartment to your mother at less than a fair rental price. You are using the apartment for personal purposes on the days that your mother rents it.

Days Not Counted as Personal Use

Some days you spend at the dwelling unit are not counted as days of personal use.

Repairs and maintenance. Any day that you spend working substantially full time repairing and maintaining your property is not counted as a day of personal use. Do not count such a day as a day of personal use even if family members use the property for recreational purposes on the same day.

Use as home before or after renting. When determining if you used your property as a home, the following special rule applies. Do not count as days of personal use the days on which you used the property as your main home either before or after renting it or offering it for rent in the following circumstances:

1) You rented or tried to rent the property for 12 or more consecutive months, or
2) You rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because you sold or exchanged the property.

This special rule does not apply when dividing expenses between rental and personal use.

How to Divide Expenses

If you use a dwelling unit for both rental and personal purposes, you must divide your expenses between the rental use and the personal use. For purposes of dividing your expenses:

1) Any day that the unit is rented at a fair rental price is a day of rental use even if you have personally used the unit for that day, and
2) A unit is not considered used for rental during the time that it is held out for rent but not actually rented.

Example. You offer your beach cottage for rent from June 1 through August 31 (92 days). Your family uses the cottage during the last 2 weeks in May (14 days). During 1994, you were unable to find a renter for the first week in August (7 days). The person who rented the cottage for July allowed you to use it over a weekend (2 days) without any reduction in or refund of rent. The cottage was not used at all before May 17 or after August 31.

The cottage was used for rental a total of 85 days (92 – 7). The days it was held out for rent but not rented (7 days) are not days of rental use. For purposes of dividing expenses, the July weekend on which you used it (2 days) is rental use because you received a fair rental price for the weekend.

You used the cottage for personal purposes for 14 days (the last 2 weeks in May).

The total use of the cottage was 99 days (14 days personal use + 85 days rental use). You use 85/99 (86%) of these expenses as rental expenses.

How to Figure Your Income and Deductions

How you figure your rental income and deductions depends on how much personal use you made of the property and how many days the property was rented.

General Rule

If you do not use a dwelling unit as a home, you divide your expenses between personal use and rental use based on the number of days it was used for each purpose.

Your deductible rental expenses can be more than your gross rental income. However, see *Limits on Rental Losses,* later.

Where to report. Report the rental income and all of the rental expenses on Schedule E (Form 1040), *Supplemental Income and Loss.*

You can deduct allowable interest, taxes, and casualty losses for the personal use of the property on Schedule A (Form 1040) if you itemize deductions.

Income and Deductions for Property Used as a Home

If you use a dwelling unit as a home during the year (as explained earlier), how you figure your rental income and deductions depends on how many days the unit was rented.

Rented fewer than 15 days. If you use a dwelling unit as a home and you rent it for fewer than 15 days during the year, you do not include in income any of the rental income. Also, you cannot deduct any expenses as rental expenses.

However, you can deduct your allowable interest, taxes, and casualty and theft losses on Schedule A (Form 1040) if you itemize deductions.

Rented 15 days or more. If you use a dwelling unit as a home and rent it for 15 days or more during the year, you include all your rental income in your gross income. You must divide your expenses between the personal use and the rental use based on the number of days used for each purpose. If you had a net profit from the rental property for the year (that is, if your rental income is more than the total of your rental expenses, including depreciation), deduct all of your rental expenses. However, if you had a net loss, you may not be able to deduct all of your rental expenses.

Use *Table 10–1* to figure your deductible expenses.

Depreciation

When you use your property to produce income, such as rents, the law generally allows you to recover (get back) some or all of

Table 10-1. **Worksheet for Figuring the Limit on Rental Deductions for a Dwelling Unit Used as a Home**

Use this worksheet only if you answer "yes" to all of the following questions.

- Did you use the dwelling unit as a home this year? (See *Dwelling Unit Used as a Home*.)
- Did you rent the dwelling unit 15 days or more this year?
- Are the total of your rental expenses and depreciation more than your rental income?

1. Enter rents received		_____
2. a. Enter the rental portion of deductible home mortgage interest (see instructions)	_____	
b. Enter the rental portion of real estate taxes	_____	
c. Enter the rental portion of deductible casualty and theft losses (see instructions)	_____	
d. Enter indirect rental expenses (see instructions)	_____	
e. **Fully deductible rental expenses.** Add lines 2a–2d		_____
3. Subtract line 2e from line 1. If zero or less, enter zero		_____
4. a. Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities)	_____	
b. Enter the rental portion of excess mortgage interest (see instructions)	_____	
c. Add lines 4a and 4b	_____	
d. **Allowable operating expenses.** Enter the smaller of line 3 or line 4c		_____
5. Subtract line 4d from line 3. If zero or less, enter zero		_____
6. a. Enter the rental portion of excess casualty and theft losses (see instructions)	_____	
b. Enter the rental portion of depreciation of the dwelling unit	_____	
c. Add lines 6a and 6b	_____	
d. **Allowable excess casualty and theft losses and depreciation.** Enter the smaller of line 5 or line 6c		_____
7. a. **Operating expenses to be carried over to next year.** Subtract line 4d from line 4c		_____
b. **Excess casualty and theft losses and depreciation to be carried over to next year.** Subtract line 6d from line 6c		_____

Enter the amounts on **lines 2e, 4d, and 6d** on the appropriate lines of Schedule E (Form 1040), Part I.

Worksheet Instructions

Follow these instructions for the worksheet above. If you were unable to deduct all your expenses last year, including operating expenses, casualty and theft losses, and depreciation, because of the rental income limit, add these unused amounts to your expenses for this year.

Line 2a. Figure the mortgage interest on the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the unit. **Do not** include interest on a loan that did not benefit the dwelling unit. For example, **do not** include interest on a home equity loan used to pay off credit cards or other personal loans, buy a car, or pay college tuition. Include interest on a loan used to buy, build, or improve the dwelling unit, or to refinance such a loan. Enter the rental portion of this interest on line 2a of the worksheet.

Line 2c. Figure the casualty and theft losses related to the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the dwelling unit. To do this, complete Section A of Form 4684, treating the losses as personal losses. On line 17 of Form 4684, enter 10% of your adjusted gross income figured **without** your rental income and expenses from the dwelling unit. Enter the rental portion of the result from line 18 of Form 4684 on line 2c of this worksheet. **Note:** Do **not** file this Form 4684 or use it to figure your personal losses on Schedule A. Instead, figure the personal portion on a separate Form 4684.

Line 2d. Enter the total of your rental expenses that are not directly related to operating or maintaining the dwelling unit. These include interest on loans used for rental activities other than to buy, build, or improve the dwelling unit. Also include rental agency fees, advertising, office supplies, and depreciation on office equipment used in your rental activity.

Line 4b. On line 2a, you entered the mortgage interest you could deduct on Schedule A if you had not rented out the dwelling unit. Enter on line 4b of this worksheet the mortgage interest you could not deduct on Schedule A because it is **more than** the limit on home mortgage interest. **Do not** include interest on a loan that did not benefit the dwelling unit (as explained in the line 2a instructions).

Line 6a. To find the rental portion of excess casualty and theft losses you can deduct, follow these steps. Use the Form 4684 you prepared for line 2c of this worksheet.

A. Enter the amount from line 10 of Form 4684	_____
B. Enter the rental portion of (A)	_____
C. Enter the amount from line 2c of the worksheet	_____
D. Subtract (C) from (B). Enter the result here and on line 6a of the worksheet	_____

Allocating the limited deduction. If you cannot deduct all of the amount on line 4c or 6c this year, you can allocate the allowable deduction in any way you wish among the expenses included on line 4c or 6c. Enter the amount you allocate to each expense on the appropriate line of Schedule E, Part I.

what you paid for the property through tax deductions. You do this by "depreciating" the property; that is, by deducting some of your cost on your tax return each year.

Several factors determine how much depreciation you can deduct. The main factors are: (1) your basis in the property, and (2) the recovery period for the property.

You can deduct depreciation only on the part of your property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange. You may have to use **Form 4562,** *Depreciation and Amortization,* to figure and report your depreciation. See *How to Report Rental Income and Expenses,* later.

You should claim the correct amount of depreciation each tax year. If, in an earlier year, you did not claim depreciation that you were entitled to deduct, you must still reduce your basis in the property by the amount of depreciation that you should have deducted. You cannot deduct the unclaimed depreciation in the current or any later tax year. However, you may be able to claim the depreciation on an amended return (Form 1040X) for the earlier year. See *Amended Returns and Claims for Refund* in Chapter 1 for more information.

Land. You can never depreciate land. This generally includes the cost of clearing, grading, planting, and landscaping because

these expenses are all part of the cost of land.

Depreciation Systems

There are three ways to figure depreciation. The depreciation system you use depends on the type of asset and when the asset was placed in service. For ***tangible property*** you use:

1) MACRS if placed in service after 1986,
2) ACRS if placed in service after 1980 but before 1987, or
3) Straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.

Tangible property is any property that you can see and touch. This includes automobiles, buildings, and equipment.

If you placed property in service before 1994, continue to use the same method of figuring depreciation that you used in the past. If you need information about any other method of depreciation, see Publication 534, *Depreciation.*

Section 179 election. You cannot claim the section 179 deduction for property merely held for the production of income, including certain rental property. See Publication 534.

Cannot be more than basis. The total of all your yearly depreciation deductions cannot be more than your cost or other basis of the property. For this purpose, the total depreciation must include any depreciation that you were allowed to claim, even if you did not claim it.

Cooperative apartments. If you are a tenant-stockholder in a cooperative housing corporation and you rent your cooperative apartment to others, you may deduct your share of the corporation's depreciation. See *Cooperative apartments* in Publication 527 for information on how to figure your depreciation deduction.

Modified Accelerated Cost Recovery System (MACRS)

The modified accelerated cost recovery system (MACRS) applies to all tangible property placed in service during 1994.

MACRS consists of two systems that determine how you depreciate your property. The main system is called the ***General Depreciation System (GDS)***. The second system is called the ***Alternative Depreciation System (ADS)***. GDS is used to figure your depreciation deduction for property used in most rental activities, unless you elect ADS.

To figure your MACRS deduction, you need to know the following information about your property:

1) Its recovery period,
2) Its placed-in-service date, and
3) Its depreciable basis.

Excluded property. You cannot use MACRS for certain personal property placed in service before 1987 (before August 1, 1986, if election made) that is transferred after 1986 (after July 31, 1986, if election made). Generally, if you acquired the property from a related party, or if you or a related party used the property before 1987, you cannot use MACRS. Property that does not come under MACRS must be depreciated under ACRS or one of the other methods of depreciation, such as straight line or declining balance. In addition, you may elect to exclude certain property from the application of MACRS. See Publication 534 for more information.

Personal home changed to rental use. You must use MACRS to figure the depreciation on property you used as your home and changed to rental property in 1994.

Recovery Periods Under GDS

Each item of property that can be depreciated is assigned to a property class. The recovery period of a piece of property depends on the class the property is in. The property classes are:

3–year property,

5–year property,

7–year property,

10–year property,

15–year property,

20–year property,

Nonresidential real property, and

Residential rental property.

The class to which property is assigned is determined by its class life. Class life is discussed in Publication 534.

Under GDS, tangible property that you placed in service during 1994 in your rental activities generally falls into one of the following classes. Also see *Table 10–2* in this chapter. The other recovery classes are discussed in Publication 534.

1) ***5–year property.*** This class includes computers and peripheral equipment, office machinery (typewriters, calculators, copiers, etc.), automobiles, and light trucks.

   Depreciation on automobiles, certain computers, and cellular telephones is limited. See Chapter 4 of Publication 534.

2) ***7–year property.*** This class includes office furniture and equipment (desks, files, etc.), and appliances, carpets, furniture, etc. used in residential rental property. This class also includes any property that does not have a class life and that has not been designated by law as being in any other class.
3) ***15–year property.*** This class includes roads and shrubbery (if depreciable).
4) ***Residential rental property.*** This class includes any real property that is a rental building or structure (including a mobile home) for which 80% or more of the gross rental income for the tax year is from dwelling units. A dwelling unit is a house or an apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, inn, or other establishment where more than half of the units are used on a transient basis. If you live in any part of the building or structure, the gross rental income includes the fair rental value of the part you live in. This property is depreciated over ***27.5 years.***

Additions or improvements to property. Treat additions or improvements you make to any property as separate property items for depreciation purposes. The recovery period for an addition or improvement begins on the later of:

1) The date the addition or improvement is placed in service, or
2) The date the property to which the addition or improvement was made is placed in service.

The class and recovery period of the addition or improvement is the one that would apply to the underlying property if it were placed in service at the same time as the addition or improvement.

Example. You own a residential rental house that you have been renting out since 1980 and are depreciating under ACRS. If you put an addition onto the house, and you place the improvement in service after 1986, you use MACRS for the addition. Under MACRS, the addition would be depreciated as residential rental property.

When to begin depreciation. You can begin to depreciate property when you place it in service in your trade or business or for the production of income. Property is considered placed in service in a rental activity when it is ready and available for a specific use in that activity.

Basis

To deduct the proper amount of depreciation each year, you must first determine your basis in the property you intend to depreciate. The basis used for figuring depreciation is your original basis in the property increased by any improvements made to the property. Your original basis is usually your cost. However, if you acquire the property in some other way, such as by inheriting it, getting it as a gift, or building it yourself, you may have to figure your original basis in another way. Other adjustments could also affect your basis. See Chapter 14.

Table 10-2. **MACRS Recovery Periods for Property Used in Rental Activities**

Type of property	MACRS Recovery Period to use: General Depreciation System	MACRS Recovery Period to use: Alternative Depreciation System
Computers and their peripheral equipment	5 years	5 years
Office machinery, such as: typewriters, calculators, copiers	5 years	6 years
Automobiles	5 years	5 years
Light trucks	5 years	5 years
Office furniture and equipment, such as: desks, files	7 years	10 years
Appliances, such as: stoves, refrigerators	7 years	12 years
Carpets	7 years	12 years
Furniture used in rental property	7 years	12 years
Any property that does not have a class life and that has not been designated by law as being in any other class	7 years	12 years
Roads	15 years	20 years
Shrubbery	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, water pipes, venting, etc.	27.5 years	40 years
Improvements and additions, such as a new roof	The recovery period of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the improvement or addition.	

Figuring MACRS Depreciation Under GDS

You can figure your MACRS depreciation under GDS in one of two ways. The deduction is the same both ways. You can either:

1) Actually compute the deduction using the depreciation method and convention that apply over the recovery period of the property, or
2) Use the percentage from the optional MACRS tables.

If you actually compute the deduction, the depreciation method you use depends on the class of the property.

5–, 7–, or 15–year property. For property in the 5– or 7–year class, you use the double (200%) declining balance method over 5 or 7 years and a half-year convention. Or use the mid-quarter convention if it applies. These conventions are explained later. For property in the 15–year class, you use the 150% declining balance method over 15 years and a half-year convention.

You can also choose to use the 150% declining balance method for property in the 5–, 7–, or 15–year class over its ADS recovery period. See *Figuring MACRS Depreciation Under ADS,* later, for the ADS recovery periods. You make this election on Form 4562. In Part II, column (f), enter ''150 DB.''

Change from either declining balance method to the straight line method in the first tax year that the straight line method gives you a larger deduction.

You can also choose to use the straight line method with a half-year or mid-quarter convention for 5–, 7–, and 15–year property. The choice to use the straight line method for one item in a class of property applies to all property in that class that is placed in service during the tax year of the election. You elect the straight line method on Form 4562. In Part II, column (f), enter ''S/L.'' Once you make this election, you cannot change to another method.

Residential rental property. You must use the straight line method and a mid-month convention (explained later) for residential rental property.

Declining Balance Method

To figure your MACRS deduction, first determine your declining balance rate from the table later. However, if you elect to use the 150% declining balance method for 5– or 7–year property, figure the declining balance rate by dividing 1.5 (150%) by the ADS recovery period for the property.

Multiply the adjusted basis of the property by the declining balance rate, and apply the convention that applies to figure your depreciation for the first year. In later years, use the following steps to figure your depreciation.

1) Adjust your basis by subtracting the amount of depreciation allowable for the earlier years.
2) Multiply your adjusted basis in (1) by the same rate used in the first year.

Follow these steps each year that you use the declining balance method. See *Conventions,* later, for information on depreciation in the year you dispose of property.

Declining balance rates. The following table shows the declining balance rate that applies for each class of property and the first year for which the straight line method will give an equal or greater deduction. (The rates for 5– and 7–year property are based on the 200% declining balance method.)

Class	Declining Balance Rate	Year
5	40.00%	4th
7	28.57%	5th
15	10.00%	7th

Straight Line Method

To figure your MACRS deduction under the straight line method, you must figure a new depreciation rate for each tax year in the recovery period. For any tax year, figure the straight line rate by dividing the number 1 by the years remaining in the recovery period at the beginning of the tax year. Multiply the unrecovered basis of the property by the straight line rate. You must figure the depreciation for the first year using the convention that applies. (See *Conventions,* later.) If the remaining recovery period at the beginning of the tax year is less than 1 year, the straight line rate for that tax year is 100%.

Example. Using the straight line method for property with a 5–year recovery period, the straight line rate is 20% (1 ÷ 5) for the first tax year. After applying the half-year convention, the first year rate is 10% (20% ÷ 2).

At the beginning of the second year, the remaining recovery period is 4½ years because of the half-year convention. The straight line rate for the second year is 22.22% (1 ÷ 4.5).

To figure your depreciation deduction for the second year:

1) Subtract the depreciation taken in the first year from the basis of the property, and
2) Multiply the remaining basis in (1) by 22.22%.

Residential rental property. In the first year you claim depreciation for residential rental property, you can only claim depreciation for the number of months the property is in use, and you must use the mid-month convention (explained later). Also, for the first year of depreciation under ADS, you must use the mid-month convention (explained later) to figure your depreciation deduction.

Conventions

In the year that you place property in service or in the year that you dispose of property, you are only allowed to claim depreciation for only part of the year. The part of the year (or convention) depends on the class of the property.

A half-year convention is used to figure the deduction for property used in rental activities other than residential rental property. However, under a special rule, a mid-quarter convention may have to be used. For residential rental property, use a mid-month convention in all situations.

Half-year convention. The half-year convention treats all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, in the middle of that tax year.

A half year of depreciation is allowable for the first year property is placed in service, regardless of when the property is placed in service during the tax year. For each of the remaining years of the recovery period, you will take a full year of depreciation. If you hold the property for the entire recovery period, a half year of depreciation is allowable for the year following the end of the recovery period. If you dispose of the property before the end of the recovery period, a half year of depreciation is allowable for the year of disposition.

Mid-quarter convention. Under a mid-quarter convention, all property placed in service, or disposed of, during any quarter of a tax year is treated as placed in service, or disposed of, in the middle of the quarter.

A mid-quarter convention must be used in certain circumstances for property used in rental activities, other than residential rental property. This convention applies if the total basis of such property that is placed in service in the last 3 months of a tax year is more than 40% of the total basis of all such property you place in service during the year.

Do not include in the total basis any property placed in service and disposed of during the same tax year.

Example. During 1994, John Joyce purchased the following items to use in his rental property:

A dishwasher for $400, which he placed in service in January;

Used furniture for $100, which he placed in service in September; and

A refrigerator for $500, which he placed in service in October.

John uses the calendar year as his tax year. The total basis of all property placed in service in 1994 is $1,000. The $500 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds $400 (40% × $1,000). John must use the mid-quarter convention for all three items. The dishwasher, refrigerator, and used furniture are 7–year property under GDS.

Mid-month convention. Under a mid-month convention, residential rental property placed in service, or disposed of, during any month is treated as placed in service, or disposed of, in the middle of that month.

Optional Tables

You can use *Table 10–3* to compute annual depreciation under MACRS. The percentages in Tables A, B, and C make the change from declining balance to straight line in the year that straight line will yield a larger deduction. See *Declining Balance Method,* earlier.

If you elect to use the straight line method for 5–, 7–, or 15–year property, or the 150% declining balance method for 5– or 7–year property, use the tables in *Appendix A* of Publication 534.

How to use the tables. The following section explains how to use the optional tables. Figure the depreciation deduction by multiplying your unadjusted basis in the property by the percentage shown in the appropriate table. Your ***unadjusted basis*** is your depreciable basis without reduction for depreciation previously claimed. The tables show the percentages for the first 6 years.

Tables A, B, and C. These tables take the half-year and mid-quarter conventions into consideration in figuring percentages. Use Table A for 5–year property, Table B for 7–year property, and Table C for 15–year property. Use the percentage in the second column (half-year convention) unless you must use the mid-quarter convention (explained earlier). If you must use the mid-quarter convention, use the column that corresponds to the calendar year quarter in which you placed the property in service.

Example 1. You purchased a stove and refrigerator and placed them in service on February 1, 1994. Your basis in the stove is $300, and your basis in the refrigerator is $500. Both are 7–year property. Using the half-year convention column in Table B, you find the depreciation percentage for year 1 is 14.29%. Your 1994 depreciation deduction on the stove is $43 ($300 × .1429). Your 1994 depreciation deduction on the refrigerator is $71 ($500 × .1429).

Using the half-year convention for year 2, you find your depreciation percentage is 24.49%. Your 1995 depreciation deduction will be $73 ($300 × .2449) for the stove and $122 ($500 × .2449) for the refrigerator.

Example 2. Assume the same facts in Example 1, except you buy the refrigerator in October 1994 instead of February. You must use the mid-quarter convention to figure depreciation on the stove and refrigerator. The basis of the refrigerator ($500), placed in service in the last 3 months of the tax year, is more than 40% of the total basis of all property ($800) placed in service during the year.

Because you placed the stove in service in February, you use the first quarter column of Table B and find that the depreciation percentage for year 1 is 25%. Your 1994 depreciation deduction on the stove is $75 ($300 × .25).

Because you placed the refrigerator in service in October, you use the fourth quarter column of Table B and find that the depreciation percentage for year 1 is 3.57%. Your depreciation deduction on the refrigerator is $18 ($500 × .0357).

Table D. Use this table for residential rental property. Find the row for the month that you placed the property in service. Use the percentages listed for that month for your depreciation deduction. The mid-month convention is considered in the percentages used in the tables.

Example. You purchased a single family rental house and placed it in service on February 1, 1994. Your basis in the house is $80,000. Using Table D, you find that the percentage for property placed in service in February of year 1 is 3.182%. Your 1994 depreciation deduction is $2,546 ($80,000 × .03182).

Figuring MACRS Depreciation Under ADS

If you choose, you can use the ADS method for most property. Under ADS, you use the straight line method of depreciation.

Table 10–2 shows the recovery periods for property used in rental activities that you depreciate under ADS. See *Appendix B* in Publication 534 for other property. If your property is not listed, it is considered to have no class life.

Use the mid-month convention for residential rental property. For all other property, use the half-year or mid-quarter convention.

Election. You choose to use ADS by entering the depreciation on line 15, Part II of Form 4562.

The election of ADS for one item in a class of property generally applies to all property in that class that is placed in service during the tax year of the election. However, the election applies on a property-by-property basis for residential rental property.

Once you choose to use ADS, you cannot change your election.

Table 10-3. Optional MACRS TABLES

Table 10-3-A. MACRS 5-Year Property

	Half-year convention	Mid-quarter convention			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Fourth quarter**
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68
5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58

Table 10-3-B. MACRS 7-Year Property

	Half-year convention	Mid-quarter convention			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Fourth quarter**
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.85	8.73

Table 10-3-C. MACRS 15-Year Property

	Half-year convention	Mid-quarter convention			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Fourth quarter**
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00
5	6.93	6.65	6.83	7.02	7.20
6	6.23	5.99	6.15	6.31	6.48

Table 10-3-D. Residential Rental Property (27.5-year)

	Use the row for the month of the taxable year placed in service.					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Jan.	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
Feb.	3.182	3.636	3.636	3.636	3.636	3.636
March	2.879	3.636	3.636	3.636	3.636	3.636
Apr.	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
June	1.970	3.636	3.636	3.636	3.636	3.636
July	1.667	3.636	3.636	3.636	3.636	3.636
Aug.	1.364	3.636	3.636	3.636	3.636	3.636
Sept.	1.061	3.636	3.636	3.636	3.636	3.636
Oct.	0.758	3.636	3.636	3.636	3.636	3.636
Nov.	0.455	3.636	3.636	3.636	3.636	3.636
Dec.	0.152	3.636	3.636	3.636	3.636	3.636

Other Rules About Depreciable Property

In addition to the rules about what methods you can use, there are other rules you should be aware of with respect to depreciable property.

If you dispose of depreciable property at a profit, you may have to report, as ordinary income, all or part of the profit. See Chapter 2 of Publication 527.

Additional tax on preference items. If you use accelerated depreciation, you may have to file **Form 6251,** *Alternative Minimum Tax — Individuals.* Accelerated depreciation includes MACRS and ACRS and any other method that allows you to deduct more depreciation than you could deduct using a straight line method.

Limits on Rental Losses

Rental real estate activities are generally considered passive activities and the amount of loss you can deduct is limited. Generally, you cannot deduct losses from rental real estate activities unless you have income from other passive activities. See *Passive Activity Limits,* later.

Losses from passive activities are first subject to the ***at-risk rules.*** At-risk rules limit the amount of deductible losses from holding most real property placed in service after December 31, 1986.

Exception. If your rental losses are less than $25,000 ($12,500 if married filing separately), the passive activity limits probably do not apply to you. See *Losses From Rental Real Estate Activities,* later.

Property used as a home. If you used the rental property as a home during the year, the passive activity rules do not apply to that home. Instead, you must follow the rules explained earlier under *Personal Use of Vacation Homes and Other Dwelling Units.*

At-Risk Rules

The at-risk rules place a limit on the amount you can deduct as losses from activities often described as tax shelters. Holding real property (other than mineral property) placed in service before 1987 is not subject to the at-risk rules.

Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount you have at risk in the activity at the end of the tax year. You are considered at risk in an activity to the extent of cash and the adjusted basis of other property you contributed to the activity and certain amounts borrowed for use in the activity. See Publication 925, *Passive Activity and At-Risk Rules,* for more information.

Passive Activity Limits

Prior to 1994, all rental activities (regardless of the level of your participation) were passive activities. Losses from such activities were limited.

Beginning in 1994, rental activities in which you materially participate will no longer be passive activities if you meet certain requirements. Losses from these activities are not limited by the passive activity rules.

Requirements. The time you spend performing services in real property trades or businesses in which you materially participate must be:

1) More than half of the time spent performing all personal services during the year, and
2) More than 750 hours.

A real property trade or business is one that develops, redevelops, constructs, reconstructs, acquires, converts, rents, operates, manages, leases, or sells real property.

Services you performed as an employee are not treated as performed in a real property trade or business, unless you own more

than 5% of the stock (or more than 5% of the capital or profits interest) in the employer.

Once you meet the requirements, you can determine whether you materially participate in your rental activities on a property-by-property basis or you can treat all interests in rental real estate as one activity.

Married persons. In the case of a joint return, you meet the requirements only if either you or your spouse separately satisfies the requirements. However, you can count the time your spouse spends to determine whether you materially participate.

Passive activity rules. If you do not meet the above requirements, you generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities.

In general, any rental activity not meeting the above requirements is a passive activity. For this purpose, a rental activity is an activity from which you receive income mainly for the use of tangible property, rather than for services.

Use **Form 8582,** *Passive Activity Loss Limitations* to figure the amount of any passive activity loss for the current year for all activities and the amount of the passive activity loss allowed on your tax return.

Losses From Rental Real Estate Activities

You can deduct up to $25,000 ($12,500 if married filing separately and living apart from your spouse the entire year; $0 if married filing separately and not living apart from your spouse the entire year) of losses from rental real estate activities in which you ***actively participated*** during the tax year. This allows you to deduct up to $25,000 of otherwise unallowable losses from rental real estate activities against other income (nonpassive income). The $25,000 ($12,500) figure is reduced if your adjusted gross income is more than $100,000 ($50,000 if married filing separately and living apart from your spouse the entire year).

If you lived with your spouse at any time during the year and are filing a separate return, you cannot use this special offset to reduce your nonpassive income or tax on nonpassive income.

Active participation. You actively participate in a rental real estate activity if you own at least 10% of the rental property and you make management decisions in a significant and bona fide sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions. For these purposes, you are considered to own any portion of the property owned by your spouse.

See Publication 925 for more information on the passive loss limits, including information on the treatment of unused disallowed passive losses and credits and the treatment of gains and losses realized on the disposition of a passive activity.

How to Report Rental Income and Expenses

Report rental income on your return for the year you actually or constructively receive it (if you are a cash-basis taxpayer). You are considered to constructively receive income when it is made available to you, for example, by being credited to your bank account.

For more information about when you constructively receive income, see *Accounting Methods* in Chapter 1.

Expenses carried over. If you could not deduct all of your 1993 rental expenses because you used your property as a home, treat the part you could not deduct in 1993 as a 1994 rental expense. Deduct the expenses carried over to 1994 only up to the amount of your 1994 gross rental income, even if you did not use the property as your home in 1994.

Where to report. Where you report rental income and expenses, including depreciation, depends on whether you provide certain services to your tenant.

If you rent out buildings, rooms, or apartments, and provide only heat and light, trash collection, etc., you normally report your rental income and expenses in Part I of Schedule E (Form 1040), *Supplemental Income and Loss.* However, see *Not Rented For Profit,* earlier.

If you provide additional services that are primarily for your tenant's convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C (Form 1040), *Profit or Loss From Business* or Schedule C–EZ, *Net Profit From Business.* For information, see Publication 334. You also may have to pay self-employment tax on your rental income. See Publication 533, *Self-Employment Tax.*

Form 1098. If you paid $600 or more of mortgage interest on your rental property, you should receive a Form 1098, *Mortgage Interest Statement,* or a similar statement showing the interest you paid for the year. If you and at least one other person (other than your spouse if you file a joint return) were liable for, and paid interest on the mortgage, and the other person received the Form 1098, report your share of the interest on line 13 of Schedule E. Attach a statement to your return showing the name and address of the other person. In the left margin of Schedule E, next to line 13, write ''See attached.''

Schedule E

Use Part I of Schedule E (Form 1040) to report your rental income and expenses. List your total income, expenses, and depreciation for each rental property. Be sure to answer the question on line 2. On line 20 of Schedule E (Form 1040), show the depreciation you are claiming.

You must complete and attach Form 4562 for rental activities only if you are claiming:

- Depreciation on rental property placed in service during 1994, or
- Depreciation on any rental property that is listed property (such as a car), regardless of when it was placed in service, or
- Any automobile expenses (actual or the standard mileage rate).

Otherwise, figure your depreciation on your own worksheet. You do not have to attach these computations to your return.

If you have more than three rental or royalty properties, complete and attach as many Schedules E as are needed to list the properties. Complete lines 1 and 2 for each property. However, fill in the ''Totals'' column on only one Schedule E. The figures in the ''Totals'' column on that Schedule E should be the combined totals of all Schedules E. If you need to use page 2 of Schedule E, use page 2 of the same Schedule E you used to enter the combined totals in Part I.

Example. Eileen Green owns a townhouse that she rents out. She receives $1,100 a month rental income. Her rental expenses for 1994 are as follows:

Fire insurance (1–year policy)	$ 200
Mortgage interest	5,000
Fee paid to real estate company for collecting monthly rent	572
General repairs	175
Real estate taxes imposed and paid in 1994	800

Eileen bought the property and placed it in service on January 1, 1994. Her basis for depreciation of the townhouse is $65,000. She is using MACRS with a 27.5–year recovery period. On April 1, 1994, Eileen bought a new dishwasher for the rental property at a cost of $425. She uses the MACRS method with a 7–year recovery period.

Eileen uses the percentage for ''January'' in *Table 10–3–D* to figure her deduction for the townhouse. She uses the percentage under ''Half-year convention'' in *Table 10–3–B* to figure her deduction for the dishwasher. She must report the depreciation on Form 4562.

Eileen figures her net rental income or loss for the townhouse as follows:

Total rental income received ($1,100 × 12)		$13,200
Minus Expenses:		
Fire insurance (1-year policy)	$ 200	
Mortgage interest	5,000	
Real estate fee	572	
General repairs	175	
Real estate taxes	800	
Total expenses		6,747
Balance		$ 6,453
Minus Depreciation:		
On townhouse ($65,000 × 3.485%)	$2,265	
On dishwasher ($425 × 14.29%)	61	
Total depreciation		2,326
Net rental income for townhouse		$ 4,127

11.

Retirement Plans, Pensions, and Annuities

Introduction

This chapter discusses the tax treatment of amounts you receive from:

- Employee pensions and annuities,
- Disability retirement, and
- Purchased annuities.

If you are retired from the Federal Government (either regular or disability retirement), get Publication 721, *Tax Guide to U.S. Civil Service Retirement Benefits.* Also, you should get Publication 721 if you are the survivor or beneficiary of a federal employee or retiree who died.

Information on amounts you receive from an individual retirement arrangement (IRA), as well as general information on IRAs, is in Chapter 18.

Useful Items

You may want to see:

Publications

- ❑ **559** Survivors, Executors, and Administrators
- ❑ **575** Pension and Annuity Income (Including Simplified General Rule)
- ❑ **721** Tax Guide to U.S. Civil Service Retirement Benefits
- ❑ **939** Pension General Rule (Nonsimplified Method)

Forms and Instructions

- ❑ **W–4P** Withholding Certificate for Pension or Annuity Payments
- ❑ **4972** Tax on Lump-Sum Distributions
- ❑ **5329** Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts

Employee Pensions and Annuities

Generally, if you did not pay any part of the cost of your employee pension or annuity and your employer did not withhold part of the cost of the contract from your pay while you worked, the amounts you receive each year are fully taxable. You must report them on your income tax return.

If you paid part of the cost of your annuity, you are not taxed on the part of the annuity you receive that represents a return of your cost. The rest of the amount you receive is taxable. You use either the ***General Rule*** or the ***Simplified General Rule*** to figure the taxable and nontaxable parts of your pension or annuity.

If your annuity starting date was ***before*** July 2, 1986, and you recovered your cost under the ***Three-Year Rule,*** you cannot use the General Rule or the Simplified General Rule because your payments are fully taxable.

Changing the method. If your annuity starting date is after July 1, 1986, you can change the way you figure your pension cost recovery exclusion. You can change from the General Rule to the Simplified General Rule, or the other way around. Make the change by filing amended returns for all your tax years beginning with the year in which your annuity starting date occurred. You must use the same method for all years. Generally, you can make the change only within 3 years from the due date of your return ***for the year in which you received your first annuity payment.*** You can make the change later if the date of the change is within 2 years after you paid the tax for that year.

If your annuity starting date was before July 2, 1986, you cannot choose the Simplified General Rule at any time.

More than one program. If you receive benefits from more than one program, such as a pension plan and a profit-sharing plan, you must figure the taxable part of each separately. Make separate computations even if the benefits from both are included in the same check. For example, benefits from one of your programs could be fully taxable, while the benefits from your other program could be taxable under the General Rule or the Simplified General Rule. Your former employer or the plan administrator should be able to tell you if you have more than one program.

Railroad retirement benefits. Part of the railroad retirement benefits you receive is treated like social security benefits, and part is treated like an employee pension. For information about railroad retirement benefits treated as an employee pension, see *Railroad Retirement* in Publication 575, *Pension and Annuity Income (Including Simplified General Rule).*

Credit for the elderly or the disabled. If you receive a pension or annuity, you may be able to take the credit for the elderly or the disabled. See Chapter 34.

Withholding and estimated tax. The payer of your pension, profit-sharing, stock bonus, annuity, or deferred compensation plan will withhold income tax on the taxable parts of amounts paid to you. You can choose not to have tax withheld except for amounts paid to you that are eligible rollover distributions. See *Eligible rollover distributions* under *Rollovers,* later. You make this choice by filing Form W–4P, *Withholding Certificate for Pension or Annuity Payments.*

For payments other than eligible rollover distributions, you can tell the payer how to withhold by filing Form W–4P. If an eligible rollover distribution is paid directly to you, 20% will generally be withheld. There is no withholding on a direct rollover of an eligible rollover distribution. See *Direct rollover option* under *Rollovers,* later. If you choose not to have tax withheld or you do not have enough tax withheld, you may have to pay estimated tax.

For more information, see *Withholding on Pensions and Annuities* and *Estimated Tax* in Chapter 5.

Loans. If you borrow money from an employer's qualified pension or annuity plan, a tax-sheltered annuity program, a government plan, or from a contract purchased under any of these plans, you may have to treat the loan as a distribution. This means that you may have to include in income all or part of the amount borrowed. Even if you do not have to treat the loan as a distribution, you might not be able to deduct the interest on the loan in some situations. For details, see *Loans Treated as Distributions* in Publication 575. For information on the deductibility of interest, see Chapter 25.

Elective deferrals. Some retirement plans allow you to choose (elect) to have part of your pay contributed by your employer to a retirement fund, rather than have it paid to you. You do not pay tax on this money until you receive it in a distribution from the fund.

Elective deferrals generally include elective contributions to cash or deferred arrangements (known as ***section 401(k) plans***), section 501(c)(18) plans, salary reduction simplified employee pension (SEP) plans, and tax-sheltered annuities provided for employees of tax-exempt organizations and public schools.

For information on the tax treatment of elective deferrals, including their limits, see *Elective deferrals* under *Excess Contributions, Deferrals, and Annual Additions* in Publication 575. For information about tax-sheltered annuities, see Publication 571, *Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations.*

H.R. 10 (Keogh) plans. Keogh plans are retirement plans that can only be set up by a sole proprietor or a partnership (but not a partner). They can cover self-employed persons, such as the sole proprietor or partners, as well as regular (common-law) employees.

Distributions from these plans are usually fully taxable. If you have an investment (cost) in the plan, however, your pension or annuity payments are taxed under the General Rule or the Simplified General Rule.

Deferred compensation plans of state and local governments and tax-exempt

organizations. If you participate in one of these plans (known as ***section 457 plans***), you will not be taxed currently on your pay that is deferred under the plan. You or your beneficiary will be taxed on this deferred pay only when it is distributed or otherwise made available to either of you.

Distributions of deferred pay are not eligible for 5– or 10–year tax option, rollover treatment, or the death benefit exclusion, all discussed later. Distributions are, however, subject to the tax for failure to make minimum distributions, discussed later.

For information on these deferred compensation plans and their limits, see *Section 457 plans—deferred compensation plans of state and local governments and tax-exempt organizations* under *Excess Contributions, Deferrals, and Annual Additions* in Publication 575.

Cost

Before you can figure how much, if any, of your pension or annuity benefits is taxable, you must determine your cost in the plan (your investment). Your total cost in the plan includes everything that you paid. It also includes amounts your employer paid that were taxable at the time paid. Cost does not include any amounts you deducted or excluded from income.

From this total cost paid or considered paid by you, subtract any refunds of premiums, rebates, dividends, unrepaid loans, or other tax-free amounts you received before the later of the annuity starting date or the date on which you received your first payment. If you use the General Rule to figure the tax treatment of your payments, you must also subtract from your cost the value of any refund feature in your contract.

The ***annuity starting date*** is the later of the first day of the first period that you receive a payment from the plan or the date on which the plan's obligation became fixed.

Your employer or the organization that pays you the benefits (plan administrator) should show your cost in Box 5 of your Form 1099–R.

Foreign employment. If you worked in a foreign country before 1963 and your employer paid into your retirement plan, a part of those payments may be considered part of your cost. For details, see *Foreign employment* under *Investment in the Contract (Cost)* in Publication 575.

Simplified General Rule

If you can use the Simplified General Rule to figure the taxability of your annuity, it will probably be simpler and more beneficial than the General Rule, discussed later.

Who can use it. You may be able to use the Simplified General Rule if you are a retired employee or if you are receiving a survivor annuity as the survivor of a deceased employee. You can use it to figure the taxability of your annuity ***only*** if:

- Your annuity starting date is after July 1, 1986,
- The annuity payments are for either (a) your life, or (b) your life and that of your beneficiary,
- The annuity payments are from a qualified employee plan, a qualified employee annuity, or a tax-sheltered annuity, ***and***
- At the time the payments began, either you were under age 75 ***or*** the payments were ***guaranteed*** for fewer than 5 years.

If you are not sure whether your retirement plan is a qualified plan (that meets certain Internal Revenue Code requirements), ask your employer or plan administrator.

Your annuity contract provides **guaranteed payments** if a minimum number of payments or a minimum amount (for example, the amount of your investment) is payable even if you and any survivor annuitant do not live to receive the minimum. If the minimum amount is less than the total amount of the payments you are to receive, barring death, during the first 5 years after payments begin (figured by ignoring any payment increases), you are entitled to fewer than 5 years of guaranteed payments.

If you are a survivor of a deceased retiree, you can use the Simplified General Rule if the retiree used it.

Amount of exclusion. If your annuity starting date is after 1986, the total you can exclude from your taxable income over the years is limited to your cost.

If your annuity starting date was after July 1, 1986, and before January 1, 1987, you continue to take your monthly exclusion for as long as you receive your annuity.

In both cases, any unrecovered cost at your, or the last annuitant's, death is allowed as a miscellaneous itemized deduction on the final return of the decedent. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

How to use it. If you meet the conditions and you choose the Simplified General Rule, use the following worksheet to figure your taxable annuity. In completing this worksheet, use your age at the birthday preceding your annuity starting date. Be sure to keep a copy of the completed worksheet; it will help you figure your taxable pension in later years.

Worksheet for Simplified General Rule

1. Total pension received this year. Also add this amount to the total for Form 1040, line 16a, or Form 1040A, line 11a ..... $ _____
2. Your cost in the plan (contract) at annuity starting date, plus any death benefit exclusion* ..... _____
3. Age at annuity starting date: _____ Enter:

55 and under	300
56 – 60	260
61 – 65	240
66 – 70	170
71 and over	120

4. Divide line 2 by line 3 ..... _____
5. Multiply line 4 by the number of months for which this year's payments were made ..... _____

   NOTE: If your annuity starting date is **before 1987,** enter the amount from line 5 on line 8 below. Skip lines 6, 7, 10, and 11.
6. Any amounts previously recovered tax free in years after 1986 ..... _____
7. Subtract line 6 from line 2 ..... _____
8. Enter the smaller of line 5 or line 7 _____
9. **Taxable pension for year.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also add this amount to the total for Form 1040, line 16b, or Form 1040A, line 11b ..... $ _____

   NOTE: If your Form 1099–R shows a larger taxable amount, use the amount on line 9 instead.
10. Add lines 6 and 8 ..... _____
11. Balance of cost to be recovered. Subtract line 10 from line 2 ..... $ _____

***Statement for death benefit exclusion**

Cost in plan (contract) ..... $ _____

Death benefit exclusion ..... _____

Total (enter on line 2 above) ..... $ _____

Signed: _____

Date: _____

KEEP FOR YOUR RECORDS

Example. Bill Kirkland, age 65, began receiving retirement benefits under a joint and survivor annuity to be paid for the joint lives of him and his wife, Kathy. He received his first annuity payment in January 1994. He had contributed $24,000 to the plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of $1,000 a month, and Kathy is to receive a monthly survivor benefit of $500 upon Bill's death.

Bill chooses to use the Simplified General Rule computation. He fills in the worksheet as follows:

Worksheet for Simplified General Rule

1. Total pension received this year. Also add this amount to the total for Form 1040, line 16a, or Form 1040A, line 11a $12,000
2. Your cost in the plan (contract) at annuity starting date, plus any death benefit exclusion* 24,000

3. Age at annuity starting date:	Enter:	
55 and under	300	
56 – 60	260	
61 – 65	240	
66 – 70	170	
71 and over	120	240
4. Divide line 2 by line 3		100
5. Multiply line 4 by the number of months for which this year's payments were made		1,200
NOTE: If your annuity starting date is **before 1987,** enter the amount from line 5 on line 8 below. Skip lines 6, 7, 10, and 11.		
6. Any amounts previously recovered tax free in years after 1986		0
7. Subtract line 6 from line 2		24,000
8. Enter the smaller of line 5 or line 7		1,200
9. **Taxable pension for year.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also add this amount to the total for Form 1040, line 16b, or Form 1040A, line 11b		$10,800
NOTE: If your Form 1099–R shows a larger taxable amount, use the amount on line 9 instead.		
10. Add lines 6 and 8		1,200
11. Balance of cost to be recovered. Subtract line 10 from line 2		$22,800

***Statement for death benefit exclusion**

Cost in plan (contract)	$
Death benefit exclusion	
Total (enter on line 2 above)	$

Signed:

Date:

KEEP FOR YOUR RECORDS

Bill's tax-free monthly amount is $100 (see line 4 of the worksheet). If he lives to collect more than 240 monthly payments, he will have to include the full amount of the additional payments in his gross income.

If Bill dies before collecting 240 monthly payments and Kathy begins receiving monthly payments, she will also exclude $100 from each payment until her payments, when added to his, total 240 payments. If she dies before 240 payments are made, a miscellaneous itemized deduction will be allowed for the unrecovered cost on her final income tax return. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

Death benefit exclusion. If you are a beneficiary of a deceased employee or former employee, you may qualify for a death benefit exclusion of up to $5,000. This exclusion is discussed later in this chapter. If you choose the Simplified General Rule and you qualify for the death benefit exclusion, increase your cost in the pension or annuity plan by the allowable death benefit exclusion. Your cost is on line 2 of the worksheet.

The payer of the annuity does not add the death benefit exclusion to the cost for figuring the nontaxable and taxable part of payments reported on Form 1099–R. Therefore, the Form 1099–R taxable amount will be larger than the amount you will figure for yourself. Report on your return the smaller amount that you figure. You must attach a signed statement to your income tax return stating that you are entitled to the death benefit exclusion in making the Simplified General Rule computation. Or you may use the statement shown at the bottom of the worksheet. You must attach this statement to your return every year until you fully recover the cost in the pension or annuity plan.

Example. Diane Greene, age 48, began receiving a $1,500 monthly annuity in 1994 upon the death of her husband. She received 10 payments in 1994. Her husband had contributed $25,000 to his qualified employee plan. Diane is entitled to a $5,000 death benefit exclusion for the annuity payments. She adds that amount to her husband's contributions to the plan, increasing her total cost in the plan to $30,000.

Diane chooses to use the Simplified General Rule. She fills out the worksheet as follows:

Worksheet for Simplified General Rule

1. Total pension received this year. Also add this amount to the total for Form 1040, line 16a, or Form 1040A, line 11a		$15,000
2. Your cost in the plan (contract) at annuity starting date, plus any death benefit exclusion*		30,000
3. Age at annuity starting date:	Enter:	
55 and under	300	
56 – 60	260	
61 – 65	240	
66 – 70	170	
71 and over	120	300
4. Divide line 2 by line 3		100
5. Multiply line 4 by the number of months for which this year's payments were made		1,000
NOTE: If your annuity starting date is **before 1987,** enter the amount from line 5 on line 8 below. Skip lines 6, 7, 10, and 11.		
6. Any amounts previously recovered tax free in years after 1986		0
7. Subtract line 6 from line 2		30,000
8. Enter the smaller of line 5 or line 7		1,000
9. **Taxable pension for year.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also add this amount to the total for Form 1040, line 16b, or Form 1040A, line 11b		$14,000
NOTE: If your Form 1099–R shows a larger taxable amount, use the amount on line 9 instead.		
10. Add lines 6 and 8		1,000
11. Balance of cost to be recovered. Subtract line 10 from line 2		$29,000

***Statement for death benefit exclusion**

Cost in plan (contract)	$25,000
Death benefit exclusion	5,000
Total (enter on line 2 above)	$30,000

Signed: Diane Greene

Date: 1-18-95

KEEP FOR YOUR RECORDS

In completing Form 1099–R, the payer of the annuity chooses to report the taxable part of the annuity payments using the Simplified General Rule. However, since the payer does not adjust the investment in the contract by the death benefit exclusion, the payer figures the tax-free part of each monthly payment to be $83.33, as follows:

$$\frac{\text{Total investment: \$25,000}}{\text{Expected payments: 300}} = \$83.33 \text{ (Monthly return of investment)}$$

However, Diane figures a $100 monthly tax-free amount (see line 4 of the worksheet). Because of this difference in the computations, the Form 1099–R given by the payer shows a greater taxable amount than what she figures for herself. She reports on line 16b of Form 1040 only the smaller taxable amount based on her own computation. She attaches to her Form 1040 a signed copy of the worksheet, which shows that she is entitled to the death benefit exclusion.

General Rule

You must use the General Rule to figure the taxability of your pension or annuity if your annuity starting date is after July 1, 1986, and you do not qualify for, or you do not choose, the Simplified General Rule (explained earlier). You must also use the General Rule if your annuity starting date was before July 2, 1986, and you did not qualify to use the Three-Year Rule. (The Three-Year Rule was repealed.)

Under the General Rule, a part of each payment is nontaxable because it is considered a return of your cost. The remainder of each payment (including the full amount of any later cost-of-living increases) is taxable. Finding the nontaxable part is very complex and requires you to use actuarial tables. For a full explanation and the tables you need, get Publication 939, *Pension General Rule (Nonsimplified Method).*

The nontaxable amount remains the same even if the total payment increases. If your annuity starting date was before 1987, you continue to exclude the same nontaxable amount from each annuity payment for as long as you receive your annuity. If your annuity starting date is after 1986, your total exclusion over the years cannot be more than your cost of the contract reduced by the value of any refund feature.

If your annuity starting date is after July 1, 1986, and you (or a survivor annuitant) die before the cost is recovered, a miscellaneous itemized deduction is allowed for the unrecovered cost on your, or your survivor's, final income tax return. The deduction is not

subject to the 2%-of-adjusted-gross-income limit.

Survivors

If you receive a survivor annuity because of the death of a retiree who had reported the annuity under the Three-Year Rule, include the total received in income. (The retiree's cost has already been recovered tax free.)

If the retiree was reporting the annuity payments under the General Rule, apply the same exclusion percentage the retiree used to your initial payment called for in the contract. The resulting tax-free amount will then remain fixed. Any increases in the survivor annuity are fully taxable.

If the retiree had chosen to report the annuity under the Simplified General Rule, the monthly tax-free amount remains fixed. Continue to use the same monthly tax-free amount for your survivor payments.

If the annuity starting date is after 1986, the total exclusion over the years cannot be more than the cost minus (if the General Rule is used) the value of any refund feature.

If you are the survivor of an employee, or former employee who died before becoming entitled to any annuity payments, you must figure the taxable and nontaxable parts of your annuity payments. You may qualify to add up to $5,000 to the decedent's cost to be recovered tax free. This ***death benefit exclusion*** is treated as an addition to the cost of the annuity. See *Death benefit exclusion,* earlier, under *Simplified General Rule.*

Estate tax. If your annuity was a joint and survivor annuity that was included in the decedent's estate, an estate tax may have been paid on it. You can deduct, as a miscellaneous itemized deduction, the part of the total estate tax that was based on the annuity. This deduction is not subject to the 2%-of-adjusted-gross-income limit. The deceased annuitant must have died after the annuity starting date. This amount cannot be deducted in one year. It must be deducted in equal amounts over your remaining life expectancy.

How to Report

If you file Form 1040, report your total annuity on line 16a and the taxable part on line 16b. If your pension or annuity is fully taxable, enter it on line 16b; do not make an entry on line 16a.

If you file Form 1040A, report your total annuity on line 11a and the taxable part on line 11b. If your pension or annuity is fully taxable, enter it on line 11b; do not make an entry on line 11a.

More than one annuity. If you receive more than one annuity and at least one of them is not fully taxable, enter the total amount received from ***all*** annuities on line 16a, Form 1040, or line 11a, Form 1040A, and enter the taxable part on line 16b, Form 1040, or line 11b, Form 1040A. If all the annuities you receive are fully taxable, enter the total of all of them on line 16b, Form 1040, or line 11b, Form 1040A.

Joint return. If you file a joint return and you and your spouse each receive one or more pensions or annuities, report the total of the pensions and annuities on line 16a, Form 1040, or line 11a, Form 1040A, and report the taxable part on line 16b, Form 1040, or line 11b, Form 1040A.

Death Benefit Exclusion

If you are the beneficiary of a deceased employee or former employee, the pension or annuity you get because of that person's death may qualify for a death benefit exclusion. This exclusion cannot be more than $5,000.

If you are eligible for the exclusion, add it to the cost or unrecovered cost of the annuity when you figure your cost at the annuity starting date.

If you are the survivor under a joint and survivor annuity, the exclusion applies only if:

1) The decedent died before receiving, or becoming entitled to receive, retirement pension or annuity payments, or
2) The decedent received disability income payments that were not treated as pension or annuity income (the decedent had not reached minimum retirement age).

For more information, see *Payments to beneficiaries of deceased employees (death benefit exclusion)* under *Life Insurance Proceeds* in Chapter 13, and *Death benefit exclusion* under *Investment in the Contract (Cost)* in Publication 575.

Lump-Sum Distributions

You may be able to elect optional methods of figuring the tax on lump-sum distributions you receive from a qualified retirement plan (an employer's qualified pension, stock bonus, or profit-sharing plan). A qualified plan is a plan that meets certain requirements of the Internal Revenue Code. For information on a distribution you receive that includes employer securities, see *Distributions of employer securities* under *Lump-Sum Distributions* in Publication 575.

Distributions that qualify. A lump-sum distribution is paid within a single tax year. It is the distribution of a plan participant's ***entire balance,*** from all of the employer's qualified pension plans, all of the employer's qualified stock bonus plans, or all of the employer's qualified profit-sharing plans. (The participant's entire balance does not include deductible voluntary employee contributions or certain forfeited amounts.)

The distribution is paid:

1) Because of the plan participant's death,
2) After the participant reaches age 59½,
3) Because the participant, if an employee, separates from service, or
4) After the participant, if a self-employed individual, becomes totally and permanently disabled.

Tax treatment. You can recover your ***cost*** in the lump sum tax free. Also, you may be entitled to special tax treatment for the remaining part of the distribution.

In general, your ***cost*** consists of:

1) The plan participant's total nondeductible contributions to the plan,
2) The total of the plan participant's taxable costs of any life insurance contract distributed,
3) Any employer contributions that were taxable to the plan participant, and
4) Repayments of loans that were taxable to the plan participant.

You must reduce this cost by amounts previously distributed tax free.

Capital gain treatment. If the plan participant reached age 50 before 1986 (was born before 1936), you can elect to treat a portion of the taxable part of a lump-sum distribution as a capital gain that is taxable at a 20% (.20) rate. This treatment applies to the portion you receive for the participation in the plan before 1974. You can elect this treatment only once for any plan participant. Use Form 4972, *Tax on Lump-Sum Distributions,* to make this choice.

5- or 10-year tax option. If the plan participant reached age 50 before 1986 (was born before 1936), you can elect to use the 5– or 10–year option to compute the tax on the ordinary income portion of the distribution. (This also includes the capital gain portion of the distribution if you do not elect the capital gain treatment for it.) To qualify, you must elect to use the 5- or 10-year tax option for all lump-sum distributions received in the tax year.

To qualify for the 5- or 10-year option for a distribution you receive for your own participation in the retirement plan, you must have been a participant in the plan for at least 5 full tax years. You can only make one lifetime election to use this option for any plan participant.

If you choose the tax option, you generally figure your tax, using Form 4972, as though the distribution were received over 5 years.

However, you can instead treat the distribution as though it were received over 10 years if you apply the special 1986 tax rates to it. Form 4972 shows how to make this computation. The Form 4972 Instructions contain a special 1986 tax rate schedule that you must use in making the 10–year tax option computation.

Form 1099–R. If you receive a total distribution from a plan, you should receive a Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* If the distribution qualifies as a lump-sum distribution, box 3 shows the capital gain, and box 2a minus box 3 is the ordinary income. If you do not get a Form 1099–R, or if you have questions about it, contact your plan administrator.

Life insurance proceeds. An employee's life insurance proceeds paid in a lump sum under an insurance contract on the death of an employee usually are not taxable. However, any amount you received to the extent larger than the face amount of the life insurance is taxable. Life insurance proceeds is discussed in Chapter 13.

Rollovers

Generally, a rollover is a tax-free distribution to you of cash or other assets from a qualified retirement plan that you transfer to an ***eligible retirement plan.*** However, see *Direct rollover option,* later.

An eligible retirement plan is an IRA, a qualified employee retirement plan, or a qualified annuity plan. See Chapter 18 for information on rollovers from IRAs.

In general, the most you can roll over is the part that would be taxable if you did not roll it over. You cannot roll over your contributions, other than your deductible employee contributions. You do not pay tax on the amount that you roll over. This amount, however, is generally taxable later when it is paid to you or your survivor.

You must complete the rollover by the 60th day following the day on which you receive the distribution. (This 60–day period is extended for the period during which the distribution is in a frozen deposit in a financial institution.) For all rollovers to an individual retirement arrangement (IRA), you must irrevocably elect rollover treatment by written notice to the trustee or issuer of the IRA.

Eligible rollover distributions. Generally, you can roll over any part of the taxable portion of most nonperiodic distributions from a qualified retirement plan, unless it is a required minimum distribution.

Direct rollover option. You can choose to have the administrator of your old plan transfer the distribution directly from your old plan to the new plan (if permitted) or IRA. If you decide on a rollover, it is generally to your advantage to choose this direct rollover option. Under this option, the plan administrator would not withhold tax from your distribution.

Withholding tax. If you choose to have the distribution paid to you, it is taxable in the year distributed unless you roll it over to a new plan or IRA within 60 days. The plan administrator must withhold income tax of 20% from the taxable distribution paid to you. (See *Withholding on Pensions and Annuities* in Chapter 5.) This means that, if you decide to roll over an amount equal to the distribution before withholding, your contribution to the new plan or IRA must include other money (for example, from savings or amounts borrowed) to replace the amount withheld. The administrator should give you a written explanation of your distribution options within a reasonable period of time before making an eligible rollover distribution.

Deductible voluntary employee contributions. If you receive an eligible rollover distribution from your employer's qualified plan of part of the balance of your accumulated deductible voluntary contributions, you can roll over tax free any part of this distribution. The rollover can be either to an IRA or to certain other qualified plans.

Rollover by surviving spouse or other beneficiary. You may be entitled to roll over into an IRA part or all of a retirement plan distribution you receive as the surviving spouse of a deceased employee. The rollover rules apply to you as if you were the employee. However, you cannot roll it over to another qualified retirement plan.

A beneficiary other than the employee's surviving spouse cannot roll over a distribution.

Alternate payee under qualified domestic relations order. You may be able to roll over all or any part of a distribution from a qualified employer plan that you receive under a qualified domestic relations order (QDRO). If you receive the distribution as an employee's spouse or former spouse under a QDRO, the rollover rules apply to you (the alternate payee) as if you were the employee. You can rollover the distribution from the plan into an IRA or to another eligible retirement plan. See Publication 575 for more information on benefits received under a QDRO.

For more information on the rules for rolling over distributions, see Publication 575.

Bond Purchase Plans

The Department of the Treasury stopped issuing U.S. Retirement Plan Bonds after April 30, 1982. They are a special series of interest-bearing bonds that retirement plans could buy.

If your plan bought retirement bonds, you can cash them at any time. A beneficiary can cash them after the participant's death. Interest on the bonds stops 5 years after the owner of the bonds dies. They may be cashed at any Federal Reserve Bank branch or at the office of the Treasurer of the United States.

If a retirement bond is distributed from a bond purchase plan to you as an employee or beneficiary and you cash in the bond, you are taxed on the amount received minus your cost (normally, any voluntary nondeductible employee payments used to buy that bond). However, you can defer the tax on the amount received by rolling it over to an IRA as discussed under *Rollovers* in Chapter 18. You can also roll it over to a qualified employer plan (but later distributions of the rollover amount do not qualify for the 5– or 10–year tax option or capital gain treatment covered earlier).

Tax on Early Distributions

Distributions you receive from your ***qualified retirement plan or deferred annuity contract*** before you reach age 59½, and amounts you receive when you cash in retirement bonds before you reach age 59½, are usually subject to an additional tax of 10%. The tax applies to the taxable part of the distribution.

For this purpose, a ***qualified retirement plan*** means:

1) A qualified employee retirement plan,
2) A qualified annuity plan,
3) A tax-sheltered annuity plan for employees of public schools or tax-exempt organizations, or
4) An individual retirement arrangement (IRA).

Exceptions to tax. The 10% tax does not apply to distributions that are:

1) Made to a beneficiary or to the estate of the plan participant or annuity holder on or after his or her death,
2) Made because you are totally and permanently disabled,
3) Made as part of a series of substantially equal periodic (at least annual) payments over your life expectancy or the joint life expectancy of you and your beneficiary (if from a qualified employee plan, payments must begin after separation from service),
4) Made to you after you separated from service if the separation occurred during or after the calendar year in which you reached age 55,
5) Not more than your deductible medical expense (the medical expense that exceeds 7.5% of your adjusted gross income) whether or not you itemize deductions for the tax year,
6) Paid to alternate payees under qualified domestic relations orders,
7) Made to you if, as of March 1, 1986, you separated from service and began receiving benefits from the qualified plan under a written election designating a specific schedule of benefit payments,
8) Made to you to correct excess deferrals, excess contributions, or excess aggregate contributions,
9) Allocable to investment in a deferred annuity contract before August 14, 1982,
10) From an annuity contract under a qualified personal injury settlement,
11) Made under an immediate annuity contract, or
12) Made from a deferred annuity contract purchased by your employer upon the termination of a qualified employee retirement plan or qualified annuity that is held by your employer until you separate from the service of the employer.

Only exceptions (1) through (3) apply to distributions from IRAs. Exceptions (4) through (8) apply only to distributions from qualified employee plans. Exceptions (9) through (12) apply only to distributions from deferred annuity contracts.

Reporting tax or exception. If distribution code 1 is shown in box 7 of Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* multiply the taxable part of the early distribution by 10% and enter the result on line 51 of Form 1040 and write ''No'' on the dotted line.

However, if you owe this tax and also owe any other additional tax on a distribution, you must file Form 5329, *Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts,* to report the taxes.

You do not have to file Form 5329 if you qualify for an exception to the 10% tax and distribution code 2, 3, or 4 is shown in box 7 of Form 1099–R. You must file Form 5329 if the code is not shown or the code shown is incorrect (e.g., code 1 is shown although you meet an exception).

Tax on Excess Distributions

If you received ***retirement distributions*** in excess of $150,000 during the calendar year, you are subject to an additional 15% excise tax on the amount over $150,000. The 15% tax is offset by any 10% early distribution tax that applies to the excess distribution. (See the preceding discussion.)

Retirement distributions means distributions from qualified employee retirement plans, qualified annuity plans, tax-sheltered annuities, and individual retirement arrangements (IRAs).

Exceptions to tax. The 15% tax on excess distributions does not apply to the following distributions:

1) Distributions after death,
2) Distributions paid to your spouse or former spouse under a qualified domestic relations order (QDRO) that are taxable to the payee (the distributions are included in determining your spouse's or former spouse's excess distributions),
3) Distributions based on the employee's investment in the contract,
4) Distributions to the extent rolled over,
5) Retirement distributions of annuity contracts, the value of which is not taxable at the time of the distribution (other than distributions under, or proceeds from the sale or exchange of, such contracts),
6) Retirement distributions of excess deferrals (and income allocable to them), and
7) Retirement distributions of excess contributions (and income allocable to them) under section 401(k) plans or IRAs, or excess aggregate contributions (and income on them) under qualified plans. (The aggregate contributions relate to highly compensated employees and the plan will figure the excess.)

Combining distributions. If distributions for you are made to you and others, you must combine the distributions in figuring the amount of excess distributions for the year.

Lump-sum distributions. A different limit applies to a lump-sum distribution for which you elect to use the 5- or 10-year tax option or capital gain treatment. In this case, the $150,000 annual amount increases five times to $750,000. You must figure a separate tax on the lump-sum distribution over $750,000.

Special grandfather election. If you made a special ''grandfather election'' on your 1987 or 1988 return, you can exclude from the tax a prorated part of a distribution that is related to your accrued benefits on August 1, 1986. To have made this special choice, your accrued benefit as of August 1, 1986, must have exceeded $562,500. For more information, see the instructions for Part IV of Form 5329.

Form 5329. You must file a Form 5329 if you receive excess distributions from a qualified retirement plan, whether or not you owe tax.

Tax for Failure to Make Minimum Distribution

Your qualified retirement plan must distribute to you your entire interest in the plan, or begin to make minimum distributions to you, by April 1 of the year following the calendar year in which you reach age 70½. It does not matter whether you have retired. This rule applies to qualified employee retirement plans, qualified annuity plans, deferred compensation plans under section 457, tax-sheltered annuity programs (for benefits accruing after 1986), and IRAs.

You reach age 70½ on the date that is 6 calendar months after the date of your 70th birthday. For example, if your 70th birthday was on July 1, 1993, you were age 70½ on January 1, 1994. Your required beginning date is April 1, 1995. If your 70th birthday was on June 30, 1993, you were age 70½ on December 30, 1993, and your required beginning date was April 1, 1994.

Exceptions. The above rule does not apply to governmental plans or church plans. Nor does it apply to any individual (unless a 5% owner) who reached age 70½ before 1988.

In these cases, distributions must begin no later than April 1 of the calendar year following the later of:

1) The calendar year in which you reach age 70½, or
2) The calendar year in which you retire.

5% owners. If you are a 5% (or more) owner of the company maintaining the plan, distributions to you must begin by April 1 of the calendar year after the year in which you reach 70½, regardless of when you retire.

Minimum distributions. These are regular periodic distributions that are large enough to use up the entire interest over your life expectancy or over the joint life expectancies of you and a designated surviving beneficiary (or over a shorter period).

Additional information. For more information on this rule, see *Tax on Excess Accumulation* in Publication 575.

Tax on failure to distribute. If you do not receive these required minimum distributions, you, as the payee, are subject to an additional excise tax. The tax equals 50% of the difference between the amount that was required to be distributed and the amount that was distributed during the tax year. You can get this excise tax excused if you establish that the shortfall in distributions was due to reasonable error and that you are taking reasonable steps to remedy the shortfall.

State insurer delinquency proceedings. You might not receive the minimum distribution because of state insurer delinquency proceedings for an insurance company. If your payments are reduced below the minimum due to these proceedings, you should contact your plan administrator. Under certain conditions, you will not have to pay the excise tax.

Form 5329. You must file a Form 5329 if you owe a tax because you did not receive a minimum required distribution from your qualified retirement plan.

Disability Income

Generally, if you retire on disability, you must report your pension or annuity as income.

If you were 65 or older at the end of the tax year, or if you were under 65, retired on permanent and total disability, and you received taxable disability income, you may be able to claim the credit for the elderly or the disabled. See Chapter 34 for more information about the credit.

Taxable Disability Pensions and Annuities

Whether you must report your disability pension or annuity as income depends on your plan's financing method.

Generally, you must report as income any amount you receive for your disability through an accident or health insurance plan that is paid for by your employer. However, certain payments may not be taxable to you. A discussion of these payments appears in Chapter 13 under *Other Sickness and Injury Benefits.*

No employee contributions. If the plan does not say that you must pay a specific part of the cost of the disability pension, your employer is considered to provide the disability pension. You must report on your return all payments you receive.

Employee contributions. If the plan says that you must pay a specific part of the cost of your disability pension, any amounts you receive that are due to your payments to the

disability pension are not taxed. You do not report them on your return. They are treated as benefits received under an accident or health insurance policy that you bought. You generally must include in income the rest of the amounts you receive that are due to your employer's payments.

Plan details. Your employer should be able to give you specific details about your pension plan and to tell you the portion, if any, of payments that are due to your contributions.

Accrued leave payment. If you retired on disability, any lump-sum payment you received for accrued annual leave is a salary payment, not a disability payment. You should report it as wages in the year you received it.

Worker's compensation. If part of your disability pension is worker's compensation, you do not pay tax on that part. If you die, your survivor does not pay tax on the part of a survivor's benefit that represents a continuation of the worker's compensation.

How to report. You must report all your taxable disability income on line 7, Form 1040, or line 7, Form 1040A, until you reach minimum retirement age.

If you made contributions to your pension or annuity plan, your payments are taxable under the General Rule or Simplified General Rule (discussed earlier) beginning with the day after you reach ***minimum retirement age.***

Generally, minimum retirement age is the age at which you may first receive a pension or annuity if you are not disabled.

Military and Certain Government Disability Pensions

Generally, you must report disability pensions as income. But certain military and government disability pensions are not taxable. If your disability pension is taxable, you may be able to take the credit for the elderly or the disabled. See Chapter 34 for more information about the credit.

Members of government services. Generally, you must report on your return any disability payments you receive for personal injuries or sickness resulting from active service in the armed forces of any country or in the National Oceanic and Atmospheric Administration, the Public Health Service, or the Foreign Service. However, do not include payments in income if they are based on percentage of disability, and:

1) You were entitled to receive a disability payment before September 25, 1975, or
2) You were a member of a government service or its reserve component, or were under a binding written commitment to become a member, on September 24, 1975, or
3) You receive disability payments for a ***combat-related injury,*** or
4) You would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if you filed an application for it.

A combat-related injury is a personal injury or sickness that:

1) Directly results from armed conflict,
2) Takes place while you are engaged in extra-hazardous service,
3) Takes place under conditions simulating war, including training exercises such as maneuvers, or
4) Is caused by an instrumentality of war.

Disability based on years of service. If you receive a disability pension based on years of service, you generally must include it in your income. But do not include in income the part of your pension that you could have excluded under the rules explained above if the pension had been based on percentage of disability. You must include the rest of your pension in income.

Terrorist attack. You do not include disability payments in income if you receive them for injuries directly resulting from a violent attack that occurred while you were a U.S. government employee performing official duties outside the United States. For your disability payments to be tax exempt, the Secretary of State must determine that the attack was a terrorist attack.

VA disability benefits. Disability benefits you receive from the VA are tax free. If you are a military retiree and receive your disability benefits from other than the VA, exclude from income the amount of disability benefits equal to the VA benefits to which you are entitled.

If you retire from the armed services (based on years of service) and at a later date are given a retroactive service-connected disability rating by the VA, exclude from income for the retroactive period the part of your retirement pay you would have been entitled to receive from the VA during that period. However, you must include in income any lump-sum readjustment payment you received on release from active duty, even though you are later given a retroactive disability rating by the VA.

Purchased Annuities

If you privately purchased an annuity contract from a commercial organization, such as an insurance company, you must use the General Rule to figure the tax-free part of each annuity payment. For more information, get Publication 939, *Pension General Rule (Nonsimplified Method).*

Sale of annuity. Gain on the sale of an annuity contract before its maturity date is ordinary income to the extent that the gain is due to interest accumulated on the contract. You do not recognize gain or loss on an exchange of an annuity contract solely for another annuity contract.

See *Transfers of Annuity Contracts* in Publication 575 for more information about exchanges of annuity contracts.

12.

Social Security and Equivalent Railroad Retirement Benefits

Introduction

This chapter discusses the taxability of any social security or equivalent tier 1 railroad retirement benefits you may have received. It also explains:

- How to figure whether your benefits are taxable,
- How to use the social security benefits worksheet,
- How to report your taxable benefits on Form 1040 and Form 1040A (with examples), and
- How to treat repayments that are more than the benefits you received during the year.

Note. This chapter does not discuss the tax rules that apply to railroad retirement benefits that exceed the social security equivalent benefit portion of tier 1 benefits (including special guaranty benefits). The tax rules that apply to the non-social security equivalent benefit portion of tier 1 benefits, tier 2 benefits, and also to vested dual benefits, and supplemental annuity benefits, are discussed in Publication 575, *Pension and Annuity Income (Including Simplified General Rule).*

The tax rules that apply to foreign social security benefits also are not discussed in this chapter. These benefits are taxable as a pension or annuity unless exempt from U.S. tax under a treaty.

Useful Items

You may want to see:

Publication

- ❑ **505** Tax Withholding and Estimated Tax
- ❑ **575** Pension and Annuity Income (Including Simplified General Rule)
- ❑ **590** Individual Retirement Arrangements (IRAs)
- ❑ **915** Social Security Benefits and Equivalent Railroad Retirement Benefits

Taxation of Benefits

In figuring if any of your benefits are taxable, use the amount shown in box 5 of the Form SSA–1099 or Form RRB–1099 you received. If you received more than one form, add together the amount in box 5 of each form.

Form SSA–1099. If you received or repaid social security benefits during 1994, you will receive Form SSA–1099, *Social Security Benefit Statement.* An IRS Notice 703 will be enclosed with your Form SSA–1099. This notice includes a worksheet you can use to determine if any of your benefits may be taxable. Keep this notice for your own records. Do ***not*** mail it to either the IRS or the SSA.

Every person who received social security benefits will receive a Form SSA–1099, even if the benefit is combined with another person's in a single check. If you receive benefits on more than one social security record, you may get more than one Form SSA–1099.

Form RRB–1099. If you received or repaid the social security equivalent portion of tier 1 railroad retirement benefits or special guaranty benefits during 1994, you will receive Form RRB–1099, *Payments by the Railroad Retirement Board.*

Each beneficiary will receive his or her own Form RRB–1099. If you receive benefits on more than one railroad retirement record, you may get more than one Form RRB–1099.

Who is taxed. The person who has the legal right to receive the benefits must determine if the benefits are taxable. For example, if you and your child receive benefits, but the check for your child is made out in your name, you must use only your portion of the benefits in figuring if any part is taxable to you. The portion of the benefits that belongs to your child must be added to your child's other income to see if any of those benefits are taxable.

Are Any of Your Benefits Taxable?

If the only income you received during 1994 was your social security or equivalent tier 1 railroad retirement benefits, your benefits generally are not taxable and you probably do not have to file a return. However, if you have income in addition to your benefits, you may have to include part of your benefits in your taxable income.

How To Determine

To determine whether any of your benefits are taxable, you will need to figure the total amount of your income and one-half of your benefits and compare the total to a *base amount* for your filing status, as explained next.

Base amount. If you received income during 1994 in addition to benefits, **up to 50% of your benefits** could be included in your taxable income if your income (the amount on line 7 of Worksheet 1 or 1A) is more than the following **base amounts:**

- $25,000 if you are single, head of household, or qualifying widow(er),
- $25,000 if you are married filing separately and ***lived apart*** from your spouse for ***all*** of 1994,
- $32,000 if you are married filing jointly, or
- $–0– if you are married filing separately and ***lived*** with your spouse at any time during 1994.

Adjusted base amount. If you received income during 1994 in addition to benefits, **up to 85% of your benefits** could be included in your taxable income if your income (the amount on line 7 of Worksheet 1 or 1A, provided later) is more than the following **adjusted base amounts:**

- $34,000 if you are single, head of household, or qualifying widow(er),
- $34,000 if you are married filing separately and ***lived apart*** from your spouse for all of 1994,
- $44,000 if you are married filing jointly, or
- $–0– if you are married filing separately and ***lived with*** your spouse at any time during 1994.

How 50% and 85% rates apply. The 50% rate is used to figure the taxable part of income (the amount on line 7 of Worksheet 1 or 1A, provided later) that exceeds the base amount but does not exceed the higher adjusted base amount. The 85% rate is used to figure the taxable part of income that exceeds the adjusted base amount.

Limits on taxable benefits. If your income (the amount on line 7 of Worksheet 1 or 1A, provided later):

1) Is equal to or less than your base amount, none of your benefits are included in taxable income,
2) Exceeds your base amount but does not exceed your adjusted base amount, no more than 50% of your benefits can be included in taxable income, or
3) Exceeds your adjusted base amount, no more than 85% of your benefits can be included in taxable income.

Married filing separately and lived with spouse. If you are married filing separately and you lived with your spouse at any time during 1994, your base amount and adjusted base amount will be zero. In that case, your gross income will include the lesser of:

1) 85% of your benefits, or
2) 85% of your income on line 7 of Worksheet 1 or 1A, provided later.

Joint return. If you are married and file a joint return for 1994, you and your spouse must combine your incomes and your benefits when figuring if any of your combined benefits are taxable. Even if your spouse did

not receive any benefits, you must add your spouse's income to yours when figuring if any of your benefits are taxable.

You can use the worksheet in the following example, substituting your own amounts, to figure whether your income is more than the base amount for your filing status. A similar worksheet is included in your Form SSA–1099 package.

Example. You and your spouse are filing a joint return for 1994, and you both received social security benefits during the year. In January 1995, you received a Form SSA–1099 showing net benefits of $6,600 in box 5. Your spouse received a Form SSA–1099 showing $2,400 in box 5. You also received a taxable pension of $10,000 and interest income of $500 during 1994. You did not have any tax-exempt interest in 1994. Your benefits are not taxable for 1994 because your income, as figured in the following worksheet, is not more than your base amount ($32,000).

A. Write in the amount from ***box 5*** of all your Forms SSA–1099 and RRB–1099. Include the full amount of any lump-sum benefit payments received in 1994, for 1994 and earlier years, if you choose to report the full amount for the 1994 tax year. (If you received more than one form, combine the amounts from box 5 and write in the total.)	A.	$ 9,000

Note: *If the amount on line A is zero or less, stop here; none of your benefits are taxable this year.*

B. Divide line A by 2 and write in the result	B.	4,500
C. Add your taxable pensions, wages, interest, dividends, and other taxable income and write in the total	C.	10,500
D. Write in any tax-exempt interest (such as interest on municipal bonds) plus any exclusions from income (such as U.S. Savings Bond interest exclusion)	D.	–0–
E. Add lines B, C, and D and write in the total	E.	15,000

Note. *If the amount on line E is more than the* ***base amount*** *for your filing status, part of your benefits will be taxable this year. If the amount on line E is less than the base amount for your filing status, none of your benefits are taxable this year.*

Repayments. Any repayment of benefits you made during 1994 is automatically subtracted from the gross benefits you received in 1994. It does not matter if the repayment you made in 1994 was for a benefit you received before 1994. Your gross benefits are shown in box 3 of Form SSA–1099 or RRB–1099 and your repayments are shown in box 4. The amount in box 5 shows your net benefits for 1994 (box 3 minus box 4). This is the amount you will use to figure if any of your benefits are taxable.

How Much Is Taxable?

Your social security or equivalent tier 1 railroad retirement benefits may be taxable, depending on the amount of your income in addition to these benefits and on your filing status.

If your benefits are taxable, you can generally figure the taxable amount by using Worksheet 1 (for Form 1040 filers) or Worksheet 1A (for Form 1040A filers), provided at the end of this chapter.

Special worksheets for IRA deduction and taxable benefits. If you made contributions to an individual retirement arrangement (IRA) for 1994 and if your IRA deduction is limited because you or your spouse is covered by a retirement plan at work, you must use the special worksheets in Appendix B of Publication 590 to figure your IRA deduction and taxable benefits to be reported on your return.

What to do first. Before you figure the amount of your taxable benefits, read *How To Figure and Report,* later, and the following examples, which you can use as a guide to figure taxable benefits. You will find that the amount of benefits to be included in taxable income cannot be more than 50% or 85% of the total net benefits (amounts received minus amounts repaid) received during the year. See *How 50% and 85% rates apply* under *Are Any of Your Benefits Taxable?* and its discussion *How To Determine,* earlier.

Lump-Sum Benefits. If you received a lump-sum (or retroactive) payment of benefits during 1994 that includes benefits you should have received before 1994, it will be included in box 3 of your Form SSA–1099 or Form RRB–1099.

Special election. Generally, a lump-sum (or retroactive) payment of benefits is included in your total benefits for the year in which you receive it. However, if you receive a lump-sum payment of benefits in 1994 that includes benefits for one or more earlier years, you can figure whether any part of these earlier year benefits are taxable based on the earlier year's income. If that method gives you a lower taxable benefit, you can make the election discussed next.

Election to treat benefits as received in earlier year. If it will lower your taxable benefits, you can choose to treat the earlier benefits as received in the earlier year. In that case, any part of the earlier year benefits that is taxable is then added to your taxable benefits for the current year and the total is included in your current year's income.

For more information on lump-sum benefits and what worksheets to complete, see Publication 915.

Estimated tax. Tax is not withheld on social security benefits. This means that you may have to pay estimated tax during the year if these benefits are taxable and you do not have enough taxes withheld from other income. See Chapter 5 for more information on estimated tax.

How To Figure and Report

After you figure your taxable benefits on one of the worksheets at the end of the chapter or in Publication 915, report your taxable benefits on Form 1040 or Form 1040A. You ***cannot*** use Form 1040EZ. Report your net benefits (the amount in box 5 of your Form SSA–1099 or RRB–1099) on line 20a, Form 1040, or line 13a, Form 1040A. Report the taxable part (from the last line of the worksheet) on line 20b, Form 1040, or line 13b, Form 1040A. If none of your benefits are taxable, do not enter any amounts on lines 13a or 13b (Form 1040A) or lines 20a or 20b (Form 1040).

Which worksheet to use. To help you figure your taxable benefits, use the worksheet in the Form 1040 or Form 1040A instruction package, as long as you are not required to use the Publication 590 worksheets (see *Special worksheets for IRA deduction and taxable benefits,* earlier). Publication 915 also has worksheets you can use. However, if you are not required to use the worksheets in Publication 590 and you take the U.S. savings bond interest exclusion, the foreign earned income exclusion, the foreign housing exclusion or deduction, the exclusion of income from U.S. possessions, or the exclusion of income from Puerto Rico by bona fide residents of Puerto Rico, you ***must*** use the worksheets in Publication 915.

Note. The worksheets mentioned in the preceding discussion and those in this chapter do not include a line to enter the adjusted base amount of $0, $34,000, or $44,000. Instead, they include a special line to enter $0, $9,000, or $12,000, which is the difference between the adjusted base amount and the base amount ($0, $25,000, or $32,000 entered on a previous line). This special line reflects the adjusted base amount in figuring your taxable benefits and helps reduce the number of steps in the worksheet computation.

Lump-sum payment. If you received a lump-sum benefit payment in 1994 that includes benefits for one or more earlier years and choose to treat the payment as if it were received in those years, you ***must*** use the worksheets in Publication 915. Otherwise, you should treat the amount as if it were fully attributable to 1994 and include it in your total benefits received during that year.

Examples

Following are a few examples you can use as a guide to figure the taxable part of your benefits.

Example 1. George White is single and files Form 1040 for 1994. He received the following income in 1994:

Fully taxable pension	$18,600
Wages from part-time job	9,400
Interest income	990
Total	$28,990

George also received social security benefits during 1994. The Form SSA–1099 he received in January 1995 shows $7,200 in box 3; $1,220 in box 4; and $5,980 in box 5. To figure his taxable benefits, George completes the worksheet shown here (for Form 1040 filers).

Social Security and Equivalent Railroad Retirement Benefits Worksheet 1 — Form 1040 Filers (Keep for your records)

Check only one box

- ☑ A. Single, Head of household, or Qualifying widow(er)
- ❑ B. Married filing jointly
- ❑ C. Married filing separately and **lived with** your spouse at any time during 1994
- ❑ D. Married filing separately and **lived apart** from your spouse for all of 1994

1. Enter the total amount from **box 5** of **ALL** your **Forms SSA–1099 and RRB–1099** (if applicable) 5,980

Note. *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.*

2. Enter one-half of line 1 2,990
3. Add the amounts on Form 1040, lines 7, 8a, 8b, 9 through 14, 15b, 16b, 17 through 19, and line 21. Do not include here any amounts from box 5 of Forms SSA–1099 or RRB–1099 28,990
4. Enter the amount of any exclusions from: U.S. savings bonds interest, foreign earned income, foreign housing, income from U.S. possessions, or income from Puerto Rico by bona fide residents of Puerto Rico that you claimed ..... –0–
5. Add lines 2, 3, and 4 31,980
6. Enter the total adjustments plus any write-in amounts from Form 1040, line 30 (other than foreign housing deduction) ..... –0–
7. Subtract line 6 from line 5 31,980
8. Enter:

   $25,000 if you checked box **A** or **D,** or
   $32,000 if you checked box **B,** or
   –0– if you checked box **C** 25,000
9. Subtract line 8 from line 7. If zero or less, enter –0– 6,980

   Is line 9 more than zero?
   No. Stop here. None of your social security benefits are taxable. Do not enter any amounts on lines 20a or 20b. But if you are married filing separately and you lived apart from your spouse for all of 1994, enter –0– on line 20b. Be sure you entered "D" to the left of line 20a.
   Yes. Go to line 10.
10. Enter $9,000 ($12,000 if married filing jointly; $0 if married filing separately and you lived with your spouse at any time in 1994) 9,000
11. Subtract line 10 from line 9. If zero or less, enter –0– ..... –0–
12. Enter the **smaller** of line 9 or line 10. 6,980
13. Enter one-half of line 12 3,490
14. Enter the **smaller** of line 2 or 13 2,990
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter –0– ..... –0–
16. Add lines 14 and 15 2,990
17. Multiply line 1 by 85% (.85) 5,083
18. **Taxable benefits.** Enter the smaller of line 16 or line 17 2,990
    - Enter on Form 1040, line 20a, the amount from line 1
    - Enter on Form 1040, line 20b, the amount from line 18

The amount on line 18 of George's worksheet shows that $2,990 of his social security benefits is taxable. On line 20a of his Form 1040, George enters his net benefits of $5,980. On line 20b, he enters his taxable part of $2,990.

Example 2. Ray and Alice Hopkins file a joint return on Form 1040A for 1994. Ray is retired and receives a fully taxable pension of $15,500. Ray also receives social security benefits and his Form SSA–1099 for 1994 shows net benefits of $5,600 in box 5. Alice worked during the year and had wages of $14,000. She made a deductible payment to her IRA account of $1,000. Ray and Alice have two savings accounts. The Forms 1099–INT they received showed they had a total of $250 in interest income for 1994. They complete the worksheet which follows for Form 1040A filers and find that none of Ray's social security benefits are taxable.

Social Security and Equivalent Railroad Retirement Benefits Worksheet 1A — Form 1040A Filers (Keep for your records)

Check only one box.

- ❑ A. Single, Head of household, or Qualifying widow(er)
- ☑ B. Married filing jointly
- ❑ C. Married filing separately and **lived with** your spouse at any time during 1994
- ❑ D. Married filing separately and **lived apart** from your spouse for all of 1994

1. Enter the total amount from **box 5** of **ALL** your **Forms SSA–1099 and RRB–1099** (if applicable) 5,600

Note. *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.*

2. Enter one-half of line 1 2,800
3. Add the amounts on Form 1040A, lines 7, 8a, 8b, 9, 10b, 11b, and 12. Do not include here any amounts from box 5 of Forms SSA–1099 or RRB–1099 29,750
4. Enter the amount of any U.S. savings bond interest exclusion from Schedule 1, line 3, that you claimed –0–
5. Add lines 2, 3, and 4 32,550
6. Enter the amount from Form 1040A, line 15c 1,000
7. Subtract line 6 from line 5 31,550
8. Enter:

   $25,000 if you checked box **A** or **D,** or
   $32,000 if you checked box **B,** or
   –0– if you checked box **C** 32,000
9. Subtract line 8 from line 7. If zero or less, enter –0– ..... –0–

   Is line 9 more than zero?
   No. Stop here. None of your social security benefits are taxable. Do not enter any amounts on lines 13a or 13b. But if you are married filing separately and you lived apart from your spouse for all of 1994, enter –0– on line 13b. Be sure you entered "D" to the left of line 13a.
   Yes. Go to line 10.
10. Enter $9,000 ($12,000 if married filing jointly; $0 if married filing separately and you lived with your spouse at any time in l994) .....
11. Subtract line 10 from line 9. If zero or less, enter –0– .....
12. Enter the **smaller** of line 9 or line 10
13. Enter one-half of line 12 .....
14. Enter the **smaller** of line 2 or line 13
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter –0– .....
16. Add lines 14 and 15 .....
17. Multiply line 1 by 85% (.85) .....

18. **Taxable benefits.** Enter the smaller of line 16 or line 17 ..... _____
    - Enter on Form 1040A, line 13a, the amount from line 1.
    - Enter on Form 1040A, line 13b, the amount from line 18 .....

Example 3. Joe and Betty Johnson file a joint return on Form 1040 for 1994. Joe is a retired railroad worker and in 1994 received the social security equivalent portion of tier 1 benefits. Joe's Form RRB–1099 shows $10,000 in box 5. Betty is a retired government worker and receives a fully taxable pension of $38,000. The only other income Joe and Betty had in 1994 was $2,300 in interest income. They also received interest of $200 on a U.S. savings bond that they redeemed in 1994. Joe and Betty paid qualified higher educational expenses for their dependent daughter and the interest qualified for the U.S. savings bonds interest exclusion. They figure their taxable benefits by completing the worksheet shown below.

Social Security and Equivalent Railroad Retirement Benefits Worksheet 1 — Form 1040 Filers (Keep for your records)

Check only one box:

- ❑ A. Single, Head of household, or Qualifying widow(er)
- ☑ B. Married filing jointly
- ❑ C. Married filing separately and **lived with** your spouse at any time during 1994
- ❑ D. Married filing separately and **lived apart** from your spouse for all of 1994

1. Enter the total amount from **box 5** of **ALL** your **Forms SSA–1099 and RRB–1099** (if applicable) 10,000

Note. *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.*

2. Enter one-half of line 1 5,000
3. Add the amounts on Form 1040, lines 7, 8a, 8b, 9 through 14, 15b, 16b, 17 through 19, and line 21. Do not include here any amounts from box 5 of Forms SSA–1099 or RRB–1099 40,300
4. Enter the amount of any exclusions from: U.S. savings bond interest, foreign earned income, foreign housing, income from U.S. possessions, or income from Puerto Rico by bona fide residents of Puerto Rico that you claimed 200
5. Add lines 2, 3, and 4 45,500
6. Enter the total adjustments plus any write-in amounts from Form 1040, line 30 (other than foreign housing deduction) ..... –0–
7. Subtract line 6 from line 5 45,500
8. Enter:
   $25,000 if you checked box **A** or **D,** or
   $32,000 if you checked box **B,** or
   –0– if you checked box **C** 32,000
9. Subtract line 8 from line 7. If zero or less, enter –0– 13,500

   Is line 9 more than zero?
   No. Stop here. None of your social security benefits are taxable. Do not enter any amounts on lines 20a or 20b. But if you are married filing separately and you lived apart from your spouse for all of 1994, enter –0– on line 20b. Be sure you entered "D" to the left of line 20a.
   Yes. Go to line 10.
10. Enter $9,000 ($12,000 if married filing jointly; $0 if married filing separately and you lived with your spouse at any time in 1994) 12,000
11. Subtract line 10 from line 9. If zero or less, enter –0– 1,500
12. Enter the **smaller** of line 9 or line 10. 12,000
13. Enter one-half of line 12 6,000
14. Enter the **smaller** of line 2 or 13 5,000
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter –0– 1,275
16. Add lines 14 and 15 6,275
17. Multiply line 1 by 85% (.85) 8,500
18. **Taxable benefits.** Enter the smaller of line 16 or line 17 6,275
    - Enter on Form 1040, line 20a, the amount from line 1
    - Enter on Form 1040, line 20b, the amount from line 18

Repayments More Than Gross Benefits

In some situations, your Form SSA–1099 or Form RRB–1099 will show that the total benefits you repaid (box 4) is more than the gross benefits (box 3) you received. If this occurred, your net benefits in box 5 will be a negative figure and none of your benefits will be taxable. If you receive more than one form, a negative figure in box 5 of one form is used to offset a positive figure in box 5 of another form. If you have any questions about this negative figure, contact your local Social Security Administration office or your local U.S. Railroad Retirement Board field office.

Joint return. If you and your spouse file a joint return, and your Forms SSA–1099 or RRB–1099 show that your repayments are more than your gross benefits, but your spouse's are not, subtract the amount in box 5 of your form from the amount in box 5 of your spouse's form. You do this to get your net benefits when figuring if your combined benefits are taxable.

Example. John and Mary file a joint return for 1994. John received Form SSA–1099 showing $3,000 in box 5. Mary also received Form SSA–1099 and the amount in box 5 was ($500). John and Mary will use $2,500 ($3,000 minus $500) as the amount of their net benefits when figuring if any of their combined benefits are taxable.

Repayment of benefits received in an earlier year. If the sum of the amount shown in box 5 of all of your Forms SSA–1099 and RRB–1099 is a negative figure and all or part of this negative figure is for benefits you included in gross income in an earlier year, you can take an itemized deduction on Schedule A, Form 1040, for the amount of the negative figure that represents those benefits.

This deduction, ***if $3,000 or less,*** is subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions and is claimed on line 22, Schedule A (Form 1040).

If this deduction is more than $3,000, you should figure your tax two ways:

1) Figure your tax for 1994 with the itemized deduction. This more-than-$3,000 deduction is ***not*** subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions.

2) Figure your tax for 1994 without the deduction. If a portion of the negative figure represents a repayment of 1984 benefits, you must first recompute your 1984 tax, reducing your 1984 social security benefits by that portion. Recompute your 1985, 1986, etc., tax in the same manner, using any portion of the negative figure that represents a repayment of benefits for those years. Reduce your 1994 tax, figured without the deduction, by the total decrease in your 1984, 1985, 1986, etc., tax as recomputed.

Compare the tax figured in methods (1) and (2). Your tax for 1994 is the smaller of the two amounts. If method (1) results in less tax, take the itemized deduction on line 28, Schedule A (Form 1040). If method (2) results in less tax, claim a credit for the applicable amount on line 59 of Form 1040 and write "I.R.C. 1341" in the margin to the left of line 59. If both methods produce the same tax, deduct the repayment in full on line 28, Schedule A (Form 1040).

Worksheet 1-for Form 1040 Filers. **Social Security and Equivalent Railroad Retirement Benefits**
(Keep for your records)

Check only one box:
- ❑ **A.** Single, Head of household, or Qualifying widow(er)
- ❑ **B.** Married filing jointly
- ❑ **C.** Married filing separately and lived with your spouse at any time during 1994
- ❑ **D.** Married filing separately and lived apart from your spouse for all of 1994

1. Enter the total amount from box 5 of ALL your Forms SSA–1099 and RRB–1099 (if applicable) ..... **1.** _____
Note: *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.*

2. Enter one half of line 1 ..... **2.** _____

3. Add the amounts on Form 1040, lines 7, 8a, 8b, 9 through 14, 15b, 16b, 17 through 19, and line 21. Do not include any amounts from box 5 of Forms SSA–1099 or RRB–1099 here ..... **3.** _____

4. Enter the amount of any exclusions from: U.S. savings bond interest, foreign earned income, foreign housing, income from U.S. possessions, or income from Puerto Rico by bona fide residents of Puerto Rico that you claimed ..... **4.** _____

5. Add lines 2, 3, and 4 ..... **5.** _____

6. Enter the total adjustments plus any write-in amounts from Form 1040, line 30 (other than the foreign housing deduction) ..... **6.** _____

7. Subtract line 6 from line 5 ..... **7.** _____

8. Enter:
$25,000 if you checked Box **A** or **D,** or
$32,000 if you checked Box **B,** or
–0– if you checked Box **C** ..... **8.** _____

9. Subtract line 8 from line 7. If zero or less, enter –0– ..... **9.** _____
Is line 9 more than zero?
No. *Stop here. None of your benefits are taxable. Do not enter any amounts on lines 20a or 20b. But if you are married filing separately and you lived apart from your spouse for all of 1994, enter –0– on line 20b. Be sure you entered "D" to the left of line 20a.*
Yes. *Go to line 10.*

10. Enter $9,000 ($12,000 if married filing jointly; $0 if married filing separately and you lived with your spouse at any time in 1994) ..... **10.** _____

11. Subtract line 10 from line 9. If zero or less, enter –0– ..... **11.** _____

12. Enter the **smaller** of line 9 or line 10 ..... **12.** _____

13. Enter one half of line 12 ..... **13.** _____

14. Enter the **smaller** of line 2 or line 13 ..... **14.** _____

15. Multiply line 11 by 85% (.85). If line 11 is zero, enter –0– ..... **15.** _____

16. Add lines 14 and 15 ..... **16.** _____

17. Multiply line 1 by 85% (.85) ..... **17.** _____

18. **Taxable benefits.** Enter the smaller of line 16 or line 17 ..... **18.** _____
- Enter on Form 1040, line 20a, the amount from line 1.
- Enter on Form 1040, line 20b, the amount from line 18.

Note: *Use this worksheet whether or not you received a lump-sum payment. If you received a lump-sum payment in this year that was for an earlier year, see Lump-Sum Benefits, earlier. As that discussion suggests (under special election), if this worksheet shows that part of your benefits is taxable, complete Worksheets 2 and 3 in Publication 915 to see whether you can report a lower taxable benefit.*

Worksheet 1A (for 1040A filers). **Social Security and Equivalent Railroad Retirement Benefits**
(Keep for your records)

Check only one box:
- ❑ **A.** Single, Head of household, or Qualifying widow(er)
- ❑ **B.** Married filing jointly
- ❑ **C.** Married filing separately and lived with your spouse at any time during 1994
- ❑ **D.** Married filing separately and lived apart from your spouse for all of 1994

1. Enter the total amount from box 5 of ALL your Forms SSA–1099 and RRB–1099 (if applicable) ..... **1.** _____
Note: *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go to line 2.*
2. Enter one half of line 1 ..... **2.** _____
3. Add the amounts on Form 1040A, lines 7, 8a, 8b, 9, 10b, 11b, and 12. Do not include here any amounts from box 5 of Forms SSA–1099 or RRB–1099 ..... **3.** _____
4. Enter the amount of any U.S. savings bond interest exclusion from Schedule 1, line 3, that you claimed **4.** _____
5. Add lines 2, 3, and 4 ..... **5.** _____
6. Enter the amount from Form 1040A, line 15c ..... **6.** _____
7. Subtract line 6 from line 5 ..... **7.** _____
8. Enter:
$25,000 if you checked Box **A** or **D,** or
$32,000 if you checked Box **B,** or
–0– if you checked Box **C** ..... **8.** _____

9. Subtract line 8 from line 7. If zero or less, enter –0– ..... **9.** _____
Is line 9 more than zero?
No. *Stop here. None of your benefits are taxable. Do not enter any amounts on lines 13a or 13b. But if you are married filing separately and you lived apart from your spouse for all of 1994, enter –0– on line 13b. Be sure you entered "D" to the left of line 13a.*
Yes. *Go to line 10.*
10. Enter $9,000 ($12,000 if married filing jointly; $0 if married filing separately and you lived with your spouse at any time in 1994) ..... **10.** _____
11. Subtract line 10 from line 9. If zero or less, enter –0– ..... **11.** _____
12. Enter the **smaller** of line 9 or line 10 ..... **12.** _____
13. Enter one half of line 12 ..... **13.** _____
14. Enter the **smaller** of line 2 or line 13 ..... **14.** _____
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter –0– ..... **15.** _____
16. Add lines 14 and 15 ..... **16.** _____
17. Multiply line 1 by 85% (.85) ..... **17.** _____
18. **Taxable benefits.** Enter the smaller of line 16 or line 17 ..... **18.** _____
- Enter on Form 1040, line 13a, the amount from line 1.
- Enter on Form 1040, line 13b, the amount from line 18.

Note: *Use this worksheet whether or not you received a lump-sum payment. If you received a lump-sum payment in this year that was for an earlier year, see Lump-Sum Benefits, earlier. As that discussion suggests (under special election), if this worksheet shows that part of your benefits is taxable, complete Worksheets 2 and 3A in Publication 915 to see whether you can report a lower taxable benefit.*

13.

Other Income

Introduction

This chapter discusses many kinds of income and explains whether they are taxable or nontaxable.

- Income that is taxable must be reported on your tax return and is subject to tax.
- Income that is nontaxable may have to be shown on your tax return but is not subject to tax.

You must include on your return all income you receive in the form of money, property, and services unless the tax law states that you do not include them. Some items, however, are only partly excluded from income. They are listed and discussed briefly in this chapter.

Useful Items

You may want to see:

Publication

- ❑ **501** Exemptions, Standard Deduction, and Filing Information
- ❑ **520** Scholarships and Fellowships
- ❑ **525** Taxable and Nontaxable Income
- ❑ **544** Sales and Other Dispositions of Assets
- ❑ **550** Investment Income and Expenses

Miscellaneous Taxable Income

This section begins with brief discussions of numerous income items, arranged in alphabetical order. These discussions are followed by discussions of other taxable income items which are discussed in greater detail as follows:

Bartering

Recoveries (including state income tax refunds)

Repayments

Royalties

Note. When you report miscellaneous taxable income on line 21 of Form 1040, write a brief description of the income on the dotted line next to line 21.

Activity not for profit. You must include on your return income from an activity not for profit. An example of this type of activity would be a hobby or a farm you operate mostly for recreation and pleasure. Enter this income on line 21 of Form 1040. Deductions for expenses related to the activity are limited. They cannot total more than the income you report, and can be taken only if you itemize deductions on Schedule A (Form 1040). See *Not-for-Profit Activities* in Publication 535, *Business Expenses,* for information on whether an activity is considered carried on for a profit.

Alaska oil royalties. If you were a resident of Alaska and qualified to receive a payment from Alaska's mineral income fund (Alaska Permanent Fund dividends), you must report this amount on line 21, Form 1040. The state of Alaska will send you a Form 1099–MISC which shows this amount. The IRS will also receive a copy of this form.

Alimony. Include in your income on line 11, Form 1040, any alimony payments you receive. Amounts you receive for child support are not income to you. Alimony and child support payments are discussed in Chapter 20.

Allowances and reimbursements. If you receive travel, transportation, or other business expense allowances or reimbursements from your employer, or you are reimbursed for the business use of your car, see Chapter 28. If you are reimbursed for moving expenses, see Chapter 19.

Canceled debt. A canceled debt is generally income to you and must be reported on line 21, Form 1040.

A discount offered by a financial institution for the prepayment of a mortgage loan is income from the cancellation of a debt. However, you have no income from the cancellation of a debt if the cancellation is intended as a gift to you.

If your debt is canceled in a bankruptcy case (title 11) or when you are insolvent, do not include the canceled debt in your gross income. Get Publication 908, *Tax Information on Bankruptcy.*

Cancellation of student loan. You do not have income if your student loan is canceled because you agreed to certain conditions to obtain the loan and then performed the services required. Under the terms of the loan you must be required to work for a specified period of time in certain professions for one of a broad class of employers. To qualify, the loan must have been made by:

1) The government—federal, state, or local, or an instrumentality, agency, or subdivision thereof,
2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or
3) An educational organization under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan.

Cancellations of student loans under section 465 of the Higher Education Act of 1965 also are not income.

Court awards and damages. To determine if settlement amounts you receive by compromise or judgment must be included in your income, you must consider the item that the settlement replaces. Include the following as ordinary income:

1) Interest on any award.
2) Compensation for lost wages or lost profits in most cases.
3) Punitive damages awarded in cases not involving physical injury or sickness. Report this income on line 21, Form 1040.
4) Amounts received in settlement of pension rights (if you did not contribute to the plan).
5) Damages for:
   a) Patent or copyright infringement,
   b) Breach of contract, or
   c) Interference with business operations.

Do not include as your income compensatory damages for the following:

1) Personal injury or sickness (whether received in a lump sum or installments) including punitive damages.
2) Disparate treatment or discrimination (including back wages) from suits brought under the Civil Rights Act or the Americans with Disabilities Act.
3) Damage to your character.
4) Alienation of affection.
5) Surrender of custody of a minor child.

Estate and trust income. An estate or trust, unlike a partnership, may have to pay federal income tax. If you are a beneficiary of an estate or trust, you are taxed on your share of its income. However, there is never a double tax. Estates and trusts file their returns on Form 1041, *U.S. Income Tax Return for Estates and Trusts,* and report your share of the income on Schedule K–1 of Form 1041.

Current income required to be distributed. If you are the beneficiary of a trust that must distribute all of its current income, you must report your share of the distributable net income whether or not you have actually received it.

Current income not required to be distributed. If you are the beneficiary of an estate or trust and the fiduciary has the choice of whether to distribute all or part of the current income, you must report all income that is required to be distributed to you, whether or not it is actually distributed, plus all other amounts actually paid or credited to you, to the extent of your share of distributable net income.

How to report estate and trust income. Each item of income is treated the same for you as for the estate or trust. If it is dividend income for the trust, it is the same for you.

The fiduciary of the estate or trust must tell you the type of items making up your

share of the estate or trust income and any credits you are allowed on your individual income tax return.

Losses. Losses of estates and trusts generally are not deductible by the beneficiaries.

Grantor trust. Income earned by a grantor trust is taxable to the grantor, not the beneficiary. This rule applies if the property put into the trust will revert (be returned) to the grantor or the grantor's spouse. Generally, for transfers after March 1, 1986, a trust is a grantor trust if the grantor has a reversionary interest valued (at the date of transfer) at more than 5% of the value of the transferred property. For transfers in trust made before March 2, 1986, a trust was a grantor trust if it was expected that the property would revert to the grantor within 10 years.

Fees. Include all fees for your services in your gross income. Examples of these fees are amounts you receive for services as:

1) A corporate director,
2) An executor or administrator of an estate,
3) A notary public, or
4) An election precinct official.

Corporate director. If you received (or should have received) a Form W–2 showing corporate director fees, report these fees on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

Otherwise, report these payments on Schedule C (Form 1040) or Schedule C–EZ (Form 1040) as self-employment income.

Executor or administrator of an estate. If these payments total $600 or more for the year, the payer must report the fees to the IRS on Form 1099–MISC. You will receive a copy of the Form 1099–MISC. Report these payments on Schedule C (Form 1040) or Schedule C–EZ (Form 1040) as self-employment income. ***Exception:*** If you are not in the trade or business of being an executor (for instance, you are the executor of a friend's or relative's estate), do not include these amounts on Schedule C or Schedule C–EZ. Report them on line 21 of Form 1040.

Notary public. Report payments for these services on line 21 of Form 1040.

Election precinct official. You should receive a Form W–2 showing payments for services as an election precinct official. Report these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

Free tour. A free tour you receive from a travel agency for organizing a group of tourists must be included in your income on line 21, Form 1040, or on Schedule C or Schedule C–EZ (Form 1040), at the fair market value of the tour. You cannot deduct your expenses in serving as the voluntary leader of the group at the group's request.

Gambling winnings. You must include your gambling winnings in income on line 21, Form 1040.

If you itemize your deductions on Schedule A (Form 1040), you can deduct gambling losses you had during the year, but only up to the amount of your winnings. See Publication 529, *Miscellaneous Deductions,* for information on recordkeeping.

Lotteries and raffles. Winnings from lotteries and raffles are gambling winnings. In addition to cash winnings, you must include in your income bonds, cars, houses, and other noncash prizes at their fair market value.

Note. If you win a state lottery prize payable in installments, you must include in your gross income the annual payments and any amount you receive designated as ''interest'' on the unpaid installments.

Form W–2G. You may have received a Form W–2G showing the amount of your gambling winnings and any tax withheld. Include the amount from box 1 on line 21 of Form 1040. Be sure to include any amount from box 2 on line 54 of Form 1040.

Hobby losses. Losses from a hobby are not deductible from other income. A hobby is an activity from which you do not expect to make a profit. See *Activity not for profit,* earlier.

Note. If you collect stamps, coins, or other items as a hobby for recreation and pleasure, and you sell any of the items, your gain is taxable as a capital gain. (See Chapter 17.) However, if you sell items from your collection at a loss, you cannot deduct a net loss.

Illegal income. Illegal income, such as stolen or embezzled funds, must be included in your gross income on line 21, Form 1040, or on Schedule C or Schedule C–EZ (Form 1040) if from your self-employment activity.

Indian fishing rights. If you are a member of a qualified Indian tribe that has fishing rights secured by treaty, executive order, or an Act of Congress as of March 17, 1988, do not include in your income amounts you receive from activities related to those fishing rights. The income is not subject to income tax, self-employment tax, or employment taxes.

Investment clubs. An investment club is a group of friends, neighbors, business associates, or others who pool limited or stated amounts of funds to invest in stock or other securities. The club may or may not have a written agreement, charter, or by-laws. Usually the group operates informally with members pledging a regular amount to be paid into the club monthly. Some clubs have a committee that gathers information on securities, selects the most promising, and recommends that the club invest in them. Other clubs rotate the investigatory responsibilities among all their members. Most require all members to vote for or against all investments, sales, exchanges, or other transactions.

How the income from an investment club is reported on your tax return depends on how the club operates. Most clubs operate as partnerships and are treated as such for federal tax purposes. Others operate as corporations, trusts, or associations taxed as corporations.

For more information about investment clubs, get Publication 550.

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

If you are required to give the pay to your employer because your employer continues to pay your salary while you serve on the jury, you can deduct the amount turned over to your employer as an adjustment to your income. Include the amount you repay your employer on line 30, Form 1040, and write ''Jury pay'' and the amount on the dotted line next to line 30.

Kickbacks. You must include in your income on line 21, Form 1040, or on Schedule C or Schedule C–EZ (Form 1040), kickbacks, side commissions, push money, or similar payments you receive.

Example. You are a car salesperson and help arrange car insurance for buyers. Insurance brokers pay back part of their commissions to you for referring customers to them. You must include the kickbacks in your income.

Note received for services. If your employer gives you a note as payment for your services, you must include the fair market value (usually the discount value) of the note in your income as wages for the year you receive it. When you later receive payments on the note, part of each payment is a recovery of the fair market value that you previously included in your income. Do not include that part in your income again. Include the rest of the payment in your income in the year of payment.

Prizes and awards. If you win a prize in a lucky number drawing, television or radio quiz program, beauty contest, or other event, you must include it in your income. For example, if you win a $50 prize in a photography contest, you must report this income on line 21, Form 1040.

Employee cash awards or bonuses. Cash awards or bonuses given to you by your employer for good work or suggestions generally must be included in your income. However, certain employee awards can be excluded from your income. See *Employee achievement awards,* later.

Goods or services. Prizes and awards in goods or services must be included in income at their fair market value. If you refuse to accept a prize, do not include its value in your income.

Pulitzer, Nobel, and other prizes. If you were awarded a Pulitzer, Nobel, or other

prize in recognition of past accomplishments (in religious, charitable, scientific, artistic, educational, literary, or civic fields) you do not include this prize in your income if you meet ***all*** of the following requirements.

1) You were selected without any action on your part to enter the contest or proceeding.
2) You are not required to perform substantial future services as a condition to receiving the prize or award.
3) The prize or award is transferred directly to a governmental unit or tax-exempt charitable organization as designated by you.

Get Publication 525 for more information about the conditions that apply to the transfer.

Sale of personal items. If you sell an item that you owned for personal use, such as a car, refrigerator, furniture, stereo, jewelry, or silverware, a gain is taxable as a capital gain reported on Schedule D (Form 1040). You cannot deduct a loss.

However, if you sell an item that you held for investment, such as gold or silver bullion, coins, or gems, a gain is taxable as a capital gain and a loss is deductible as a capital loss.

Bartering

Bartering is an exchange of property or services. You must include in your income, at the time received, the fair market value of property or services you receive in bartering. If you exchange services with another person and you both have agreed ahead of time as to the value of the services, that value will be accepted as fair market value unless the value can be shown to be otherwise.

Report this income on Schedule C or Schedule C–EZ (Form 1040).

Example 1. You are a self-employed attorney and perform legal services for a client, a small corporation. The corporation gives you shares of its stock as payment for your services. You must include in income the fair market value of the shares on Schedule C or Schedule C–EZ (Form 1040) in the year that you receive them.

Example 2. You are self-employed and a member of a barter club. The club uses ''credit units'' as a means of exchange. It adds credit units to your account for goods or services you provide to members, which you can use to purchase goods and services offered by other members of the barter club. The club subtracts credit units from your account when you receive goods or services from other members. You must include in income the value of credit units that are added to your account, even though you may not actually receive goods or services from other members until a later tax year.

Example 3. You own a small apartment building and an artist gives you a work of art that the artist created in return for 6 months' rent-free use of an apartment. You must report as rental income on Schedule E (Form 1040) the fair market value of the art work, and the artist must report as income on Schedule C or Schedule C–EZ (Form 1040) the fair rental value of the apartment.

Barter exchange. If you exchanged property or services through a barter exchange, you should receive Form 1099–B or a similar statement. You should receive the statement by January 31, 1995, and it will generally show the value of cash, property, services, credits, or scrip you received from exchanges during the year. The IRS will also get a copy of Form 1099–B.

Backup withholding. The income you receive from bartering is generally not subject to withholding. However, backup withholding will apply in certain circumstances to ensure that income tax is collected on this income.

If you join a barter exchange, you must certify under penalties of perjury that your social security or employer identification number is correct and that you are not subject to backup withholding. If you do not make this certification, backup withholding may begin immediately. The barter exchange will give you a Form W–9, *Request for Taxpayer Identification Number and Certification,* or a similar form, for you to make this certification. For more information, see *Backup Withholding* in Chapter 5.

Reporting the tax withheld. If tax is withheld from your barter income, the barter exchange must give you a Form 1099–B, or similar statement, that indicates the amount of tax withheld.

Partnership Income

A partnership is not a taxable entity. The income, gains, losses, credits, and deductions of a partnership are ''passed through'' to the partners based on each partner's distributive share of these items.

The partnership must file a return on Form 1065, *U.S. Partnership Return of Income,* and send Schedule K–1 to each partner. In addition, the partnership will send each partner a copy of the *Partner's Instructions for Schedule K–1 (Form 1065),* to help each partner report his or her share of the partnership's income, credits, deductions, and tax preference items. Do not attach Schedule K–1 (Form 1065) to your Form 1040. Keep it for your records.

For an example of how to report partnership items, see Chapter 39.

For more information on partnerships, get Publication 541, *Tax Information on Partnerships.*

S Corporation Income

In general, an S corporation does not pay tax on its income. Instead, the income and expenses of the corporation are ''passed through'' to the shareholders.

An S corporation must file a return on Form 1120S, *U.S. Income Tax Return for an S Corporation,* and send Schedule K–1 (Form 1120S) to each shareholder. In addition, the S corporation will send each shareholder a copy of the *Shareholder's Instructions for Schedule K–1 (Form 1120S)* to help each shareholder report his or her share of the S corporation's income, credits, and deductions. Do not attach Schedule K–1 (Form 1120S) to your Form 1040. Keep it for your records.

For more information on S corporations and their shareholders, get Publication 589, *Tax Information on S Corporations.*

Recoveries

A recovery is a return of an amount you deducted or took a credit for in an earlier year. Generally, you must include all or part of the recovered amounts in your income in the year the recovery is received. The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A (Form 1040). Non-itemized deduction recoveries include such items as payments you receive on previously deducted bad debts and recoveries of items for which you previously claimed a tax credit.

Federal income tax refund. Refunds of federal income taxes are not included in your income because they are never allowed as a deduction from income.

Interest. Interest on any of the amounts you recover must be reported as interest income in the year received.

Recovery and expense in same year. If the refund or other recovery and the deductible expense occur in the same year, the refund or recovery reduces the deduction and is not reported as income.

Recovery for 2 or more years. If you receive a refund or other recovery that is for amounts you paid in 2 or more separate years, you must allocate, on a pro rata basis, the recovered amount between the years in which it was paid.

This allocation is necessary to determine the amount of recovery attributable to any earlier years and to determine the amount, if any, of your allowable deduction for this item for the current year. For information on how to compute the allocation, see *Recoveries* in Publication 525.

Tax benefit rule. If you did not derive a tax benefit from your prior year deduction, you do not have to include the amount you received this year in income. This could happen if you were subject to the alternative minimum tax or had credits that reduced your tax liability to zero. For more information, get Publication 525.

Itemized Deduction Recoveries

If you recover any amount that you deducted in an earlier year on Schedule A (Form 1040), you must determine how much, if any, of the recovery to include in your income.

Due to changes in the tax law, different computations are needed for the recovery of items deducted after 1986 or before 1987. The discussions in this section apply to recovery of items deducted after 1986. If you recovered an item deducted before 1987, contact your local IRS office for assistance, or see a tax practitioner.

Standard deduction. To determine if amounts deducted in 1993 and recovered in 1994 must be included in your income, you must know the standard deduction for your filing status in 1993. Standard deduction amounts for 1993 are in Publication 525.

Form 1099–G. If you received a state or local income tax refund in 1994, you may receive a statement, Form 1099–G, *Certain Government Payments,* from the payer of the refund (or credit or offset) by January 31, 1995. The IRS will also receive a copy of the Form 1099–G.

Report any interest you received on state or local income tax refunds on line 8a of Form 1040.

No earlier year deduction. If you did not itemize deductions in the year for which you received the recovery, do not include any of the recovery amount in your income.

Recovery limited to deduction. You do not include in your income any amount of your recovery that is more than the amount you deducted in the earlier year. The amount you include in your income is limited to the smaller of:

1) The amount deducted on Schedule A (Form 1040), or
2) The amount recovered.

Example. During 1993 you paid $1,700 for medical expenses. From this amount you subtracted $1,500, which was 7.5% of your adjusted gross income. Your taxable income for 1993 was $13,500. Your actual medical expense deduction was $200. In 1994, you received a $500 reimbursement from your medical insurance for your 1993 expenses. The only amount of the $500 reimbursement that must be included in your income in 1994 is $200—the amount actually deducted.

Total recoveries included in income. The total amount recovered in 1994 is included in your income if certain requirements are met.

Recoveries of amounts deducted **after 1986** will generally be included in your income if:

1) The recoveries are not more than the amount deducted,
2) The recoveries are equal to or less than the amount by which your itemized deductions exceeded the standard deduction for your filing status in the earlier year, and
3) Your total deductions on the earlier year return did not exceed your total income.

Where to report. Enter your state and local income tax refund on line 10, Form 1040, and the total of all other recoveries as other income on line 21, Form 1040.

Example. In 1993, you filed a joint return. Your taxable income was $20,000. The standard deduction for your filing status was $6,200, and you had itemized deductions of $7,200. In 1994, you received the following recoveries for amounts deducted in 1993:

Medical expenses	$200
State and local income tax refund	400
Real estate tax rebate	325
Total recoveries	$925

None of the recoveries were more than the deductions taken in 1993.

Because your total recoveries are less than the amount by which your itemized deductions exceeded the standard deduction ($7,200 – 6,200 = $1,000), you must include your total recoveries in your income in 1994. Report the state and local income tax refund of $400 on line 10, Form 1040, and the balance of your recoveries, $525, on line 21, Form 1040.

Total recoveries not included in income. The total recovery that must be included in your income is limited to the itemized deduction amount that reduced your tax in the earlier year. (See *Tax benefit rule,* earlier.)

You are generally allowed to claim the standard deduction if you do not itemize your deductions. Only your itemized deductions that are more than your standard deduction are subject to the recovery rule. Therefore, if your total deductions on the earlier year return did not exceed your income, include in your income the smaller of:

1) Your recoveries, or
2) The amount by which your itemized deductions exceeded the standard deduction.

Example. You filed a joint return in 1993 with taxable income of $20,000. Your itemized deductions were $7,200. The standard deduction that you could have claimed was $6,200. In 1994 you recover $2,400 of your 1993 itemized deductions. None of the recoveries were more than the actual deductions in 1993. Include $1,000 of the recoveries in your 1994 income. This is the smaller of your recoveries ($2,400) or the amount by which your itemized deductions exceeded the standard deduction ($7,200 – 6,200 = $1,000).

Other recoveries. See *Recoveries* in Publication 525 if:

1) Your total deductions exceeded your income in the prior year.
2) You have recoveries of items other than itemized deductions.
3) Your standard deduction was zero in the prior year for which you received the recovery.
4) You received a recovery for an item for which you claimed a tax credit (other than investment credit or foreign tax credit) in a prior year.
5) You were subject to the alternative minimum tax, or you had credits that reduced your tax liability to zero, in the year the deduction was claimed.
6) Your last payment of 1993 estimated state income tax was made in 1994.
7) Your itemized deductions for 1993 were limited as discussed in Chapter 22.

Repayments

If you had to repay an amount that you had included in your income in an earlier year because at that time you thought you had an unrestricted right to it, you can deduct the amount repaid from your income in the year in which you repay it.

Type of deduction. The type of deduction you are allowed in the year of repayment depends on the type of income you included in the earlier year. For instance, if you repay an amount that you previously reported as a capital gain, deduct the repayment as a capital loss.

Repayment $3,000 or less. If the amount you repaid was $3,000 or less, deduct it from your income in the year you repaid it. If you reported it as wages, unemployment compensation, or other ordinary income, enter it on line 22, Schedule A (Form 1040). If you reported it as a capital gain, deduct it on Schedule D (Form 1040).

Repayment over $3,000. If the amount you repaid was more than $3,000, you can take a deduction for the amount repaid, or you can take a credit against your tax. Follow the steps below and compare the results. Use the method (credit or deduction) that results in less tax.

1) Figure your tax for 1994 claiming a deduction for the repaid amount.
2) Figure your tax for 1994 ***without*** deducting the amount you repaid. Then,
   a) Refigure your tax from the earlier year without including in income the amount you repaid in 1994.
   b) Subtract the tax in (a) from the tax shown on your return for the earlier year.
   c) Then subtract the answer in (b) from the tax for 1994 figured without the deduction.

How you treat the repayment on your 1994 return depends on which answer above results in less tax.

- If the answer in Step (1) is less tax, deduct the amount repaid on the same form or schedule on which you previously reported it. For example, if you reported it as self-employment income, deduct it on Schedule C or Schedule C–EZ (Form 1040), or if

you reported it as wages, deduct it on line 28 of Schedule A (Form 1040).

- If the answer in Step (2) is less tax, claim a credit on line 59, Form 1040, and write "I.R.C. 1341" next to line 59.

An example of this computation can be found in Publication 525.

Royalties

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

You generally report royalties on Part I, Schedule E (Form 1040). However, if you hold an operating oil, gas, or mineral interest, or are in business as a self-employed writer, inventor, artist, etc., report gross income and expenses on Schedule C or Schedule C–EZ (Form 1040).

Copyrights and patents. Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

Oil, gas, and minerals. Royalty income from oil, gas, and mineral properties is the amount you receive when natural resources are extracted from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

Depletion. If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance. For information on this subject, see Chapter 13 of Publication 535, *Business Expenses.*

Coal and iron ore. Under certain circumstances, you can treat amounts you receive from the disposal of coal and iron ore as payments from the sale of a capital asset, rather than as royalty income. For information about gain or loss from the sale of coal and iron ore, get Publication 544.

Interest in the property sold. If you sell your complete interest in the oil, gas, or mineral rights, the amount you receive is considered payment for the sale of your property, not royalty income. Under certain circumstances, the sale is subject to capital gain or loss treatment on Schedule D (Form 1040). For information on capital gain or loss, see Chapter 15.

Also, you can report the sale as an installment sale if you are to receive at least one payment after the tax year in which the sale took place. For more information, get Publication 537, *Installment Sales.*

Part of future production sold. If you own mineral property but sell part of the future production, you generally treat the money you receive from the buyer at the time of the sale as a loan from the buyer. Do not include it in your income or take depletion based on it.

When production begins, you include all the proceeds in your income, deduct all the production expenses, and deduct depletion from that amount to arrive at your taxable income from the property.

Your payments for the buyer's share of the proceeds are treated as a loan repayment. The buyer will treat the share as a return of capital that is not included in your income or subject to a depletion allowance. Any interest factor received by the buyer will be treated as ordinary income not subject to the allowance for depletion.

Retained interest. If you retain a royalty, an overriding royalty, or a net profit interest in a mineral property for the life of the property, you have made a lease or a sublease, and any cash you receive for the assignment is ordinary income subject to a depletion allowance.

Income Not Taxed

You generally should not report the following items on your return. Some of the items, however, are only partly excluded from your income. A discussion of other totally and partly excluded items follows this list.

- **Accident and health insurance proceeds**
- **"Black lung" benefits**
- **Casualty insurance and other reimbursements** (Chapter 27)
- **Child support payments** (Chapter 20)
- **Damages awarded for physical injury or sickness**
- **Employment agency fees** (Chapter 30)
- **Federal Employees' Compensation Act payments**
- **Government cost-of-living allowances for civilian employees stationed outside the continental U.S. (other than Alaska)** (Chapter 6)
- **Interest on state or local government obligations** (Chapter 8)
- **Meals and lodging**
- **Members of the clergy housing allowance** (Chapter 6)
- **Military allowances** (Chapter 6)
- **Moving expense reimbursements** (Chapter 19)
- **Scholarship and fellowship grants**
- **Social security benefits and equivalent railroad retirement benefits** (Chapter 12)
- **Supplemental security income**
- **Veterans' benefits** (Chapter 6)
- **Welfare benefits**
- **Workers' compensation**

Campaign contributions. These contributions are not income to a candidate unless they are diverted to his or her personal use. To be exempt from tax, the contributions must be spent for campaign purposes or kept in a fund for use in future campaigns. However, interest earned on bank deposits, dividends received on contributed securities, and net gains on sales of contributed securities are taxable and must be reported on Form 1120–POL, *U.S. Income Tax Return for Certain Political Organizations.* Excess campaign funds transferred to an office account must be included in the officeholder's income on line 21, Form 1040, in the year transferred.

Cash rebates. A cash rebate you receive from a dealer or manufacturer of an item you buy is not income.

Example. You buy a new car for $9,000 cash and receive a $400 rebate check from the manufacturer. The $400 is not income to you. Your cost is $8,600. This is your basis on which you figure gain or loss if you sell the car, and depreciation if you use it for business.

Employee achievement awards. You can exclude from income employee achievement awards you receive only if your employer can deduct them. To be deducted by your employer, and excluded by you, the awards must meet all the following requirements:

1) Be given for length of service or safety achievement.
2) Be tangible personal property other than cash, gift certificates, or equivalent items.
3) Be given under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.
4) Be given as part of a meaningful presentation.
5) Be no more than the specified dollar limits.

Dollar limits. There are limits to the total awards you can exclude in one year. Awards from nonqualified plans are limited to $400, and total awards, from both qualified and nonqualified plans, are limited to $1,600. The cost to your employer is the determining factor for these limits. Amounts over the limits cannot be deducted by your employer and must be included in your income.

Qualified plan award. A qualified plan award is one you are awarded as part of an established written plan by your employer that does not discriminate in favor of highly compensated employees. An award will not be considered a qualified plan award if the average cost of all employee achievement awards given by your employer during the tax year is more than $400. In determining average cost, awards of nominal value are not taken into account.

Example. Ben Green received three employee achievement awards during 1994: a nonqualified plan award of a watch valued at $250, and two qualified plan awards of a stereo valued at $1,000 and a set of golf

clubs valued at $500. Assuming that the requirements for qualified plan awards are otherwise satisfied, each award by itself would be excluded from his income. However, since the total value of the awards is more than $1,600, Ben must include the excess of $150 ($1,750 – $1,600) in his income.

Energy conservation subsidies. Residential customers can exclude from gross income any subsidy provided, either directly or indirectly, by public utilities for the purchase or installation of an energy conservation measure with respect to a dwelling unit.

Energy conservation measure. This includes installations or modifications that are primarily designed to reduce consumption of electricity or natural gas, or improve the management of energy demand with respect to a dwelling unit.

Dwelling unit. This includes a house, apartment, condominium, mobile home, boat, or similar property. If a building or structure contains both dwelling and other units, any subsidy must be properly allocated.

Foster-care providers. Payments you receive from a state, political subdivision, or tax-exempt child-placement agency for providing foster care to qualified individuals in your home are not included in your income. You cannot deduct the related expenses. However, you must include in your income payments received for the care of more than 5 individuals age 19 or older.

A qualified foster individual is a person who:

1) Is living in a foster family home, and
2) Was placed there by:
   a) An agency of a state or one of its political subdivisions, or
   b) A tax-exempt child placement agency licensed by a state, if the individual is under age 19.

Difficulty-of-care payments. These payments are not included in your income. These are additional payments made to foster-care providers of physically, mentally, or emotionally handicapped individuals by a state, political subdivision, or tax-exempt child placement agency that are designated as difficulty-of-care payments. A state must determine that the additional compensation is needed. You must include in your income difficulty-of-care payments received for more than:

1) 10 children under age 19, and
2) 5 individuals age 19 or older.

Maintaining space in home. If you are paid by a placement agency to maintain space in your home for foster-care individuals, or if you receive payments that you must include in your income, you are in business as a foster-care provider and you are self-employed. You must include these payments in your income. You can deduct expenses related to these payments.

Report the income and expenses on Schedule C or Schedule C–EZ (Form 1040) and net business income on Schedule SE (Form 1040). See *Home Office* in Chapter 30.

For more information on foster care, get Publication 501.

Gifts and inheritances. Generally, property you receive as a gift, bequest, or inheritance is not included in your income. However, if property you receive this way later produces income such as interest, dividends, or rentals, that income is taxable to you. If property is given to a trust and the income from it is paid, credited, or distributed to you, that also is income to you. If the gift, bequest, or inheritance is the income from the property, that income is taxable to you.

Items given to you as an incentive to enter into a business transaction are not gifts. For example, items such as small appliances or dinnerware given to you by a bank as an incentive to make a deposit are interest income to you and must be reported at their fair market value.

For more information, see Publication 525.

Inherited IRA. If you inherited an individual retirement arrangement (IRA), special rules apply. See Chapter 18.

Interest on frozen deposits. In general, you must exclude from your income the amount of interest earned on a frozen deposit. A deposit is frozen if, at the end of the calendar year, you cannot withdraw any part of the deposit because:

1) The financial institution is bankrupt or insolvent, or
2) The state where the institution is located has placed limits on withdrawals because other financial institutions in the state are bankrupt or insolvent.

Excludable amount. The amount of interest you must exclude from gross income for the year is the interest that was credited on the frozen deposit for that tax year minus the sum of:

1) The net amount withdrawn from the deposit during that year, and
2) The amount that could have been withdrawn at the end of that tax year (not reduced by any penalty for premature withdrawals of a time deposit).

The excluded part of the interest is included in your gross income in the tax year it becomes withdrawable.

Interest on qualified savings bonds. You can exclude from your income the interest from qualified U.S. savings bonds you redeem if you pay qualified higher educational expenses in the same year. ''Qualified higher educational expenses'' are those you pay for tuition and required fees at an eligible educational institution for you, your spouse, or your dependent. A ''qualified U.S. savings bond'' is a Series EE savings bond issued after December 31, 1989, to an individual 24 years of age or older. For more information on this exclusion, see Chapter 8.

Living expenses paid by insurance. Do not include in income amounts you receive under an insurance policy for additional living expenses you and your family had because you lost the use of your home by fire, storm, or other casualty. The amount you exclude from income is limited to your extra living expenses that are more than the normal expenses you would have had. Extra living expenses, for this purpose, include only those to keep you and your family at the same standard of living you had before the loss.

Sale of home. If you are 55 or older and sell your main home, you may be able to exclude from income all or part of any gain from the sale. See Chapter 16.

Transporting schoolchildren. Do not include in your income a school board mileage allowance for taking children to and from school if you are not in the business of taking children to school. You cannot deduct expenses for providing this transportation.

Utility rebates. If you are a customer of an electric utility company and you participate in the utility's energy conservation program, you may receive on your monthly electric bill either:

1) A reduction in the purchase price of electricity furnished to you (rate reduction), or
2) A nonrefundable credit against the purchase price of the electricity.

The amount of the rate reduction or nonrefundable credit is not included in your income.

Life Insurance Proceeds

Life insurance proceeds paid to you because of the death of the insured person are not taxable unless the policy was turned over to you for a price. This applies even if the proceeds were paid under an accident or health insurance policy or an endowment contract.

Proceeds not received in installments. If death benefits are paid to you in a lump sum or other than at regular intervals, include them in your gross income only to the extent they are more than the amount payable to you at the time of the insured person's death. If the benefit payable at death is not specified, you include the benefit payments in your income to the extent they are more than the present value of the payments at the time of death.

Proceeds received in installments. If you receive life insurance proceeds in installments, you can exclude part of each installment from your income.

To determine the excluded part, you must divide the amount held by the insurance

company (generally the total lump sum payable at the death of the insured person) by the number of installments to be paid. Include anything over this excluded part in your income as interest. For more information, get Publication 525.

Surviving spouse. If your spouse died before October 23, 1986, and insurance proceeds are payable to you because of the death of your spouse, and you receive them in installments, you can exclude up to $1,000 a year of the interest included in the installments. This is in addition to the part of each installment that is excluded as a recovery of the lump sum payable at death. If you remarry, you can continue to take the exclusion.

If your spouse died after October 22, 1986, you cannot exclude any interest payments included in the installment payments.

See *Life Insurance Proceeds* in Publication 525.

Interest option on insurance. If an insurance company pays you only interest on proceeds from life insurance left on deposit with them, the interest you are paid is taxable.

If your spouse died before October 23, 1986, and you chose to receive only the interest from your insurance proceeds, the $1,000 interest exclusion for a surviving spouse does not apply. If you later decide to receive the proceeds from the policy in installments, you can take the interest exclusion from the time you begin to receive the installments.

Surrender of policy for cash. If you surrender a life insurance policy for cash, you must include in income any proceeds that exceed the amount of premiums that you paid.

Reporting. If you received a Form 1099–R, report these amounts on lines 16a and 16b of Form 1040, or lines 11a and 11b of Form 1040A.

Endowment proceeds. Endowment proceeds paid in a lump sum to you at maturity are taxable only if the proceeds are more than the cost of the policy. Add any amounts that you previously received under the contract and excluded from your income to the lump-sum payment to find how much of the total is a return of your cost and how much is an excess over your cost. Include any excess over your cost in your income.

Endowment proceeds that you choose to receive in installments instead of a lump-sum payment at the maturity of the policy are taxed as an annuity as explained in Publication 575, *Pension and Annuity Income (Including Simplified General Rule).* For this treatment to apply, you must choose to receive the proceeds in installments before receiving any part of the lump sum. This election must be made within 60 days after the lump-sum payment first became payable to you.

Payments to beneficiaries of deceased employees (death benefit exclusion). The first $5,000 of payments made by or for an employer because of an employee's death can be excluded from the income of the beneficiaries. The payments need not be made as the result of a contract. The amount excluded for any deceased employee cannot be more than $5,000 regardless of the number of employers or the number of beneficiaries.

This exclusion also covers payments of the balance to the credit of a deceased employee under a stock bonus, pension, or profit-sharing plan, as long as they are received during one tax year of the beneficiary.

Example. William Smith was an officer of a corporation at the time of his death last year. The board of directors voted to pay Mr. Smith's salary to his widow for the remainder of the year for his past services. During the year the corporation made payments of $18,000 to the widow. She can exclude from her income the first $5,000 she received, but must include the remaining $13,000 on line 21 of her Form 1040.

Self-employed individuals. The death benefit exclusion also applies to lump-sum distributions paid on behalf of self-employed individuals, if paid under a qualified pension, profit-sharing, or stock bonus plan.

Payments not qualifying. Any amount the deceased employee (or self-employed individual) had a guaranteed right to receive had death not occurred cannot be excluded as a tax-free death benefit. If the deceased employee was receiving a retirement annuity, and the beneficiary continues to receive payments under a joint and survivor annuity option, these payments do not qualify for the death benefit exclusion. However, if the deceased employee had retired on disability and at the time of death had not reached minimum retirement age, payments to the beneficiary may qualify for the death benefit exclusion. Minimum retirement age generally is the age at which an individual can receive a pension or annuity were that individual not disabled.

Paid in installments. Death benefits paid in installments over a period of years are annuity payments. If you are the beneficiary of an employee who died while still employed, the pension or annuity you receive may qualify for the death benefit exclusion. This exclusion is limited to $5,000 and generally applies to the amount by which the present value of the annuity, figured as of the date of the employee's death, is more than the larger of:

1) The employee's contributions to the plan, or
2) The amount the employee had a guaranteed right to receive.

If you are eligible for the exclusion, add it to the cost or unrecovered cost of the annuity in figuring, at the annuity starting date, the investment in the contract.

Treatment of annuity payments to beneficiaries of employees and the death benefit exclusion are discussed in Chapter 11.

Deceased public safety officers. If you are a surviving dependent of a public safety officer (law enforcement officer or firefighter) who died in the line of duty, do not include in your income the death benefit payable to you by the Bureau of Justice Assistance.

Welfare and Other Public Assistance Benefits

Do not include in your income the benefit payments from a public welfare fund, such as payments due to blindness. Payments from a state fund for the victims of crime should not be included in the victims' incomes if they are in the nature of welfare payments. Do not deduct medical expenses that are reimbursed by such a fund.

Payments for age and residency. Payments the state of Alaska makes to its citizens who meet certain age and residency tests that are not based on need are not welfare benefits. Include them in gross income on line 21, Form 1040.

Employment Opportunities for Handicapped Individuals Act. Persons with disabilities who are employed in community service activities under this Act do not include in income the allowances or reimbursements paid to them under the Act for training or rehabilitation. Compensation received for services performed under this Act are includible in gross income. For more information, see Publication 525.

Disaster Relief Act of 1974. Grants made under this Act to help victims of natural disasters are not included in income. Do not deduct casualty losses or medical expenses that are specifically reimbursed by these disaster relief grants. Disaster unemployment assistance payments under the Act are unemployment benefits that are taxable. See *Unemployment compensation* in Chapter 6.

Mortgage assistance payments. Payments made under section 235 of the National Housing Act for mortgage assistance are not included in the homeowner's gross income.

Interest paid for the homeowner under the mortgage assistance program cannot be deducted.

Payments to reduce cost of winter energy. Payments made by a state to qualified people to reduce their cost of winter energy use are not taxable.

Other Sickness and Injury Benefits

In addition to welfare or insurance benefits, you may receive other payments for sickness or injury. *Table 13–1* gives a general overview of some of these payments.

Workers' compensation. Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt

Table 13-1. **Are Your Sickness and Injury Benefits Taxable?**

This table is intended as a general overview. Additional rules may apply depending on your situation. For more information about your benefits, see the discussion, ''Other Sickness and Injury Benefits,'' in this chapter.

Type of Benefit	General Rule
Workers' Compensation	Not taxable if paid under a workers' compensation act or a statute in the nature of a workers' compensation act and paid due to a work related sickness or injury. However, payments received after returning to work are taxable.
Federal Employees' Compensation Act (FECA)	Not taxable if paid because of personal injury or sickness. However, payments received as ''continuation of pay'' for up to 45 days while a claim is being decided and pay received for sick leave while a claim is being processed are taxable.
Compensatory Damages	Not taxable if received for injury or sickness.
Accident or Health Insurance Benefits	Not taxable if you paid the insurance premiums.
Disability Benefits	Not taxable if received for loss of income or earning capacity due to an injury covered by a ''no-fault'' automobile policy.
Compensation for Permanent Loss or Loss of Use of a Part or Function of Your Body, or for Permanent Disfigurement	Not taxable if paid due to the injury. The payments must be figured without regard to any period of absence from work.
Reimbursements for Medical Care	Not taxable—but the reimbursement may reduce your medical expense deduction.

from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act. The exemption also applies to your survivor(s) if the payments otherwise qualify as workers' compensation. The exemption from tax, however, does not apply to retirement benefits you receive based on your age, length of service, or prior contributions to the plan, even though you retired because of occupational sickness or injury.

Note. If part of your workers' compensation reduces your social security or equivalent railroad retirement benefits received, that part is considered social security (or equivalent railroad retirement) benefits and may be taxable. For more information, see Publication 915, *Social Security Benefits and Equivalent Railroad Retirement Benefits.*

Return to work. If you return to work after qualifying for workers' compensation, payments you continue to receive while assigned to light duties are taxable. Report these payments as wages on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ.

Federal Employees' Compensation Act (FECA). Payments made under this Act for personal injury or sickness, including payments to beneficiaries in case of death, are not taxable. However, amounts are taxable that are received under this Act as ''continuation of pay'' for up to 45 days while a claim is being decided. Report this income on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. Also, pay for sick leave while a claim is being processed is taxable and must be included in your income as wages.

You can deduct the amount you spend to ''buy back'' sick leave for an earlier year to be eligible for nontaxable FECA benefits for that period. It is a miscellaneous deduction subject to the 2% limit on Schedule A (Form 1040). If you ''buy back'' sick leave in the same year you use it, the amount reduces your taxable sick leave pay. Do not deduct it separately.

Other compensation. Many other amounts you receive as compensation for injury or illness are not taxable. These include:

- ***Compensatory damages*** received for injury or illness (however, punitive damages in cases not involving physical injury or sickness are taxable),
- ***Benefits received under an accident or health insurance policy*** attributable to premiums you paid,
- ***Disability benefits*** received for loss of income or earning capacity as a result of injuries under a ''no-fault'' automobile policy, and
- ***Compensation received for permanent loss*** or loss of use of a part or function of your body, or for your permanent disfigurement. This compensation must be figured only on the injury and not on the period of your absence from work. These benefits are exempt from tax even though your employer pays for the accident and health plan that provides these benefits.

Reimbursement for medical care. A reimbursement for medical care is generally not taxable. However, this reimbursement may reduce your medical expense deduction. For more information, see Chapter 23.

Scholarship and Fellowship Grants

If you receive a scholarship or fellowship grant, you may be able to exclude from income all or part of the amounts you receive.

Qualified scholarships. Only a candidate for a degree can exclude amounts received as a qualified scholarship. A qualified scholarship is any amount you receive that is for:

1) Tuition and fees to enroll at or attend an educational organization, or
2) Fees, books, supplies, and equipment required for courses at the educational institution.

Amounts used for room and board ***do not*** qualify.

Payments for services. All payments you receive for services must be included in income, even if the services are a condition of receiving the grant and are required of all candidates for the degree. This includes amounts received for teaching and research. Include these payments on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ. Get Publication 520 for information on how to report the taxable portion of scholarships and fellowship grants.

VA payments. Allowances paid by the Department of Veterans Affairs are not included in your gross income. These allowances are not considered scholarship or fellowship grants.

Prizes. Scholarship prizes won in a contest are not scholarships or fellowships if you do not have to use the prizes for educational purposes. You must include these amounts in your gross income on line 21, Form 1040, whether or not you use the amounts for educational purposes.

Qualified tuition reductions. These reductions are excluded from your income. A qualified tuition reduction is the amount of reduction in tuition for education (below the graduate level) furnished to an employee of an educational institution (or certain other persons) provided certain requirements are met. However, graduate students who engage in teaching or research activities for the educational institution may qualify for this exclusion. For more information, get Publication 520.

Part Four.

Gains and Losses

The four chapters in this part discuss investment gains and losses, including how to figure your basis in property. A gain from selling or trading stocks, bonds, or other investment property may be taxed or it may be tax free, at least in part. A loss may or may not be deductible. These chapters also discuss gains from selling property you personally use — including the special rules for selling your home. Nonbusiness casualty and theft losses are discussed in Chapter 27 in Part Five.

14. Basis of Property

Introduction

This chapter discusses how to figure your basis in property and covers the following topics:

- Cost basis of property you purchase.
- Adjustments to basis after you acquire property.
- Property you acquire because of a casualty or condemnation.
- Property you receive in exchange for your services.
- Business or investment property you acquire in an exchange or trade-in.
- Property you receive as a gift.
- Property transferred to you because of a divorce.
- Property you inherit.
- Stocks, bonds, and mutual funds in which you invest.

Basis is a way of measuring your investment in property for tax purposes. Use the basis of property to figure the deductions for depreciation, amortization, depletion, and casualty losses. Also use it to figure gain or loss on the sale or other disposition of property. You must keep accurate records of all items that affect the basis of property so you can make these computations.

Useful Items

You may want to see:

Publication

- ❑ **448** Federal Estate and Gift Taxes
- ❑ **525** Taxable and Nontaxable Income
- ❑ **537** Installment Sales
- ❑ **550** Investment Income and Expenses
- ❑ **551** Basis of Assets
- ❑ **564** Mutual Fund Distributions
- ❑ **917** Business Use of a Car

Cost Basis

The basis of property you buy is usually its cost. The cost is the amount of cash and debt obligations you pay for it and the fair market value of other property or services you provide in the transaction. Your cost also includes amounts you pay for:

1) Sales tax charged on the purchase,
2) Freight charges to obtain the property,
3) Installation and testing charges,
4) Excise taxes,
5) Legal and accounting fees (when they must be capitalized),
6) Revenue stamps,
7) Recording fees, and
8) Real estate taxes (if assumed for the seller).

In addition, the cost basis of real estate and business assets will include other items.

Loans with low or no interest. If you buy property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price, less the amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the applicable federal rate.

For more information, see *Unstated Interest* in Publication 537.

Real Property

If you buy real property, certain fees and other expenses you pay are part of your basis in the property. Real property is land and generally anything erected on, growing on, or attached to land. For example, a building is considered real property.

Assumption of a mortgage. If you buy property and assume an existing mortgage on the property, your basis includes the amount you pay for the property plus the unpaid mortgage you assume.

Settlement fees and other costs. Legal and recording fees are some of the settlement fees or closing costs that are included in the basis of property. Some others are:

1) Abstract fees,
2) Charges for installing utility services,
3) Surveys,
4) Transfer taxes,
5) Title insurance, and
6) Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

You must reasonably allocate these fees or costs between land and improvements, such as a building, to figure the basis for depreciation of the improvements. Settlement fees do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

Expenses paid to obtain a mortgage. If you pay a deductible expense to obtain a mortgage, you generally must capitalize and deduct the expense ratably over the term of the mortgage. Do not add the expense, such as points (prepaid interest), to the basis of the related property.

Points on home mortgage. Special rules may apply to amounts you and the seller pay as points when you obtain a mortgage to purchase your main home. If these amounts meet certain requirements, you can deduct them in full as points for the year in which they are paid. If you deduct seller-paid points, reduce your purchase price by that amount when determining your basis. For more information, see *Points* in Publication 936, *Home Mortgage Interest Deduction.*

Nondeductible expenses. Any nondeductible expenses you pay to purchase real property, such as an appraisal fee for your home or other nonbusiness property, you generally add to the basis of the property. Other expenses, such as fire insurance premiums, cannot be added to the basis of the property.

Real estate taxes. If you buy real property and agree to pay taxes the seller owed on it, treat the taxes you pay as part of the cost. You cannot deduct them as taxes paid.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct that amount. Do not include that amount in the cost of the property.

Adjusted Basis

Before figuring any gain or loss on a sale, exchange, or other disposition of property, or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increases to Basis

Increase the basis of any property by all items properly added to a capital account. This includes the cost of any improvements having a useful life of more than one year and amounts spent after a casualty to restore the damaged property. Other items added to the basis of property include the cost of extending utility service lines to the property and legal fees, such as the cost of defending and perfecting title.

Improvements. Add the cost of improvements that increase the value of property, lengthen its life, or adapt it to a different use to your basis in the property. For example, putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, installing a new roof, or paving your driveway are improvements.

Assessments for local improvements. Add assessments for improvements such as streets and sidewalks, which increase the value of the property assessed, to the basis of the property. Do not deduct them as taxes. For example, if your city puts in a paved sidewalk along the street in front of your home and assesses you and the other affected landowners for the cost of the sidewalk, you must add the assessment to the basis of your property. However, you can deduct as taxes assessments you pay for maintenance or repair or meeting interest charges on the improvements.

Decreases to Basis

Some items that reduce the basis of your property are:

1) The section 179 deduction,
2) The deduction for clean-fuel vehicles and clean-fuel refueling property,
3) Nontaxable corporate distributions,
4) Recognized losses on involuntary exchanges,
5) Deductions previously allowed (or allowable) for amortization, depreciation, and depletion,
6) Exclusions from income of subsidies for energy conservation measures (see *Energy conservation subsidies,* in Chapter 13),
7) Credit for qualified electric vehicles,
8) Gain from the sale of your old home on which tax was postponed,
9) Casualty and theft losses,
10) Rebates received from the manufacturer or seller,
11) Easements,
12) Residential energy credit,
13) Gas-guzzler tax, and
14) Tax credit or refund for buying a diesel-powered highway vehicle.

Some of these decreases to basis are discussed next.

Casualties and thefts. If you have a casualty or theft loss, decrease the basis of your property by the amount of any insurance or other reimbursement you receive and by any deductible loss not covered by insurance. However, increase your basis for amounts you spend after a casualty to restore the damaged property. For more information, see Chapter 27.

Easements. The amount you receive for granting an easement is usually considered to be from the sale of an interest in your real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis to zero and treat the excess as a recognized gain.

If the recognized gain is on a capital asset, see Chapter 17 for more information on how to report it. If the recognized gain is on property used in a trade or business, see Publication 544, *Sales and Other Dispositions of Assets* for more information on how to report this gain.

Residential energy credit. The residential energy credit is no longer available. However, if in the past you were allowed the

Table 14-1. **Examples of Increases and Decreases To Basis**

This chart shows some common examples of items that increase or decrease basis. Usually, you must make these adjustments to basis before you can figure any gain or loss on a sale, exchange, or other disposition of property, or figure allowable depletion, or amortization.

Increases to Basis	Decreases to Basis
Capital improvements: • Putting an addition on your home • Replacing an entire roof • Paving your driveway • Installing central air conditioning • Rewiring your home Assessments for local improvements: • Water connections • Sidewalks • Roads Casualty Losses: • Restoring damaged property	Exclusion from income of subsidies for energy conservation measures: • Amount of the exclusion Casualty or theft losses: • Insurance reimbursements • Casualty or theft loss deductions Easements: • Amount received for granting an easement Credit for qualified electric vehicles: • Amount of the credit Gain from the sale of your old home on which tax was postponed • Amount of gain Residential energy credit: • Amount of the credit if the cost of the energy item was previously added to the basis of your home Section 179 deduction: • Amount of the deduction Deduction for clean-fuel vehicles and clean-fuel vehicle refueling property: • Amount of the deduction Depreciation: • The greater of the depreciation deduction that decreased your tax liability for any year or the deduction you could have taken under the depreciation method that you selected Corporate distributions: • Nontaxable amount

credit, decrease the basis of your home by the credit if you added the cost of the energy items to the basis of your home.

Section 179 deduction. If you take the section 179 deduction for all or part of the cost of business property, decrease the basis of the property by the deduction.

For more information, see Publication 946, *How To Begin Depreciating Your Property.*

Depreciation. Decrease the basis of your property by the depreciation you could have deducted on your tax returns under the method of depreciation you selected. If you deducted more depreciation than you should have, decrease your basis as follows. Decrease it by an amount equal to the depreciation you should have deducted, as well as by the part of the excess depreciation you deducted that actually reduced your tax liability for any year.

However, if you deducted less depreciation than you could have under the method you selected, decrease your basis by the amount that you could have deducted.

For more information on depreciation, see Publication 946.

Credit for qualified electric vehicles. If you claim the credit for qualified electric vehicles, you must reduce the basis of the property on which you claimed the credit. For more information on this credit, see Chapter 15 in Publication 535, *Business Expenses.*

Deduction for clean-fuel vehicle and clean-fuel vehicle refueling property. If you take the deduction for either clean-fuel vehicles or clean-fuel vehicle refueling property, or both, you decrease the basis of the property by the amount of the deduction. For more information on these deductions, see Chapter 15 in Publication 535.

Exclusion from income of subsidies for energy conservation measures. If you received a subsidy from a public utility company for the purchase or installation of any energy conservation measure, you can exclude it from income. Reduce the basis of the property on which you received the subsidy by the excluded amount. For more information on this subsidy, see Publication 525, *Taxable and Nontaxable Income.*

Adjusted Basis Example

You owned a duplex used as rental property that cost you $40,000. The $40,000 cost was allocated $35,000 for the building and $5,000 for the land. You added an improvement to the duplex that cost $10,000. On February 1, 1993, the duplex was damaged by fire. Up to that time you had been allowed depreciation of $23,000. You sold the salvage for $1,300 and collected $19,700 from your insurance company. You deducted a casualty loss of $1,000 on your 1993 income tax return. You spent $19,000 of the insurance proceeds for restoration of the duplex, which was completed in 1994. The adjusted basis of the duplex, after the restoration, is figured as follows:

Original cost of duplex		$35,000
Addition to duplex		10,000
Total cost of duplex		$45,000
Minus: Depreciation		23,000
Adjusted basis before casualty		$22,000
Minus: Casualty loss	$ 1,000	
Insurance proceeds	19,700	
Salvage proceeds	1,300	22,000
Adjusted basis after casualty		$ –0–
Add: Cost of restoring duplex		19,000
Adjusted basis after restoration		$19,000

Your basis in the land is its original cost of $5,000.

Other Basis

There are many times when you cannot use cost as a basis. In these cases, the fair market value or the adjusted basis of certain property may be important. Fair market value is discussed next, adjusted basis is discussed earlier.

Fair market value (FMV). FMV is the price at which the property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts. Sales of similar property, on or about the same date, may be helpful in figuring the FMV of the property.

Property received for services. If you receive property for your services, include the property's FMV in income. The amount you include in income becomes your basis.

Restricted property. If you receive property for your services and the property is subject to certain restrictions, your basis in the property is its FMV when it becomes substantially vested, unless you make an election. Property becomes substantially vested when you can transfer it or when it is not subject to a substantial risk of forfeiture. For more information, see *Restricted Property Received for Services* in Publication 525.

Bargain purchases. A bargain purchase is a purchase of an item for less than its FMV. If your employer lets you purchase goods or other property at less than FMV, include the difference between the purchase price and the property's FMV in your income. Your basis in the property is its FMV, that is, your purchase price plus the amount you include in your income. If this difference represents a qualified employee discount, you do not include the difference in income. However, your basis in the property is still its FMV. See *Qualified Employee Discount* in Chapter 4 of Publication 535.

Taxable exchanges. A taxable exchange is one in which the gain is taxable or the loss is deductible. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its FMV at the time of the exchange.

Involuntary Exchanges

If you acquire property as a result of an involuntary exchange, such as a casualty, theft, or condemnation, you may figure the basis of the replacement property you acquire using the basis of the property exchanged.

Similar or related property. If you receive property that is similar or related in service or use to the property exchanged, the new property's basis is the same as the old property's basis on the date of the exchange with the following adjustments:

Decreased by—

a) Any loss recognized on the exchange, and

b) Any money received that was not spent on similar property.

Increased by—

a) Any gain recognized on the exchange, and

b) Any cost of acquiring replacement property.

Not similar or related property. If you receive money or other property that is not similar or related in service or use to the old property, and you buy new property that is similar or related in service or use to the old property, the basis of the new property is the cost of the new property, decreased by the amount of gain that is not recognized on the exchange.

Example. The state condemned your property. The property had an adjusted basis of $26,000, and the state paid you $31,000 for it. You realized a gain of $5,000 ($31,000 – $26,000). You bought new property that is similar in use to the old property for $29,000. You recognize a gain of $2,000 ($31,000 – $29,000), the unspent part of the payment from the state. Your gain not recognized is $3,000, the difference between the $5,000 realized gain and the $2,000 recognized gain. The basis of the new property is figured as follows:

Cost of new property	$29,000
Minus: Gain not recognized	3,000
Basis of new property	$26,000

Allocating the basis. If you buy more than one piece of replacement property, allocate your basis among the properties based on their respective costs.

If, in the previous example, the state had condemned unimproved real property, and the new property you bought was improved real property with both land and buildings, you would make an allocation. Take the new

property's $26,000 basis and allocate it between land and buildings based on their costs.

Nontaxable Exchanges

A nontaxable exchange is an exchange in which any gain is not taxed and any loss cannot be deducted. In a nontaxable exchange, business or investment property is exchanged solely for like property, stock is exchanged solely for stock of the same corporation, or property is exchanged for securities of a controlled corporation. The basis of property you receive in a nontaxable exchange is usually the same as the basis of the property you exchanged. See *Nontaxable Trades* in Chapter 15.

Partially nontaxable exchange. A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property.

The basis of property you receive is usually the same as the basis of the property exchanged ***decreased*** by any money you received and any loss recognized on the exchange; and then ***increased*** by any additional costs incurred and any gain recognized on the exchange.

Allocate the basis among the properties, other than money, you received in the exchange. In making this allocation, the basis of the unlike property is its fair market value on the date of exchange. The remainder is the basis of the like property.

Example. You trade in an old truck, which has an adjusted basis of $1,700, for a new one costing $6,800. The dealer allows you $2,000 on the old truck, and you pay $4,800. This is a nontaxable exchange, and the basis of the new truck is $6,500, that is, the adjusted basis of the old one, $1,700, increased by the additional cost, $4,800. If you sell your old truck to a third party for $2,000 and then buy the new one from the dealer, you have a taxable gain on the sale, and the basis of the new truck is the price you pay the dealer for it.

Trade-in or sale and purchase. If a sale and purchase are a single transaction, you cannot increase the basis of property for depreciation by selling your old property outright to a dealer and then buying the new property from the same dealer. If the sale to the dealer of your old property and your purchase from that dealer of the new property are dependent on each other, you are considered to have traded in your old property. Treat the transaction as an exchange no matter how it is carried out.

Example. You are a salesperson and use one of your cars 100% for business. You have used this car in your sales activities for 2 years and have depreciated it. Your adjusted basis in the car is $2,600, and its FMV is $3,100.

You are interested in a new car with a listed retail price of $8,695, which usually sells for $8,000. If you trade your old car and $4,900 for the new one, your basis for depreciation for the new car would be $7,500 ($4,900 plus $2,600 basis of your old car). However, you want a higher basis for depreciating the new car, so you agree to pay the dealer $8,000 for the new car if he will pay you $3,100 for your old car.

Since the sale and purchase are dependent on each other, you are treated as if you had exchanged your old car for the new one. Your basis for depreciating the new car is $7,500, which is the same as it would be if you had traded the old car.

For information about the trade of a car used partly for business, see Publication 917.

Property Received as a Gift

To figure the basis of property you receive as a gift, you must know its adjusted basis to the donor just before it was given to you, its FMV at the time it was given to you, and any gift tax paid on it.

FMV less than donor's adjusted basis. If the FMV of the property was less than the donor's adjusted basis, your basis for gain on its sale or other disposition is the same as the donor's adjusted basis plus or minus any required adjustment to basis during the period you held the property (see *Adjusted Basis,* earlier). Your basis for loss on its sale or other disposition is its FMV at the time you received the gift plus or minus any required adjustment to basis during the period you held the property. See *Adjusted Basis,* earlier.

Example. You received an acre of land as a gift. At the time of the gift, the acre had an FMV of $8,000. The donor's adjusted basis was $10,000. After you received the property, no events occur that would increase or decrease your basis in it. If you later sell the property for $12,000, you have a $2,000 gain because you must use the donor's adjusted basis ($10,000) at the time of the gift as your basis to report a gain. If, however, you sell the property for $7,000, you have a loss of $1,000 because you must use the FMV ($8,000) at the time of the gift to report a loss.

If the sales price is between $8,000 and $10,000, you have neither a gain nor a loss. For instance, if the sales price was $9,000 and you tried to figure a gain using the donor's adjusted basis ($10,000), you would get a loss of $1,000. If you then tried to figure a loss using the FMV ($8,000), you would get a gain of $1,000.

Business property. If you hold the gift as business property, your basis for figuring any depreciation, depletion, or amortization deduction is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you hold the property.

FMV equal to or greater than donor's adjusted basis. If the FMV of the property was equal to or greater than the donor's adjusted basis, your basis is the same as the donor's adjusted basis at the time you received the gift. Increase your basis by all or part of the gift tax paid, depending on the date of the gift.

Also, for figuring gain or loss from a sale or other disposition of the property or figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis (the donor's adjusted basis) for any required adjustments to basis while you held the property. See *Adjusted Basis,* earlier.

Gift received before 1977. If you received a gift before 1977, increase your basis in the gift by the gift tax paid on it. (Your basis in the gift is the donor's adjusted basis.) However, do not increase your basis above the FMV of the gift when it was given to you.

Example 1. You were given a house in 1976 with an FMV of $21,000. The donor's adjusted basis was $20,000. The donor paid a gift tax of $500. Your basis is $20,500, the donor's adjusted basis plus the gift tax paid.

Example 2. If, in Example 1, the gift tax paid had been $1,500, your basis would be $21,000. This is the donor's adjusted basis plus the gift tax paid, limited to the FMV of the house at the time you received the gift.

Gift received after 1976. If you received a gift after 1976, increase your basis in the gift by the part of the gift tax paid that is due to the net increase in value of the gift. (Your basis in the gift is the donor's adjusted basis.) Figure the increase by multiplying the gift tax paid on the gift by a fraction. The numerator (top part) of the fraction is the net increase in value of the gift, and the denominator (bottom part) is the amount of the gift. The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis.

Example. In 1994 you received a gift of property from your mother that had an FMV of $50,000. Her adjusted basis was $20,000. She paid a gift tax of $9,000 on the property. For figuring depreciation, depletion, amortization, and gain or loss, your basis is $25,400, figured as follows:

Fair market value	$50,000
Minus: Adjusted basis	20,000
Net increase in value	$30,000
Gift tax paid	$ 9,000
Multiplied by ($30,000 ÷ $50,000)	.60
Gift tax due to net increase in value	$ 5,400
Adjusted basis of property to your mother	20,000
Your basis in the property	$25,400

Property Transferred From a Spouse

The basis of property transferred to you or transferred in trust for your benefit by your spouse, or by your former spouse if the transfer is incident to divorce, is the same as the transferor's adjusted basis of the property. However, adjust your basis for any gain recognized by the transferor on a property transferred in trust. This rule applies only to a

property transfer in which the liabilities assumed, plus the liabilities to which the property is subject, are more than the adjusted basis of the property transferred.

If the property transferred is a Series E or EE United States savings bond, the transferor must include in income the interest accrued to the date of transfer. The transferee's basis in the bond immediately after the transfer is equal to the transferor's adjusted basis in the bond increased by the interest income includible in the transferor's income.

The transferor must supply you with records necessary to determine the adjusted basis and holding period of the property as of the date of the transfer. For more information regarding the transfer of property between spouses, see Chapter 15.

Inherited Property

Your basis in property you inherit is usually its FMV at the date of the decedent's death. If a federal estate tax return has to be filed, your basis in property you inherit can be its FMV at the alternate valuation date if the estate qualifies and elects to use alternate valuation. If a federal estate tax return does not have to be filed, your basis in the property is its appraised value at the date of death for state inheritance or transmission taxes.

Your basis in inherited property may also be figured under the special farm or closely held business real property valuation method, if chosen for estate tax purposes. See Publication 448 for information on valuation methods for estate tax purposes.

For more information about the basis of inherited property, such as property held by a surviving tenant and qualified joint interest in property held by a husband and wife, see *Inherited Property* in Publication 551.

Property Changed to Business or Rental Use

When you hold property for personal use and change it to business use or use it to produce rent, you must figure the basis for depreciation. An example of this would be renting out your former main home.

Basis for depreciation. The basis for depreciation equals the lesser of:

1) The FMV (defined earlier under *Other Basis*) of the property on the date of the change, or
2) Your adjusted basis (defined earlier, see *Adjusted Basis*) on the date of the change.

Example. Several years ago you paid $60,000 to have your house built on a lot that cost you $10,000. Before changing the property to rental use last year, you paid $20,000 for permanent improvements to the house and claimed a $2,000 casualty loss deduction to the house. Because land is not depreciable, you can include only the cost of the house when figuring the basis for depreciation.

Your adjusted basis in the house when you change its use is $78,000 ($60,000 + $20,000 – $2,000). On the date of the change in use, your property has an FMV of $80,000, of which $15,000 is for the land and $65,000 is for the house. The basis for depreciation on the house is the FMV at the date of the change ($65,000) because it is less than your adjusted basis ($78,000).

Sale of property. If you later sell or dispose of the property, the basis of the property to be used will depend on whether you are figuring gain or loss.

Gain. The basis for gain is your adjusted basis when you sell the property. Assume the same facts as in the previous example, except that after being allowed depreciation deductions of $3,750 you sell the property at a gain. Your adjusted basis in this case would be $84,250 ($78,000 + $10,000 (land) – $3,750).

Loss. Figure the basis for loss using the smaller of your adjusted basis or the FMV of the property at the time of the change. Assume the same facts as in the previous example, except that after being allowed depreciation deductions of $3,750, you sell the property at a loss. Your adjusted basis in this case would be the FMV ($80,000) because it is less than the adjusted basis ($88,000) on the date of the exchange. That amount ($80,000) is reduced by the depreciation deduction to arrive at a basis of $76,250 ($80,000 – $3,750).

Stocks and Bonds

The basis of stocks or bonds you own generally is the purchase price plus the costs of purchase such as commissions and recording or transfer fees. If you acquired stocks or bonds other than by purchase, your basis is usually determined by FMV or the donor's adjusted basis, as previously discussed.

The basis of stocks must be adjusted for certain events that occur after purchase. For example, if you receive additional stock from nontaxable stock dividends or stock splits, reduce the basis of your original stock. Also reduce your basis when you receive nontaxable distributions because these are a return of capital.

Example. In 1992, you bought 100 shares of XYZ stock for $1,000 or $10 a share. In 1993, you bought 100 shares of XYZ stock for $1,600 or $16 a share. In 1994, XYZ declared a 2-for-1 stock split. You now have 200 shares of stock with a basis of $5 a share and 200 shares with a basis of $8 a share.

Other basis. There are other ways to determine the basis of stocks or bonds depending on how you acquired them. Some ways in which you can acquire stock are by automatic investment services, dividend reinvestment plans, and stock rights. For detailed information, see Publication 550.

Identifying shares. If you buy and sell securities at different times in varying quantities and you cannot definitely identify the securities you sell, the basis of those sold is figured under the first-in first-out method—that is, the first securities you acquired are the first sold.

Identification. You make an adequate identification if you show you delivered to your broker or agent certificates for securities that you purchased on a certain date or for a specific price.

If you left the security certificates with your broker or other agent, an adequate identification is made if you:

1) Tell your broker the particular security to be sold or transferred at the time of the sale or transfer, and
2) Receive a written confirmation of this from your broker or other agent within a reasonable time.

If you bought securities in different lots at different times and you hold a single certificate for these securities, you make an adequate identification if you:

1) Tell your broker the particular security to sell or transfer when you deliver the certificate to your broker, and
2) Receive a written confirmation of this from your broker or other agent within a reasonable time.

Mutual fund shares. If you sell or exchange mutual fund shares, you can choose to use an average basis if:

1) You acquired the shares at different times and prices, and
2) You left the shares on deposit in an account kept by a custodian or agent.

For more information, see *Average Basis* in Publication 564.

Premiums on bonds. If you buy a taxable bond at a premium and choose to amortize the premium paid, reduce the basis of the bond by the amount of the amortized premium deducted each year. See *Bond Premium Amortization* in Chapter 3 of Publication 550 for more information. Although you cannot take a deduction for the premium on tax-exempt bonds, each year you must amortize the premium and reduce your basis in the bonds by the amortized amount.

Original issue discount (OID) on debt instruments. You must increase your basis in an OID debt instrument by the amount of OID that you included in income for that instrument. See *Original Issue Discount* in Chapter 8.

Tax-exempt bonds. OID on tax-exempt bonds is not taxable. However, there are special rules for determining basis on tax-exempt OID bonds issued after September 3, 1982, and acquired after March 1, 1984. See Chapter 1 of Publication 550.

15.

Sale of Property

Important Reminders

Rollover provided for gain from sale of publicly traded securities. You may be able to postpone reporting part or all of your capital gain from publicly traded securities sold after August 9, 1993, if you buy certain replacement property within 60 days of the sale and meet certain other requirements. The replacement property must be common stock or a partnership interest in a specialized small business investment company. The amount of gain you can postpone may be limited. For more information, see *Rollover of Gain* later in this chapter.

Holding period. The holding period for a long-term capital gain or loss generally is more than one year. The holding period for a short-term capital gain or loss generally is one year or less.

Introduction

This chapter discusses the tax consequences of selling or trading investment property. It explains:

- What is a sale or trade,
- When you have a nontaxable trade,
- What to do with a related party transaction,
- Whether the property you sell is a capital asset or a noncapital asset,
- Whether you have a capital or ordinary gain or loss from the sale of property,
- How to determine your holding period, and
- When you can make a tax-free rollover of a gain from selling certain securities.

Sales not discussed in this publication. Certain sales or trades of property are discussed in other IRS publications. They include, for example, installment sales, covered in Publication 537, *Installment Sales,* and transfers of property at death, covered in Publication 559, *Survivors, Executors, and Administrators.*

Publication 544, *Sales and Other Dispositions of Assets,* provides information about various types of transactions involving business property, including dispositions of assets used in a trade or business or for the production of income.

Publication 550, *Investment Income and Expenses,* provides more detailed discussion about sales and trades of investment property. Publication 550 includes information about the rules covering nonbusiness bad debts, straddles, section 1256 contracts, puts and calls, commodity futures, short sales, and wash sales. It also discusses investment-related expenses.

Publication 925, *Passive Activity and At-Risk Rules,* discusses the rules that limit losses and credits from passive activities as well as the rules that apply to the disposition of an interest in a passive activity.

If you sell your home, different tax rules apply. These rules are discussed in Chapter 16.

Note: Beginning in 1998, you may have to pay tax on only one-half of your gain from the sale or exchange of ***qualified small business stock.*** This applies only to stock originally issued after August 10, 1993, and held by you for more than 5 years. You must have acquired the stock at its original issue, directly or through an underwriter, in one of the following ways:

1) In exchange for money or other property (not including stock), or
2) As compensation for services performed (other than services performed as an underwriter of the stock).

For more information, see *Exclusion for Gain From Small Business Stock* in Chapter 4 of Publication 550.

Useful Items

You may want to see:

Publication

- ❑ **504** Divorced or Separated Individuals
- ❑ **550** Investment Income and Expenses
- ❑ **564** Mutual Fund Distributions

Form (and Instructions)

- ❑ **Schedule D (Form 1040)** Capital Gains and Losses
- ❑ **8824** Like-Kind Exchanges

Sales and Trades

Sales and trades (or exchanges) of assets generally result in taxable gains or deductible losses, although some trades of property are nontaxable.

Form 1099–B. If you sold property such as stocks, bonds, or certain commodities through a broker, you should receive Form 1099–B, *Proceeds From Broker and Barter Exchange Transactions,* or an equivalent statement from the broker. You should receive the statement by January 31, 1995, showing the gross proceeds from sales during 1994. The Internal Revenue Service (IRS) will also get a copy of Form 1099–B from the broker.

If you receive a Form 1099–B or equivalent statement, you must complete Schedule D of Form 1040.

Unstated interest and imputed principal rules for sales or exchanges. For information about the unstated interest rules applicable to certain payments received on account of a ***seller-financed*** sale or exchange of property, and about the imputed principal rules applicable to any debt instrument issued on account of such transactions, see Publication 537.

What is a Sale or Trade?

A sale is generally a transfer of property for money only or for a promise to pay money, such as a mortgage or note. A trade is a transfer of property in return for other property or services and may be taxed in the same way as a sale.

Sale and purchase. Ordinarily, a transaction is not a trade when you voluntarily sell property for cash and immediately buy similar property to replace it. Such a sale and purchase are two separate transactions.

Redemption of stock. A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

Dividend vs. sale or trade. Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

1) The redemption is not essentially equivalent to a dividend (see Chapter 9),
2) There is a substantially disproportionate redemption of stock,
3) There is a complete redemption of all the stock of the corporation owned by the shareholder, or
4) The redemption is a distribution in partial liquidation of a corporation.

Redemption or retirement of bonds. A redemption or retirement of bonds or notes at their maturity is a sale or trade that you must report on Schedule D (Form 1040) whether or not you realize gain or loss on the transaction.

However, if the issuer has merely extended the maturity date of its notes, during which period some of the noteholders have agreed not to redeem their notes until all the other notes are retired or their retirement is provided for, neither a trade nor a closed or completed transaction has occurred. Under these circumstances, you do not figure gain or loss.

Surrender of stock. A surrender of stock by a dominant shareholder, who retains control of the corporation, is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must reallocate his

or her basis in the surrendered shares to the shares he or she retains.

How to Figure a Gain or Loss

You figure gain or loss on a sale or trade of property by comparing the amount you realize with the adjusted basis of the property.

Gain. If the amount you realize from a sale or trade is more than the adjusted basis of the property you transfer, the difference is a gain.

Loss. If the adjusted basis of the property you transfer is more than the amount you realize, the difference is a loss.

Adjusted basis. The adjusted basis of property is your original cost or other original basis properly adjusted (increased or decreased) for certain items. See Chapter 14 for more information about determining the adjusted basis of property.

Amount realized. The amount you realize from a sale or trade of property is everything you receive for the property. This includes the money you receive plus the fair market value of any property or services you receive.

Fair market value. Fair market value is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts.

The fair market value of notes or other evidence of indebtedness you receive as a part of the sale price is usually the best amount you can get from selling them to, or discounting them with, a bank or other buyer of such debt instruments.

Debt paid off. An indebtedness against the property, or against you, that is paid off as a part of the transaction, or that is assumed by the buyer, must be included in the amount realized. This is true even if neither you nor the buyer is personally liable for the debt. For example, if you sell or trade property that is subject to a nonrecourse loan, the amount you realize includes the full amount of the note assumed by the buyer even though the amount of the note exceeds the fair market value of the property.

Payment of cash. If you trade property for other property and in addition pay cash, the amount you realize is the fair market value of the property you receive. Determine your gain or loss by subtracting your adjusted basis (the cash you pay plus the adjusted basis of the property you traded in) from the amount you realize. If the result is a positive number, it is a gain. If the result is a negative number, it is a loss.

Example 1. You sell stock that you had pledged as security for a bank loan of $8,000. Your basis in the stock is $6,000. The buyer pays off your bank loan and pays you $20,000 in cash. The amount realized is $28,000 ($20,000 + $8,000). Your gain is $22,000 ($28,000 – $6,000).

Example 2. You trade A Company stock with an adjusted basis of $7,000 for B Company stock with a fair market value of $10,000, which is your amount realized. Your gain is $3,000 ($10,000 – $7,000). If you also receive a note for $6,000 that has a discount value of $4,000, your gain is $7,000 ($10,000 + $4,000 – $7,000).

No gain or loss. You may be required to use a basis for figuring gain different from that used for figuring loss. In this case, you may not have a gain or a loss. See *Other Basis* in Chapter 14. In these situations, if you use the basis for figuring a gain and the result is a loss, and then use the basis for figuring a loss and the result is a gain, you will have neither a gain nor a loss.

Example. You receive a gift of investment property having an adjusted basis of $10,000 at the time of the gift. The fair market value at the time of the gift is $9,000. You later sell the property for $9,500. You have neither gain nor loss. Your basis for figuring gain is $10,000, and $10,000 minus $9,500 results in a $500 loss. Your basis for figuring loss is $9,000, and $9,500 minus $9,000 results in a $500 gain.

Nontaxable Trades

Certain trades or exchanges are nontaxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. In other words, even though you may realize a gain or loss on the exchange, it will not be recognized for tax purposes. The property you get generally has the same basis as the adjusted basis of the property you gave up.

If you traded business property or depreciable investment property, see Publication 544.

Like-kind exchanges. If you traded business or investment property for other business or investment property of a like kind, you must postpone tax on the gain or postpone deducting the loss until you sell or dispose of the property you receive. To be nontaxable, a trade must meet all six of the following conditions:

1) The property must be business or investment property. You must hold both the property you trade and the property you receive for business or investment purposes. Neither property may be used for personal purposes, such as your home or family car.
2) The property must not be property held for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise. It must be property held for investment or property held for productive use in your trade or business.
3) There must be an exchange of like-kind property. The exchange of real estate for real estate and the exchange of personal property for similar personal property are exchanges of like-kind property. The trade of an apartment house for a store building, or a panel truck for a pickup truck, are like-kind exchanges. The exchange of a piece of machinery for a store building is not a like-kind exchange.
4) The property must not be stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidence of indebtedness or interest, including partnership interests. However, you can have a nontaxable exchange of corporate stocks, as discussed later under *Corporate stocks.*
5) The property must meet the identification requirement. The property to be received must be identified on or before the day that is 45 days after the date of transfer of the property given up in the exchange.
6) The exchange must meet the completed transaction requirement. The property must be received on or before the earlier of:
   a) The 180th day after the date on which you transfer the property given up in the transfer, or
   b) The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

Partially nontaxable exchange. If, in addition to like-kind property, you receive cash or nonlike-kind property, and the above conditions are met, you have a partially nontaxable trade. You are taxed on any gain you realize, but only to the extent of the cash and the fair market value of the nonlike-kind property you receive. You cannot deduct a loss.

Like-kind property and nonlike-kind property transferred. If you give up nonlike-kind property in addition to the like-kind property, you must recognize gain or loss only on the nonlike-kind property you give up. The gain or loss is the difference between the adjusted basis of the nonlike-kind property and its fair market value. See Chapter 1 of Publication 544 for more information about partially nontaxable exchanges.

Like-kind property and money transferred. If conditions (1) – (6) are met, you have a nontaxable trade even if you pay money in addition to transferring property in exchange for like-kind property.

Basis. To figure the basis of the property received, see *Nontaxable Exchanges,* in Chapter 14.

How to report. You must report the exchange of business or investment like-kind property on **Form 8824,** *Like-Kind Exchanges.* If you figure a recognized gain or loss on Form 8824, report it on Schedule D of

Form 1040 or on Form 4797, *Sales of Business Property,* whichever applies.

For exchanges you report on Schedule D, enter any gain or loss from Form 8824 on line 4 or line 12 of Schedule D. (See Chapter 17 to determine whether to use line 4 or line 12.)

To compute any partial gains or losses and for more information on like-kind exchanges, see the instructions for Form 8824. For more information on how to report the sale of business property, see Publication 544.

Transfers of property between spouses or incident to divorce. Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or a former spouse if incident to a divorce. This nonrecognition rule does not apply if the recipient-spouse or former spouse is a nonresident alien. The rule also does not apply to a transfer in trust to the extent the adjusted basis of the property is less than the amount of the liabilities assumed and liabilities on the property.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the transferee as acquired by gift and is not considered a sale or exchange. The transferee's basis in the property will be the same as the adjusted basis of the transferor immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer. This rule applies for purposes of determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

A transfer of property is incident to a divorce if the transfer occurs within one year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage.

For more information, see Publication 504.

Corporate stocks. The following trades of corporate stocks generally do not result in a taxable gain or a deductible loss.

Stock for stock of the same corporation. You can exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two persons as well as a trade between a stockholder and a corporation.

In some instances, you can trade common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation without having a recognized gain or loss. These trades must be part of mergers, recapitalizations, transfers to controlled corporations, bankruptcies, corporate divisions, corporate acquisitions, or other corporate reorganizations.

Convertible stocks and bonds. You will not have a recognized gain or loss if you convert bonds into stock or preferred stock into common stock of the same corporation according to a conversion privilege in the terms of the bond or the preferred stock certificate, except where gain is specifically required to be recognized.

Property for stock of a controlled corporation. If you transfer property to a corporation solely in exchange for stock in that corporation, and immediately after the trade you are in control of the corporation, you ordinarily will not recognize a gain or loss. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply if the corporation is an investment company.

However, if you had a gain from the disposition of depreciable property from this transaction, you may be taxed on part of the gain. See Publication 544 for more information.

For this purpose, to be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote, and at least 80% of the outstanding shares of each class of nonvoting stock of the corporation.

If this provision applies to you, you must attach to your return a complete statement of all facts pertinent to the exchange.

Additional information. For more information on trades of stock, see *Nontaxable Trades* in Publication 550.

Insurance policies and annuities. You will not have a recognized gain or loss if you trade:

1) A life insurance contract for another life insurance contract or for an endowment or an annuity contract,
2) An endowment contract for an annuity contract, or for another endowment contract that provides for regular payments beginning at a date not later than the beginning date under the old contract, or
3) An annuity contract for another annuity contract.

The insured or annuitant must stay the same as under the original contract. Exchanges of contracts not included in this list, such as an annuity contract for an endowment contract, or an annuity or endowment contract for a life insurance contract, are taxable.

U.S. Treasury notes or bonds. You can trade certain issues of U.S. Treasury obligations for other issues, designated by the Secretary of the Treasury, with no gain or loss recognized on the trade. See *U.S. Treasury Notes or Bonds* under *Nontaxable Trades* in Publication 550 for information about the tax treatment of income from these investments. For other information on Treasury notes or bonds, write to:

Bureau of the Public Debt
U.S. Department of Treasury
Customer Inquiry Section, Room 429
Washington, D.C. 20239–0001

Related Party Transactions

Special rules apply to the sale or trade of property between related parties.

Like-kind exchanges. Generally, if you trade business or investment property for other business or investment property of a like kind, no gain or loss is recognized. See *Like-kind exchanges* discussed earlier under *Nontaxable Trades.*

This rule also applies to exchanges of property between related parties, defined next under *Loss on sale or trade of property.* However, if either related party disposes of the like-kind property within 2 years after the exchange, the gain or loss on the exchange must be recognized. Each related person must report any gain or loss not recognized on the original exchange on the tax return filed for the year in which the later disposition occurred.

These rules generally ***do not apply*** to:

Dispositions due to the death of either related person,

Involuntary conversions (see Chapter 1 of Publication 544), or

Exchanges or dispositions whose main purpose is not the avoidance of federal income tax.

The 2–year period does not include the period during which the holder's risk of loss is substantially diminished by:

The holding of a put on the property,

The holding by another person of a right to acquire the property, or

A short sale or any other transaction.

Loss on sale or trade of property. You cannot deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between you and the following related parties:

1) Members of your family — this includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.),
2) A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock. See *Constructive ownership of stock,* later, or
3) A tax-exempt charitable or educational organization that is directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

In addition, a loss on the sale or trade of property is not deductible if the transaction is

directly or indirectly between the following related parties:

1) A grantor and fiduciary, or the fiduciary and beneficiary, of any trust,
2) Fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts,
3) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned by or for the trust, or by or for the grantor of the trust,
4) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership,
5) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation,
6) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation,
7) Two corporations that are members of the same controlled group (under certain conditions, however, such losses are not disallowed but must be deferred),
8) Two partnerships if the same persons own, directly or indirectly, more than 50% of the capital interests or the profits interests, or
9) A partnership and a person who owns, directly or indirectly, more than 50% of the capital interest, or the profits interest, in the partnership.

If you sell or trade to a related party a number of blocks of stock or pieces of property in a lump sum, you must figure the gain or loss separately for each block of stock or piece of property. The gain on each item may be taxable. However, you cannot deduct the loss on any item. Also, you cannot reduce gains from the sales of any of these items by losses on the sales of any of the other items.

Indirect transactions. These include sales through a stock exchange. You cannot deduct your loss on the sale of stock through your broker if, for example, under a prearranged plan a related party or entity buys the same stock that you had owned.

Constructive ownership of stock. In determining whether a person ***directly or indirectly*** owns any of the outstanding stock of a corporation, the following rules apply.

Rule 1. Stock directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

Rule 2. An individual is considered to own the stock that is directly or indirectly owned by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

Rule 3. An individual owning, other than by applying rule 2, any stock in a corporation is considered to own the stock that is directly or indirectly owned by or for his or her partner.

Rule 4. When applying rule 1, 2, or 3, stock constructively owned by a person under rule 1 is treated as actually owned by that person. But stock constructively owned by an individual under rule 2 or 3 is not treated as owned by that individual for again applying either rule 2 or 3 to make another person the constructive owner of the stock.

Property received from a related party. If you sell or trade at a gain property that you acquired from a related party, you recognize the gain only to the extent it is more than the loss previously disallowed to the transferor. This rule applies only if you are the original transferee and you acquired the property by purchase or exchange. This rule does not apply if the transferor's loss was disallowed because of the wash sale rules, described in Publication 550 under *Wash Sales.*

Example 1. Your brother sells you stock with a cost basis of $10,000 for $7,600. Your brother cannot deduct the loss of $2,400. Later, you sell the same stock to an unrelated party for $10,500, thus realizing a gain of $2,900. Your reportable gain is $500 — the $2,900 gain minus the $2,400 loss not allowed to your brother.

Example 2. If, in *Example 1,* you sold the stock for $6,900 instead of $10,500, your recognized loss is only $700 ($7,600 basis minus $6,900). You cannot deduct the loss that was not allowed to your brother.

Gain on sale or trade of depreciable property. The capital gain provisions do not apply and your gain is ordinary income, if:

1) You have a recognized gain on the sale or trade of property, including a leasehold or a patent application, that is depreciable property in the hands of the party who receives it, and
2) The transaction is between you and a controlled entity, or you and a trust in which you or your spouse is a beneficiary.

See Chapter 2 in Publication 544 for more information.

Capital or Ordinary Gain or Loss

This section discusses the tax treatment of different types of investment transactions. For information about the tax treatment of gains and losses on the sale or exchange of property used in a trade or business, see Publication 544.

If you have a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or loss, depending on the circumstances. Generally, a sale or trade of a capital asset (defined later) results in a capital gain or loss. A sale or trade of a noncapital asset generally results in ordinary gain or loss. Depending on the circumstances, a gain or loss on a sale or trade of property used in a trade or business may be treated as either capital or ordinary, as explained in Publication 544. In some situations, part of your gain or loss may be a capital gain or loss and part may be an ordinary gain or loss.

Character of gain or loss. It is important for you to properly distinguish or classify your gains and losses as either ordinary or capital gains or losses. You also need to classify your capital gains and losses as either short-term or long-term. The correct classification helps you figure the limit on capital losses and your proper tax if you can use the *Capital Gain Tax Computation* explained in Chapter 17.

For information about determining whether your capital gain or loss was short-term or long-term, see the discussion under *Holding Period,* later in this chapter.

Capital Assets and Noncapital Assets

For the most part, everything you own and use for personal purposes, pleasure, or investment is a ***capital asset.*** Some examples are:

- Stocks or bonds held in your personal account
- A house owned and used by you and your family
- Household furnishings
- A car used for pleasure or commuting
- Coin or stamp collections
- Gems and jewelry
- Gold, silver, or any other metal

The following items are ***noncapital assets:***

1) ***Property held mainly for sale to customers*** or property that will physically become a part of the merchandise that is for sale to customers;
2) ***Depreciable property*** used in your trade or business, even though fully depreciated;
3) ***Real property*** used in your trade or business;
4) ***A copyright, a literary, musical, or artistic composition, a letter or memorandum,*** or similar property:
   a) That you created by your personal efforts,
   b) That was prepared or produced for you as a letter, memorandum, or similar property, or

c) That you acquired under circumstances (for example, by gift) entitling you to the basis of a person who created the property or for whom it was prepared or produced;

5) ***Accounts or notes receivable*** acquired in the ordinary course of a trade or business, or for services rendered as an employee, or from the sale of any of the properties described in (1); and

6) ***U.S. Government publications*** that you received from the government free or for less than the normal sales price, or that you acquired under circumstances entitling you to the basis of someone who received the publications free or for less than the normal sales price.

Property Held for Personal Use

Property held for personal use is a capital asset. Gain from a sale or exchange of that property is a capital gain. Loss from the sale or exchange of that property is not deductible unless it results from a personal casualty loss, such as a loss caused by a fire or hurricane as discussed in Chapter 27.

Investment Property

Investment property is a capital asset. Any gain or loss from its sale or exchange is generally a capital gain or loss.

Gold, silver, stamps, coins, gems, etc. These are capital assets except when they are held for sale by a dealer. Any gain or loss you have from their sale or trade generally is a capital gain or loss.

Stocks, stock rights, and bonds. All of these (including stock received as a dividend) are capital assets except when held for sale by a securities dealer. However, if you own small business stock, see *Losses on Small Business Stock* and *Exclusion for Gain From Small Business Stock* in Publication 550.

Worthless securities. Stocks, stock rights, and corporate or government bonds with interest coupons or in registered form, which became worthless during the tax year, are treated as though they were capital assets sold on the last day of the tax year if they were capital assets in your hands. To determine whether they are long-term or short-term capital assets, you are considered to have held the stocks or securities until the last day of the year in which they became worthless. See *Holding Period,* later.

If you are a cash-basis taxpayer and make payments on a negotiable promissory note that you issued for stock that became worthless, you can deduct these payments as losses in the years you actually make the payments. Do not deduct them in the year the stock became worthless.

How to report loss. Report worthless securities on line 1 or line 9 of Schedule D (Form 1040), whichever is applicable. In columns (c) and (d), write "Worthless."

Filing a claim for refund. If you do not claim a loss for a worthless security on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the loss. Use Form 1040X, *Amended U.S. Individual Income Tax Return,* to amend your return for the year the security became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in Chapter 1.

Discounted debt instruments. Treat your gain or loss on the sale, redemption, or retirement of a bond or other evidence of indebtedness originally issued at a discount as follows.

Treat gains on ***short-term federal, state, or local government obligations*** as ordinary income up to the ratable share of the acquisition discount. This treatment applies to obligations that have a fixed maturity date not more than one year from the date of issue. However, this treatment does not apply for state or local government obligations with tax-exempt interest. Any gain in excess of the ratable share of the acquisition discount is capital gain. Any loss is capital loss. ***Acquisition discount*** is the excess of the stated redemption price at maturity over your basis in the obligation.

However, do not treat such gains as income to the extent you previously included the discount in income. This amount increases your basis in the obligation. See *Discount on Short-Term Obligations* in Chapter 1 of Publication 550 for more information.

Treat gains on ***short-term nongovernment obligations*** (whether or not tax exempt) as ordinary income up to the ratable share of original issue discount (OID). This treatment applies to obligations that are not short-term government obligations and that have a fixed maturity date of not more than one year from the date of issue.

However, to the extent you previously included the discount in income, you do not have to include it in income again. This amount increases your basis. See *Discount on Short-Term Obligations* in Publication 550 for more information.

Long-term debt instruments issued after 1954, and before May 28, 1969 (or before July 2, 1982, if a government issue). If you sell, exchange, or redeem for a gain one of these debt instruments, the part of your gain not exceeding your ratable share of the original issue discount (OID) at the time of the sale or redemption is ordinary income. The balance of the gain is capital gain. If, however, there was an intention to call the debt instrument before maturity, all of your gain not exceeding the entire OID is treated as ordinary income at the time of the sale. This treatment of taxable gain also applies to corporate instruments issued after May 27, 1969, under a written commitment that was binding on that date and thereafter.

See *Original Issue Discount (OID)* in Chapter 8 for information on OID.

Long-term corporate debt instruments issued after May 27, 1969, and government instruments issued after July 1, 1982. If you hold one of these debt instruments, you must include a part of the OID in your gross income each year that you own the instrument. Your basis in the instrument is increased by the amount of OID that you have included in your gross income. See *Original Issue Discount (OID)* in Chapter 8 for information about the OID that you must report on your tax return.

If you sell or exchange the debt instrument before maturity, your gain on the sale is a capital gain, provided the debt instrument was a capital asset. Any amount that you receive on the retirement of a debt instrument is treated in the same way as if you had sold or exchanged that instrument.

However, if at the time the instrument was originally issued there was an intention to call it before its maturity, your gain on the sale of the instrument generally is ordinary income to the extent of the entire OID reduced by any amounts of OID previously includible in your income. In this case, any balance of the gain is a capital gain.

See *Capital or Ordinary Gain or Loss* in Publication 550 for more information about the tax treatment on the sale or redemption of discounted debt instruments.

Tax-exempt state and local government bonds. If these bonds were originally issued at a discount before September 4, 1982, and you acquired them before March 2, 1984, treat your part of the OID as tax-exempt interest. Do not include it in income.

However, any gain from market discount is taxable on disposition or redemption of tax-exempt bonds. If you bought the bonds before May 1, 1993, the gain from market discount is capital gain. If you bought the bonds after April 30, 1993, the gain from market discount is ordinary income.

You figure the market discount by subtracting the price you paid for the bond from the sum of the original issue price of the bond and the amount of accumulated OID from the date of issue that represented interest to any earlier holders.

You must accrue OID on tax-exempt state and local government bonds issued after September 3, 1982, and acquired after March 1, 1984. Your adjusted basis at the time of disposition is figured by adding accrued OID to your basis. You must accrue OID on tax-exempt obligations under the same method used for OID on corporate obligations issued after July 1, 1982.

A loss on the sale or other disposition of a tax-exempt state or local government bond is deductible as a capital loss.

Notes of individuals. If the evidence of indebtedness you bought at a discount was issued by an individual, its retirement generally will not be given capital gain treatment. But if you sell the discounted instrument to someone other than the original borrower, any gain is a capital gain as long as it was not acquired in the ordinary course of your trade

or business for services rendered or from the sale of inventory. In figuring your adjusted basis in the note, do not reduce your original basis by any interest payments or by the part of the principal payments you received that is taxable discount income.

Example. You bought a $10,000 note of an individual for $6,000 on which no payments had been made. You receive principal payments totaling $4,000. Then you sell the note for $3,800. Only 60% ($6,000/$10,000) of the $4,000 is a return of your investment. The balance is discount income. You reduce your cost by $2,400 ($4,000 × 60%) to figure your adjusted basis. Your capital gain is $200, figured as follows:

Selling price of note		$3,800
Minus adjusted basis of note:		
Cost of note	$6,000	
Minus return on investment	2,400	3,600
Capital gain		$ 200

The OID rules discussed in Chapter 8, under *Original Issue Discount (OID),* apply to obligations issued by individuals after March 1, 1984. The OID rules will not apply to loans between individuals in amounts of $10,000 or less (including the outstanding amounts of prior loans) if the lender is not in the business of lending money, except if a principal purpose of the loan is to avoid federal tax.

Obligations issued in bearer form. Generally, any loss on a registration-required obligation held in bearer form is not deductible. Any gain on the sale or other disposition of such obligation is ordinary income, unless the issuer was subject to a tax on the issuance of the obligation.

A registration-required obligation is any obligation except an obligation:

1) That is issued by a natural person,
2) That is not of a type offered to the public,
3) That has a maturity at the date of issue of not more than 1 year, or
4) That was issued before 1983.

Loss on deposits in an insolvent or bankrupt financial institution. If you can reasonably estimate your loss on a deposit because of the bankruptcy or insolvency of a qualified financial institution, you can choose to treat the amount as either a casualty loss or an ordinary loss in the current year. Either way, you claim the loss as an itemized deduction. Otherwise, you can wait until the year of final determination of the actual loss and treat the amount as a nonbusiness bad debt (discussed later under *Nonbusiness Bad Debts*) in that year.

If you claim a casualty loss, attach **Form 4684,** *Casualties and Thefts,* to your return. Each loss must be reduced by $100. Your total casualty losses for the year are reduced by 10% of your adjusted gross income.

If you claim an ordinary loss, report it as a miscellaneous itemized deduction on line 22 of Schedule A (Form 1040). The maximum amount you can claim is $20,000 ($10,000 if you are married filing separately) reduced by any expected state insurance proceeds. Your loss is subject to the 2% of adjusted gross income limit. You cannot choose to claim an ordinary loss if any part of the deposit is federally insured.

You cannot choose either of these methods if:

You own at least 1% of the financial institution,

You are an officer of the institution, or

You are related to such an owner or officer.

If the actual loss that is finally determined is more than the amount deducted as an estimated loss, you can claim the excess loss as a bad debt. If the actual loss is less than the amount deducted as an estimated loss, you must include in income (in the final determination year) the excess loss claimed.

Sale of annuity. The part of any gain on the sale of an annuity contract before its maturity date that is attributable to interest accumulated on the contract is ordinary income.

Nonbusiness Bad Debts

If someone owes you money that you cannot collect, you have a bad debt. You may be able to deduct the amount owed to you when you figure your tax for the year the debt becomes worthless. For a bad debt to qualify for the deduction, the debt must be genuine. A debt is genuine if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed or determinable sum of money.

Bad debts that you did not get in the course of operating your trade or business are nonbusiness bad debts. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partially worthless nonbusiness bad debt.

Unpaid salaries, wages, etc. To deduct a bad debt, you must have a basis in it — that is, you already included the amount in your income or you loaned out your cash. For example, you cannot claim a bad debt deduction for court-ordered child support not paid to you by your former spouse. If you are a cash-basis taxpayer (most individuals are), you cannot take a bad debt deduction for expected income such as unpaid salaries, wages, rents, fees, interest, and dividends unless you have previously included the amount in your income.

How to report bad debts. Deduct nonbusiness bad debts as short-term capital losses on Schedule D (Form 1040). There are limits on how much of your capital losses may be deducted. For a discussion of these limits, see Chapter 17.

In Part I, line 1 of Schedule D, enter the name of the debtor and ''statement attached,'' in column (a), and the amount of the bad debt in column (f). Use a separate line for each bad debt.

For each bad debt, attach a statement to your return that contains:

1) A description of the debt, including the amount, and the date it became due,
2) The name of the debtor, and any business or family relationship between you and the debtor,
3) The efforts you made to collect the debt, and
4) Why you decided the debt was worthless. For example, you could show that the borrower has declared bankruptcy, or that legal action to collect would probably not result in payment of any part of the debt.

Filing a claim for refund. If you do not deduct a bad debt on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the bad debt. Use Form 1040X, *Amended U.S. Individual Income Tax Return.* You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in Chapter 1.

Additional information. For more information, see *Nonbusiness Bad Debts* in Publication 550.

For information on business bad debts, see Chapter 14 of Publication 535.

Losses on Small Business Stock

You can deduct as an ordinary loss, rather than as a capital loss, your loss on the sale, trade, or worthlessness of certain stock you own in a small business corporation or certain stock in a small business investment company. Gain on this stock is capital gain and is reported on Schedule D (Form 1040) if the stock is a capital asset in your hands. See *Losses on Small Business Stock* and *Losses on Small Business Investment Company Stock* in Publication 550.

Holding Period

If you sold or traded investment property, you must determine whether any capital gain or loss is a short-term or long-term capital gain or loss by determining your holding period.

Long term or short term. If you hold investment property ***more than one year,*** any capital gain or loss is a ***long-term*** capital gain or loss. If you hold the property ***one year or less,*** any capital gain or loss is a ***short-term*** capital gain or loss.

To figure how long you held the investment property, begin counting on the date after the day you acquired the property. The same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. The day you disposed of the property is part of your holding period.

Example. If you buy investment property on February 2, 1994, you start counting on February 3. The 3rd of each following month is the beginning of a new month. If you sell the property on February 2, 1995, your holding period is not more than one year and you will have a short-term capital gain or loss. If you sell it on February 3, 1995, your holding period is more than one year and you will have a long-term capital gain or loss.

Securities traded on established market. For securities traded on an established securities market, your holding period begins the day after the day you bought the securities, and ends on the day you sold them. Ignore the settlement date(s) for tax purposes.

Example. You are a cash-basis, calendar-year taxpayer. You sold stock at a gain on December 28, 1994. According to the rules of the stock exchange, the sale was closed by delivery of the stock 5 trading days after the sale, on January 5, 1995. You received payment of the sales price on that same day. Report your gain on your 1994 return, even though you received the payment in 1995. The gain is long term or short term depending on whether you held the stock more than one year. Your holding period ended on December 28. If you had sold the stock at a loss, you would also report it on your 1994 return.

Nontaxable trades. If you acquire investment property in a trade for other investment property and your basis for the new property is determined, in whole or in part, by your basis in the old property, your holding period of the new property begins on the day following the date you acquired the old property. Chapter 14 discusses basis.

Property received as a gift. If you receive a gift of property and your basis is determined by the donor's basis, your holding period is considered to have started on the same day the donor's holding period started. See *Property Received as a Gift* in Chapter 14.

If your basis is determined by the fair market value of the property, your holding period starts on the day after the date of the gift.

Inherited property. If you inherit investment property and your basis for it is:

1) Determined with reference to its fair market value at the date of the decedent's death,
2) Determined with reference to its fair market value at the alternate valuation date, or
3) The decedent's adjusted basis (for appreciated property),

your capital gain or loss on any later disposition of such property is treated as a long-term capital gain or loss. You are considered to have held the property for more than one year even if you dispose of it within one year after the decedent's death. See *Inherited Property* in Publication 551, *Basis of Assets.*

Real property bought. To figure how long you have held real property bought under an unconditional contract, begin counting on the earlier of the day after you received title to it or the day after you took possession and assumed the burdens and privileges of ownership. However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Mutual fund stock. If you received exempt-interest dividends on mutual fund stock that you held 6 months or less and sold at a loss, you cannot claim the part of the loss that is equal to or less than the exempt-interest dividends. You must report the rest of the loss as a short-term capital loss.

See Publication 564, *Mutual Fund Distributions,* for more information on mutual fund distributions.

Real estate investment trust (REIT). If you received a capital gain distribution on REIT stock that you held 6 months or less and sold at a loss, you report as a long-term capital loss the part of the loss that is equal to, or less than, the capital gain distribution. This rule does not apply to dispositions of stock under a periodic liquidation plan. See *Capital Gain Distributions* in Chapter 9 for information on capital gain distributions.

Automatic investment service and dividend reinvestment plans. If you take part in a plan to buy stock through a bank or other agent, the date the bank or other agent buys the stock is your purchase date for figuring the holding period of that stock. In determining your holding period for shares bought by the bank or agent, full shares are considered bought first and any partial shares are considered bought last. If a full share or a partial share was bought over a period of more than one purchase date, your holding period for that share is a split holding period. A part of the share is considered to have been bought on each date that stock was bought by the bank or other agent with the proceeds of available funds.

Nontaxable stock dividend. The holding period for new stock you received as a nontaxable stock dividend begins on the same day as the holding period of the old stock. This rule also applies to stock acquired in a ''spin-off,'' which is a distribution of stock or securities in a controlled corporation.

Nontaxable stock rights. Your holding period for nontaxable stock rights begins on the same day as the holding period of the underlying stock. The holding period for stock acquired through the exercise of stock rights begins on the date the right was exercised.

Rollover of Gain

This section discusses the tax-free rollover of certain gains from the sale of publicly traded securities. If you buy certain replacement property and make the choice described in this section, you postpone part or all of your gain. You postpone the gain by adjusting the basis of the replacement property as described in *Basis of replacement property,* later. This postpones your gain until the year you dispose of the replacement property.

You qualify to make this choice if you meet the following tests:

1) You sell publicly traded securities at a gain after August 9, 1993. Publicly traded securities are securities traded on an established securities market.
2) Your gain from the sale is a capital gain.
3) During the 60-day period beginning on the date of the sale, you buy replacement property. This replacement property must be either common stock or a partnership interest in a ***specialized small business investment company (SSBIC)*** (any partnership or corporation licensed by the Small Business Administration under Section 301(d) of the Small Business Investment Act of 1958, as in effect on May 13, 1993).

Amount of gain postponed. If you make the choice described in this section, you must recognize gain only up to the following amount:

1) The amount realized on the sale, ***minus***
2) The cost of any common stock or partnership interest in an SSBIC that you bought during the 60-day period beginning on the date of sale (and did not previously take into account).

If this amount is less than the amount of your gain, you can postpone the rest of your gain, subject to the limit described next. If this amount is more than the amount of your gain, you must recognize the full amount of your gain.

Limit on gain postponed. The amount of gain you can postpone each year is limited to the smaller of:

1) $50,000 ($25,000 if you are married and file a separate return), or
2) $500,000 ($250,000 if you are married and file a separate return), ***minus*** the amount of gain you postponed for all earlier years.

Basis of replacement property. You must subtract the amount of postponed gain from the basis of your replacement property.

How to report gain. If you choose to postpone gain, report the entire gain realized from the sale on line 1 or line 9 of Schedule D (Form 1040), whichever is appropriate. Directly below the line on which you report the gain, enter ''SSBIC Rollover'' in column (a)

and enter the amount of gain postponed in column (f).

Also attach a schedule showing:

1) How you figured the postponed gain,
2) The name of the SSBIC in which you purchased common stock or a partnership interest,
3) The date of that purchase, and
4) Your new basis in that SSBIC stock or partnership interest.

You must make the choice to postpone gain by the due date (including extensions) of the tax return on which you must report the gain. Your choice is revocable with the consent of the Commissioner of the IRS.

16.

Selling Your Home

Important Change for 1994

Moving expenses. If you incurred selling expenses after December 31, 1993, you no longer have the option of deducting some of these expenses as moving expenses. They are only deductible as selling expenses. See *Selling expenses* under *Old Home.*

Important Reminders

Change of address. If you change your mailing address, be sure to notify the IRS using Form 8822, *Change of Address.* Mail it to the Internal Revenue Service Center for your old address (addresses for the Service Centers are on the back of the form).

Seller-financed mortgages. If you sold your home and hold a note, mortgage, or other financial agreement, you may have to report the buyer's name, address, and social security number (SSN) when you report the interest income. See *Installment sale* under *How and When to Report,* later.

Abandonment, foreclosure, or repossession. If your home was abandoned, foreclosed on, or repossessed, you have a sale or disposition that you should report on Form 2119, *Sale of Your Home.* If the disposition resulted in a taxable gain, also report it on Schedule D (Form 1040).

Generally, you will receive **Form 1099–A,** *Acquisition or Abandonment of Secured Property,* from the lender who acquired the property. This form will have the information you need to determine whether you have a capital gain or loss, or ordinary income. If your debt is canceled, you may also receive **Form 1099–C** , *Cancellation of Debt* showing the amount of the canceled debt. See *Foreclosures and Repossessions* in Chapter 1 and *Abandonments* in Chapter 2 of Publication 544, *Sales and Other Dispositions of Assets,* for more information.

Combat zone service. The replacement period for postponing tax on any gain from the sale of your home is suspended if you served in the Persian Gulf Area combat zone. For this suspension, the area is considered a combat zone beginning August 2, 1990. See *Time Allowed for Replacement* under *Postponement of Gain,* later, for more information.

Form 1099–S. The law requires that transactions involving the sale of most residential real estate property be reported to the IRS on Form 1099–S, *Proceeds From Real Estate Transactions.* Real estate brokers are prohibited from charging any customer separately for preparing Form 1099–S.

Maximum tax rate on capital gains. A taxable gain on the sale of your home is a capital gain. The maximum tax rate on a net capital gain is 28%. See *How and When to Report,* later.

Qualified mortgage bonds and mortgage credit certificates. If you sell your main home that was purchased or improved with federally subsidized financing, you may have to recapture part of the subsidy. See *Recapture of Federal Subsidy,* later.

Home sold with undeducted points. If you have not deducted all the points you paid to secure a mortgage on your old home, you may be able to deduct the remaining points in the year of the sale. See *Mortgage ending early* under *Points* in Chapter 25 of this publication.

Introduction

This chapter discusses the tax treatment of the sale of your main home. It covers the following topics:

- How to treat any gain or loss from selling your main home,
- How to postpone paying tax on all or part of the gain from selling your main home,
- How you can exclude all or part of the gain if you are age 55 or older, and
- How to report the sale on Form 2119.

In certain cases, you must postpone paying tax on the gain from the sale of your main home if you buy or build a new main home within specific time limits. You must report the sale of your main home using Form 2119, *Sale of Your Home.* This is true whether you sell the home at a gain or a loss and whether or not you buy another main home.

If you exchange your home for other property, the exchange is treated as the sale of your home. The same rules for reporting a sale apply to reporting an exchange. (See *Trading homes* under *Old Home,* later.) However, if you transfer your home to your spouse, or former spouse incident to your divorce, no gain or loss is recognized on the transfer. Therefore, the rules in this chapter do not apply. See *Property Settlements* in Publication 504, *Divorced or Separated Individuals,* for more information.

Useful Items

You may want to see:

Publication

- ❑ **521** Moving Expenses
- ❑ **523** Selling Your Home
- ❑ **530** Tax Information for First-Time Homeowners
- ❑ **551** Basis of Assets

Form (and Instructions)

- ❑ **Schedule D (Form 1040)** Capital Gains and Losses
- ❑ **1040X** Amended U.S. Individual Income Tax Return
- ❑ **2119** Sale of Your Home
- ❑ **8822** Change of Address
- ❑ **8828** Recapture of Federal Mortgage Subsidy

Gain or Loss On the Sale

If you sell your main home, you may have to postpone paying tax on all or part of the gain from the sale. If you have a loss on the sale, you cannot deduct it.

Gain on sale. You ***must postpone*** the tax on all the gain from the sale if you buy a new home and the purchase price of the new home is at least as much as the adjusted sales price of the old home. You will generally be subject to tax on all or part of the gain if you do not buy a new home, or if the purchase price of the new home is less than the adjusted sales price of the old home. However, if you are age 55 or older, you may qualify to exclude the gain as explained later.

Loss on sale. You ***cannot*** deduct a loss on the sale of your home. It is a personal loss. However, you must report the sale on Form 2119. The loss has no effect on the basis of your new home.

Joint ownership. If you and your spouse sell your jointly owned home and file a joint return, you figure and report your gain or loss as one taxpayer. If you file separate returns, each of you must figure and report your own gain or loss according to your ownership interest in the home. Your ownership interest is determined by state law.

If you and a joint owner other than your spouse sell your jointly owned home, each of you must figure and report your own gain or loss according to your ownership interest in the home. Each of you applies the rules discussed in this chapter on an individual basis.

Purchase price at least as much as sales price. Your entire gain on the sale of your home is not taxed at the time of the sale if, within ***2 years before or 2 years after*** the sale, you buy and live in another home that costs at least as much as the adjusted sales price (described later) of the old home. If you are on active duty in the Armed Forces, if you served in a combat zone, or if your tax home is outside the U.S., the 2-year period after the sale may be suspended. See *People Outside the U.S.* and *Members of the Armed*

Forces under *Time Allowed for Replacement,* later.

Purchase price less than sales price. If the purchase price of your new home is less than the adjusted sales price of your old home and you buy and live in the new home within 2 years before or 2 years after the sale, the gain taxed in the year of the sale is the lesser of:

1) The gain on the sale of the old home (reduced by any gain you exclude as explained later under *Exclusion of Gain*), or
2) The amount by which the adjusted sales price of the old home is more than the purchase price of the new home.

You need not use the same funds received from the sale of your old home to buy or build your new home. For example, you can use less cash than you received by increasing the amount of your mortgage loan and still postpone the tax on your gain.

Recapture of Federal Subsidy

If you financed your home under a federally subsidized program (loans from tax-exempt qualified mortgage bonds or loans with mortgage credit certificates), you may have to recapture all or part of the benefit you received from that program when you sell or otherwise dispose of your home. You recapture the benefit by increasing your federal income tax for the year of the sale. The postponement and exclusion of gain provisions discussed later in this chapter do not apply to this recapture tax.

The recapture tax is figured on **Form 8828.** If your mortgage loan is subject to the recapture rules, you must file Form 8828 even if you do not owe a recapture tax.

Loans subject to recapture rules. The recapture of the subsidy applies to loans provided after 1990 that:

1) Came from the proceeds of qualified mortgage bonds issued after August 15, 1986, or
2) Were based on mortgage credit certificates issued after December 31, 1990.

The recapture also applies to assumptions of these loans.

If your mortgage loan is subject to this recapture rule, you should have received a notice containing information that you need to figure the recapture tax.

When the recapture applies. The recapture of the federal mortgage subsidy applies only if you meet ***all*** of the following conditions.

1) You sell or otherwise dispose of your home at a gain,
2) Your income for the year of disposition exceeds that year's adjusted qualifying income for your family size for that year (related to the income requirements a person must meet to qualify for the federally subsidized program), and
3) You dispose of your home during the first 9 years after the date you closed your mortgage loan.

When recapture does not apply. The recapture does ***not*** apply if any of the following situations apply to you:

- The mortgage was secured solely as a qualified home improvement loan not in excess of $15,000,
- The home is disposed of as a result of your death,
- You dispose of the home more than 9 years after the date you closed your mortgage loan,
- You transfer the home to your spouse, or to your former spouse incident to a divorce, where no gain is included in your income,
- You dispose of the home at a loss,
- Your home is destroyed by a casualty, and you repair it or replace it on its original site within 2 years after the destruction, or
- You refinance your mortgage loan unless you later meet all of the conditions listed previously under *When the recapture applies.*

See Publication 523 for information on reporting this recapture tax.

Postponement of Gain

Generally, you ***must*** postpone tax on the gain on the sale of your main home if you buy a new main home within the replacement period and it costs at least as much as the adjusted sales price of the old home. However, if you are age 55 or older and meet certain qualifications, no tax applies to the extent you elect to exclude the gain. See *Exclusion of Gain,* later.

This section explains the time allowed for replacement, how to determine the taxable gain, if any, and how to report the sale.

The tax on the gain is ***postponed, not forgiven.*** You subtract any gain that is not taxed in the year you sell your old home from the cost of your new home. This gives you a lower basis in the new home. If you sell the new home in a later year and again replace it, you continue to postpone tax on your gain.

Example. You sold your home in 1994 for $90,000 and had a $5,000 gain. Within the time allowed for replacement, you bought another home for $103,000. The $5,000 gain will not be taxed in 1994 (the year of sale), but you must subtract it from the $103,000. This makes the basis of your new home $98,000. If you later sell the new home for $110,000, and you do not buy and live in a replacement home within the allowed time, you will be subject to tax on the $12,000 gain ($110,000 – $98,000) in the year of that sale.

Main Home

Usually, the home in which you live is your main home. The home you sell and the one you buy to replace it must both qualify as your main home. *Property used partly as your home and partly for business or rental* and *Home changed to rental property* are discussed later under *Old Home.*

Your main home can be a houseboat, a mobile home, a cooperative apartment, or a condominium.

Fixtures (permanent parts of the property) generally are part of your main home. Furniture, appliances, and similar items that are not fixtures generally are not part of your main home.

Land. You may sell the land on which your main home is located, but not the house itself. In this case, you cannot postpone tax on any gain you have from the sale of the land.

Example. You sell the land on which your main home is located. Within the replacement period, you buy another piece of land and move your house to it. This sale is not considered a sale of your main home, and you cannot postpone tax on any gain on the sale.

More than one home. If you have more than one home, only the sale of your main home qualifies for postponing the tax. If you have two homes and live in both of them, your main home is the one you live in most of the time.

Example 1. You own and live in a house in town. You also own beach property, which you use in the summer months. The town property is your main home; the beach property is not.

Example 2. You own a house, but you live in another house that you rent. The rented home is your main home.

However, if a house you own is your main home, you can temporarily rent it out before its sale without changing its character as your main home.

Time Allowed for Replacement

You must buy (or build) and live in another house within ***2 years before or 2 years after*** the date of sale of your old home to postpone the tax on the gain from the sale.

Example. On April 27, 1994, before you sell your old home, you buy and move into a new home that you use as your main home. You have until April 27, 1996, a period of 2 years, to sell your old home and postpone tax on any gain.

Occupancy test. You must physically live in the replacement home as your main home within the required period. If you move furniture or other personal belongings into the new home but do not actually live in it, you have not met the occupancy test.

No added time beyond the specified period is allowed. To postpone gain on the sale of your home, you must replace the old home and occupy the new home within the specified period. You are not allowed any additional time, even if conditions beyond your control keep you from doing it. For example, destruction of the new home while it was being built would not extend the replacement period. However, there may be a suspension of the replacement period, discussed later, for people outside the U.S. or members of the Armed Forces.

If you do not replace the home in time and you had postponed gain in the year of sale, you must file an amended return for the year of sale. You must include in your income the entire gain on the sale of your old home. Also, if you began building your new home within the specified period, but for any reason were unable to live in it within 2 years, no more time for occupancy is allowed. You must report your entire gain on an amended return for the year of the sale. See *Amended Return,* later.

People Outside the U.S.

The replacement period after the sale of your old home is suspended while you have your tax home (the place where you live and work) outside the U.S. This suspension applies only if your stay abroad begins before the end of the 2-year replacement period. The replacement period, plus the period of suspension, is limited to ***4 years*** after the date of sale of your old home.

For more information, see *People Outside the U.S.* in Publication 523. For a discussion of tax home, see Chapter 28.

Nonmilitary service in a combat zone in support of the Armed Forces. The running of the replacement period (including the suspension if you live and work outside the U.S.) is suspended for any period you served in the Persian Gulf Area combat zone in support of the Armed Forces, plus 180 days, even though you were not a member of those forces. This includes Red Cross personnel, accredited correspondents, and civilians under the direction of the Armed Forces in support of those forces.

The rules for suspending the running of the replacement period and for applying that suspension to your spouse are the same as the suspension rules explained later under *Members of the Armed Forces* and its discussion, *Military service in a combat zone.*

Members of the Armed Forces

The replacement period after the sale of your old home is suspended while you serve on extended active duty in the Armed Forces. You are on extended active duty if you are serving under a call or order for more than 90 days or for an indefinite period. The suspension applies only if your service begins before the end of the 2-year replacement period. The replacement period, plus any period of suspension, is limited to ***4 years*** after the date you sold your old home. For more information, see *Members of the Armed Forces* in Publication 523.

Overseas military assignment. The suspension of the replacement period after the sale of your old home is extended for up to an additional 4 years while you are stationed outside the U.S. This also applies while you are required to live in on-base quarters following your return from a tour of duty outside the U.S. In this case, you must be stationed at a remote site where the Secretary of Defense has determined that adequate off-base housing is not available.

The suspension can continue for up to one year after the last day you are stationed outside the U.S. or the last day you are required to reside in government quarters on base. However, the replacement period, plus any period of suspension, is limited to ***8 years*** after the date of sale of your old home.

If you qualify for the time suspension for members of the Armed Forces and have already filed an income tax return reporting gain from the sale of a home that can be further postponed, you can file Form 1040X to claim a refund. See *Amended Return,* later.

Military service in a combat zone. The running of the replacement period (including any suspension) is suspended for any period you served in the Persian Gulf Area combat zone. For this suspension, the designation of the area as a combat zone is effective August 2, 1990.

If you performed military service in an area outside the combat zone that was in direct support of military operations in the combat zone ***and*** you received special pay for duty subject to hostile fire or imminent danger, you are treated as if you served in the combat zone.

This suspension ends 180 days after the later of:

1) The last day you were in the combat zone (or, if earlier, the last day the area qualified as a combat zone), or
2) The last day of any continuous hospitalization (limited to 5 years if hospitalized in the U.S.) for an injury sustained while serving in the combat zone.

For more information on extension of the replacement period, see *Military service in a combat zone* in Publication 523. For more information on other tax benefits available to those who served in a combat zone, get Publication 945, *Tax Information for Those Affected by Operation Desert Storm.*

Amended Return

If you sell your old home and do not plan to replace it, you must include the gain in income for the year of sale. If you later change your mind, buy or build and live in another home within the replacement period, and meet the requirements to postpone gain, you will have to file an amended return (Form 1040X) for the year of sale to claim a refund. For information on the time allowed for filing an amended return, see Chapter 1.

Figure 16-A. An Illustration of the Time Allowed for Replacement

This illustrates the time period during which you can replace your main home and postpone tax on the gain from sale. It does not apply if you served in the Persian Gulf Area combat zone.
Caution: The dates in this chart are for illustration purposes only. Your dates may be different.

	If you sold your former home on June 30, 1994:	
	Your time for replacement begins on:	Your time for replacement ends on or before:
Most taxpayers	June 30, 1992 (2 years before sale)	June 30, 1996 (2 years after sale)
Certain people outside the U.S. and members of the Armed Forces [1]	June 30, 1992 (2 years before sale)	June 30, 1998 (4 years after sale)
Certain members of the Armed Forces stationed overseas [2]	June 30, 1992 (2 years before sale)	June 30, 2002 (8 years after sale)

[1] Your 2-year replacement period after the sale can be suspended while you live and work outside the U.S. or are on extended active duty in the Armed Forces. However, your replacement period, plus any period of suspension, cannot exceed 4 years after the date of sale of your old home. See *People Outside the U.S.* or *Members of the Armed Forces.*

[2] Your 2-year replacement period after the sale can be suspended while you are stationed outside the U.S. or required to live in on-base quarters after returning from a tour of duty outside the U.S. However, your replacement period, plus any period of suspension, cannot exceed 8 years after the date of sale of your old home. See *Overseas military assignment* under *Members of the Armed Forces.*

Extended replacement period. If you have an extended replacement period because you have your tax home outside the U.S. or are a member of the Armed Forces, the replacement period may go beyond the last date you can file an amended return claiming a refund for the year of sale. If there is a possibility you may change your mind and buy another home during the extended replacement period, you should file a *protective claim* for refund of the tax you paid on the gain. File this claim on Form 1040X at the same time you file the return for the year of sale or anytime within the period allowed for filing an amended return.

Protective claim. To file a protective claim for refund, use Form 1040X and its instructions. However, you may leave lines 1 through 23 blank on the front of the form if you do not know the amount of your postponed gain at the time you file it. In *Part II* of the form:

1) Write ''Protective Claim,''
2) Explain that you paid tax on the gain from the sale of your old home,
3) State the amount of the gain you reported on your original return,
4) State that you have an extended replacement period and why this extended period applies to your particular situation, and
5) State that you are filing this protective claim because during your extended replacement period you may buy (or build) a new main home.

Basis

You will need to know your basis in your home as a starting point for determining any gain or loss when you sell it.

Your basis in your home is determined by how you acquired it. Your basis is its cost if you bought it or built it. If you acquired it in some other way, its basis is either its fair market value when you received it or the adjusted basis of the person you received it from.

While you owned your home, you may have made adjustments (increases or decreases) to the basis. This adjusted basis is used to figure gain or loss on the sale of your home.

You can find more information on basis and adjusted basis in Chapter 14 of this publication and in Publication 523.

Adjusted Basis

Adjusted basis is your basis ***increased*** or ***decreased*** by certain amounts.

Increases to basis. This includes any:

1) Improvements.
2) Additions.
3) Special assessments for local improvements.
4) Amounts spent after a casualty to restore damaged property.

Decreases to basis. This includes any:

1) Gain from the sale of your old home on which tax was postponed.
2) Insurance reimbursements for casualty losses.
3) Deductible casualty losses not covered by insurance.
4) Payments received for easement or right-of-way granted.
5) Depreciation allowed or allowable if you used your home for business or rental purposes.
6) Residential energy credit (generally allowed from 1977 through 1987) claimed for the cost of energy improvements that you added to the basis of your home.
7) Energy conservation subsidy excluded from your gross income because you received it (directly or indirectly) from a public utility after December 31, 1992, for the purchase or installation of any energy conservation measure.

Energy conservation measure. This includes installations or modifications that are primarily designed to reduce consumption of electricity or natural gas, or improve the management of energy demand for a home.

No effect on basis. Items that you cannot deduct from, or add to, your basis include:

1) Certain settlement fees or closing costs. These include:
   - Fire insurance premiums.
   - Mortgage insurance premiums (including VA funding fees).
   - Rent for occupancy of the house before closing.
   - Charges for utilities or other services relating to occupancy of the house before closing.
2) The cost of repairs.
3) Any item that you deducted as a moving expense.

Improvements. These are costs that add to the value of your home, prolong its useful life, or adapt it to new uses. You add the cost of improvements to the basis of your property.

Examples. Putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, putting on a new roof, or paving your driveway are improvements you add to basis.

For a list of some other examples of improvements, see *Table 1, Examples of Improvements* in Publication 523.

Repairs. These are costs that maintain your home in good condition. They do not add to its value or prolong its life, and you do not add them to the basis of your property.

Examples. Repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken window panes are examples of repairs.

Recordkeeping. You should keep records of your home's purchase price and purchase expenses. You should also save receipts and other records for all improvements, additions, and other items that affect the basis of your home. This includes any Form 2119 that you filed to report postponement of gain from the sale of a previous home.

Ordinarily, you must keep records for 3 years after the due date for filing your return for the tax year in which you sold, or otherwise disposed of, your home. But if you use the basis of your old home in figuring the basis of your new one, such as when you sell your old home and postpone tax on any gain, you should keep those records longer. Keep those records as long as they are needed for tax purposes.

Old Home

Gain or loss on the sale of your old home is figured in Part I of Form 2119. To figure the gain or loss, you must know the selling price, the amount realized, and the adjusted basis.

You use Part III of Form 2119 to figure the adjusted sales price, the taxable gain, and the postponed gain.

Selling price. The selling price (line 4 of Form 2119) is the total amount you receive for your home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part of the sale, and the fair market value of any other property you receive.

If you received a Form 1099–S, *Proceeds From Real Estate Transactions,* the total amount you received for your home (except for the fair market value of any other property or services you received or will receive) should be shown in box 2. If you received or will receive any other property or services as part of the sale, the value of these items is not shown on Form 1099–S. However, box 4 of that form should be checked.

Employer reimbursement. You may have to sell your home because of a job transfer. If your employer pays you for a loss on the sale or for your selling expenses, do ***not*** include the payment (reimbursement) as part of the selling price. Include it in your gross income as wages on line 7 of Form 1040. For more information, see *How to Report* in Chapter 19.

Option to buy. If you grant an option to buy your home and the option is exercised, add the amount you receive for the option to the sales price of your home. If the option is not exercised, you must report the amount as ordinary income in the year the option expires. Report this amount on line 21 of Form 1040.

Selling expenses. Selling expenses (line 5 of Form 2119) include commissions, advertising, and legal fees. Loan charges paid by the seller, such as loan placement fees or ''points,'' are usually a selling expense.

Moving expenses. If you incurred selling expenses after December 31, 1993, you no longer have the option of deducting some of these expenses as moving expenses. They are only deductible as selling expenses. See Chapter 19 for information on moving expenses.

Amount realized. The amount realized (line 6 of Form 2119) is the selling price minus selling expenses.

Gain. Your gain on the sale (line 8 of Form 2119) is the amount realized minus the adjusted basis of the home (line 7 of Form 2119). See *Basis,* discussed earlier, to figure the adjusted basis of your property. Also, the *Instructions for Form 2119* has a worksheet to help you figure the adjusted basis of your old home.

Fixing-up expenses. Fixing-up expenses (line 16 of Form 2119) are decorating and repair costs that you paid to sell the old home. For example, the costs of painting the home, planting flowers, and replacing broken windows are fixing-up expenses. These expenses must:

1) Be for work done during the 90-day period ending on the day you sign the contract of sale with the buyer.
2) Be paid no later than 30 days after the date of sale.
3) Not be deductible in arriving at your taxable income.
4) Not be used in figuring the amount realized.
5) Not be capital expenditures or improvements.

Note. You deduct fixing-up expenses from the amount realized ***only*** in figuring the part of the gain that you postpone. You ***cannot*** deduct them in figuring the actual gain on the sale of the old home. If the amount realized does not exceed the cost of your new home, you postpone your entire gain. In this case, you do not need to figure your fixing-up expenses.

Adjusted sales price. Use the adjusted sales price of your old home (line 18 of Form 2119) to figure the part of your gain that you can postpone. The adjusted sales price is the amount realized minus any exclusion you claim (line 14 of Form 2119) and minus any fixing-up expenses you might have. Compare the adjusted sales price with the cost of your new home to find the amount of gain that you can postpone.

Example. Your old home had a basis of $55,000. You signed a contract to sell it on December 17, 1993. On January 7, 1994, you sold it for $71,400. Selling expenses were $5,000. During the 90-day period ending December 17, 1993, you had the following work done. You paid for the work on February 4, 1994—within 30 days after the date of sale.

Inside and outside painting	$800
New venetian blinds and new water heater	$900

Within the required time, you bought and lived in a new home that cost $64,600. The amount of gain on which tax is postponed, is not postponed, and the basis of your new home, are figured as follows:

Gain Realized		
a) Selling price of old home	$71,400	
b) Minus: Selling expenses	5,000	
c) Amount realized on sale		$66,400
d) Basis of old home	$55,000	
e) Add: Improvements (blinds and heater)	900	
f) Adjusted basis of old home		55,900
g) Gain realized [(c) minus (f)]		$10,500
Gain Taxed in 1994		
h) Amount realized on sale	$66,400	
i) Minus: Fixing-up expenses (painting)	800	
j) Adjusted sales price		$65,600
k) Minus: Cost of new home		64,600
l) Excess of adjusted sales price over cost of new home		$ 1,000
m) Gain taxed in 1994 [lesser of (g) or (l)]		$ 1,000
Gain Not Taxed in 1994		
n) Gain realized [line (g)]	$10,500	
o) Minus: Gain taxed in 1994 [line (m)]	1,000	
p) Gain not taxed in 1994		$ 9,500
Adjusted Basis of New Home		
q) Cost of new home [line (k)]	$64,600	
r) Minus: Gain not taxed in 1994 [line (p)]	9,500	
s) Adjusted basis of new home		$55,100

Trading homes. If you trade your old home for another home, treat the trade as a sale and a purchase.

Example. You owned and lived in a home that had a basis of $41,000. A real estate dealer accepted your old home as a trade-in and allowed you $50,000 toward a new house priced at $80,000. You are considered to have sold your old home for $50,000 and to have had a gain of $9,000 ($50,000 – $41,000). Because you replaced it with a new home costing more than the sales price of the old one, you must postpone the tax on the gain. The basis of your new home is $71,000 ($80,000 cost minus $9,000 gain that is not currently taxed).

If the dealer had allowed you $27,000 and assumed your unpaid mortgage of $23,000 on your old home, $50,000 would still be considered the sales price of the old home (the trade-in allowed plus the mortgage assumed).

Property used partly as your home and partly for business or rental. You may use part of your property as your home and part of it for business or to produce income. Examples are a working farm on which your house is located, an apartment building in which you live in one unit and rent out the others, or a store building with an upstairs apartment in which you live. If you sell the whole property, you postpone only the tax on the part used as your home. This includes the land and outbuildings, such as a garage for the home, but not those for the business or the production of income. For more information, see *Property used partly as your home and partly for business or rental* in Publication 523.

Business use of your home. If, in the year of sale, you are entitled to deduct expenses for the business use of your home, you cannot postpone the gain on the part of the home used for business. In figuring the amount of gain on which you can postpone tax, you must make an allocation for the business-use part of the home. For information on how to figure the business part, see *Business Part of Home Expenses* in Publication 587, *Business Use of Your Home.*

Home changed to rental property. You cannot postpone tax on the gain on rental property, even if you once used it as your home. The rules explained in this chapter generally will not apply to its sale. Gains are taxable and losses are deductible as explained in Publication 527, *Residential Rental Property.* The basis of the property is determined as explained under *Property Changed to Business or Rental Use* in Chapter 14.

You have not changed your home to rental property if you ***temporarily*** rented out your old home before selling it, or your new home before living in it, as a matter of convenience or for another nonbusiness purpose. You can postpone the tax on the gain from the sale if you meet the requirements explained earlier under *Postponement of Gain.* For information on how to treat the rental income you receive, see Chapter 10.

If you place your home with a real estate agent for rent or sale and it is ***not*** rented, it is not considered business property or property held for the production of income. The rules explained in this chapter apply to the sale of the home.

Condemnation. If your home is condemned for public use and you have a gain, you can postpone the tax on the gain in one of two ways. You can postpone the tax under the rules explained in this chapter or under those discussed under *Involuntary Conversions* in Chapter 1 of Publication 544, *Sales and Other Dispositions of Assets.*

Gain on casualty. The tax on a gain from a fire, storm, or other casualty cannot be postponed under the rules explained in this chapter, but may be postponed under the rules explained in Publication 547, *Nonbusiness Disasters, Casualties, and Thefts.*

New Home

Use the ***cost of your replacement home*** to figure the gain taxed and the gain on which tax is postponed on the sale of your old home. This includes costs incurred within the replacement period (beginning 2 years before and ending 2 years after the date of sale) for the following items:

1) Buying or building the home.
2) Rebuilding the home.
3) Capital improvements or additions.

You cannot consider any costs incurred before or after the replacement period. However, if you are a person outside the U.S. or a member of the Armed Forces, you can include any costs incurred during the suspension period.

New home outside the U.S. If your new home is outside the U.S., you still may be required to postpone your gain from the sale of your old home that is in the U.S. You must buy or build and live in the new home within the time allowed for replacement.

Debts on the new property. The price of a new home includes the debts it is subject to when you buy it (purchase-money mortgage or deed of trust) and the face amount of notes or other liabilities you give for it.

Temporary housing. If a builder gives you temporary housing while your new home is being finished, you must reduce the contract price to arrive at the cost of the new home. To figure the amount of the reduction, multiply the contract price by a fraction. The numerator is the value of the housing and the denominator is the sum of the value of the housing plus the value of the home.

Seller-paid points. If you bought your new home after April 3, 1994, you must subtract any seller-paid points from the purchase price in figuring your basis in the home. If you bought your new home after 1990 but before April 4, 1994, and you chose to deduct the seller-paid points, you must reduce your basis in the home by the points the seller paid.

Settlement fees or closing costs. When buying your home, you may have to pay settlement fees or closing costs in addition to the contract price of the property. Some of the settlement fees or closing costs that you can include in the basis of your property are:

1) Abstract fees (sometimes called abstract of title fees),
2) Charges for installing utility services,
3) Legal fees (including title search and preparing documents),
4) Recording fees,
5) Surveys,
6) Transfer taxes,
7) Title insurance, and
8) Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Settlement fees do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

If you itemize your deductions in the year you buy the house, you can deduct some of the costs you paid at closing, such as real estate taxes, mortgage interest, and ''points'' that are deductible as interest. You may also be able to deduct points paid by the seller at closing. For more information, see Chapters 24 and 25.

Real estate taxes. If you agree to pay taxes the seller owed on your new home (that is, taxes up to the date of sale), the taxes you pay are treated as part of the cost. You cannot deduct them as taxes paid. If the seller paid taxes for you (that is, taxes beginning with the date of sale), you can still deduct the taxes. If you do not reimburse the seller for your part of the taxes, you must reduce your basis in your new home by the amount of those taxes. For more information, see *Settlement or closing costs* under *Basis* in Publication 530.

Note: The information reported (generally by the settlement agent) to the IRS and seller of the home on Form 1099–S, *Proceeds From Real Estate Transactions,* must include the part of any real estate tax that is treated as tax imposed on the buyer. For more information, see *Property taxes* under *Old Home* in Publication 523.

You cannot deduct, or add to your basis, certain settlement fees or closing costs. These include fire insurance premiums, mortgage insurance premiums, charges for the use of utilities, rent for occupancy before closing, and other fees or charges for services concerning occupancy of the house.

Investment in retirement home. You have not purchased a replacement home if you sell your home and invest the proceeds in a retirement home project that gives you living quarters and personal care, but does not give you any legal interest in the property. Therefore, you must include in income any gain on the sale of your home. However, if you are 55 or older, see *Exclusion of Gain,* later in this chapter.

Allocation between you and your spouse. You or your spouse may have owned the old home separately, but title to the new one is in both your names as joint tenants. Or, you and your spouse may have owned the old home as joint tenants, and either you or your spouse owns the new home separately. In both of these cases, you can postpone the gain from the sale of the old home.

You and your spouse can divide the postponed gain, which reduces the basis of the new home, if both of you meet the following requirements:

1) You used the old home as your main home and you use the new home as your main home.
2) You sign a statement that says: ''We agree to reduce the basis of the new home by the gain from selling the old home.''

Both of you must sign the statement. You can make the statement in the bottom margin of Form 2119 or on a sheet attached to your tax return. If both of you do not sign the statement, you must report the gain in the regular way without allocation.

Example 1. You sell your home that is owned separately by you, but both you and your spouse use it as your main home. The adjusted sales price is $98,000, the adjusted basis is $86,000, and the gain on the sale is $12,000. Within 2 years you and your spouse buy a new home for $100,000. The title is held jointly and, under state law, you each have a one-half interest. If you both sign the statement to reduce the basis of the new home, you postpone the gain on the sale as if you had owned both the old and new homes jointly. You and your spouse will each have an adjusted basis of $44,000 ($50,000 cost minus $6,000 postponed gain) in the new home.

If you both do not sign the statement, your entire gain of $12,000 will be currently taxed. This is because the adjusted sales price of the old home ($98,000) is greater than your part of the cost of the new home ($50,000). You and your spouse will each have a basis of $50,000 in the new home.

Example 2. Assume in Example 1 that you and your spouse owned the old home jointly and each had a one-half interest under state law. Your spouse buys the new home with separate funds and takes title individually. If you both sign the statement, you and your spouse postpone the $12,000 gain from the sale of the old home. Your spouse will have an adjusted basis of $88,000 ($100,000 cost minus $12,000 postponed gain) in the new home.

If you both do not sign the statement, you will be taxed on your share of the gain on the old home, but your spouse will postpone tax on his or her share of the gain. This is because the cost of the new home was more than your spouse's share of the adjusted sales price of the old home. Your spouse's basis in the new home will be $94,000 ($100,000 cost minus $6,000 postponed gain).

Example 3. Assume in Example 1 that you own the old home individually and your spouse owns the new home individually. If you both sign the statement, you postpone the $12,000 gain from the sale of the old home. Your spouse will have an adjusted basis in the new home of $88,000.

If you both do not sign the statement, your entire gain will be taxed and your spouse's basis in the new home will be $100,000.

Deceased spouse. If your spouse dies after you sell your old home and before you purchase a new home, you can postpone the gain from the sale of the old home if the basic requirements are met, and:

1) You were married on the date your spouse died, and
2) You use the new home as your main home.

This applies whether title to the old home is in one spouse's name or held jointly.

If you sold your home and did not postpone the entire gain on the sale because of the death of your spouse (but otherwise qualified to do so under the rules explained in this chapter), you can file an amended return (Form 1040X) to postpone the entire gain. See Chapter 1 for the time allowed to file an amended return.

Separate homes replaced by single home. If you and your spouse had two separate gains from the sales of homes that had been your separate main homes before your marriage, you may have to postpone the tax on both gains. This can happen if you jointly purchase a new replacement home and one-half the amount of the cost of the new home is at least as much as the adjusted selling price of each of your old homes.

Each spouse must individually satisfy the requirements for postponing gain. Each spouse's share of the cost of the new home is the portion equal to his or her interest in the home under state law (generally one-half). This share of the cost must be equal to or greater than the adjusted sales price of his or her old home.

Example. You sold your old home in April 1994 for an adjusted sales price of $90,000. Your spouse sold her old home in June 1994 for an adjusted sales price of $110,000. You each realized a gain from your sale. Before the end of 1994, you jointly purchased a new replacement home at a cost of $200,000. Under state law, you each have a one-half interest in the new home.

You must postpone your gain since you are treated as purchasing a replacement home for $100,000 (½ of $200,000).

There is tax on $10,000 of your spouse's gain at the time of the sale. This is the amount by which the adjusted sales price of her former home is more than her $100,000 share of the cost of the replacement home.

Report the sales of the old homes on separate Forms 2119.

Title to new home not held by either you or your spouse. You cannot postpone the tax on the gain from the sale of your old home if you reinvest the proceeds from the sale in a new home in which neither you nor your spouse holds any legal interest. For example, if someone else (such as your child) holds the title to the new home, you cannot postpone the gain from the sale.

Home replaced by two homes of spouses living apart. If you and your spouse have agreed to live apart, and you each buy and live in separate replacement homes, the postponement provisions apply separately to your gain and to your spouse's gain.

Example. You and your spouse bought a home in 1984. You owned the property jointly and used it as your main home. In 1994, you agreed to live apart, and sold the home for $98,000. The gain on the sale was $20,000. Under state law, each of you is entitled to one-half of the proceeds of the sale. Therefore, each of you had a $10,000 gain from the sale of your home.

Before the end of 1994, you and your spouse individually bought and lived in separate homes. The cost of each new home, $71,000 and $75,000 respectively, was more than your respective shares of the adjusted sales price of the old home. You and your spouse must postpone the tax on the $20,000 gain on the old home.

Your new home has an adjusted basis of $61,000 ($71,000 minus ½ of the $20,000 gain postponed). Your spouse's new home has an adjusted basis of $65,000 ($75,000 minus ½ of the $20,000 gain postponed).

You report the sale of your home on two Forms 2119 as if two separate properties were sold. You each report half of the sales price. See *Divorce after sale* under *How and When to Report,* later.

Inheritance or gift. If you receive any part of your new home as a gift or an inheritance, you cannot include the value of that part in the cost of the new home when figuring the gain taxed in the year of sale and the gain on which tax is postponed. However, you include the basis of that part in your adjusted basis to determine any gain when you sell the new home.

Example. Your father died in 1994 and you inherited his home. Its basis to you is $62,000. You spent $14,000 to modernize the home, resulting in an adjusted basis to you of $76,000.

When your father died, you owned a home that you bought in 1989 for $60,000. Assume that within 2 years of inheriting your father's home you sell your old home for $65,000, at a gain of $5,000. You have fixing-up expenses of $200 on your old home.

To find the gain taxed in the year of the sale, you compare the adjusted sales price of the old home, $64,800 ($65,000 – $200), with the $14,000 you invested in your new home. The $5,000 gain is fully taxed because the adjusted sales price of the old home is more than the amount you paid to remodel your new home. For this purpose, you do not include the value of the inherited part of your property ($62,000) in the cost of your new home.

Holding period. If you postpone tax on any part of the gain from the sale of your old home, you will be considered to have owned your new home for the combined period you owned both the old and the new homes. See Chapter 15 for more information on holding periods.

More than one main home bought or sold in a 2-year period. If you buy or build more than one main home during the replacement period, only the last one can be treated as your ***new main home*** to determine whether you must postpone the gain from the sale of the old home.

If you postponed the gain on the sale of your old home, then sell your new home within 2 years after the sale of your old home, you generally cannot postpone the gain on the sale of the new home.

The following examples illustrate these rules.

Example 1. You sold your first home in March 1993 for $120,000, and you had a $10,000 gain on the sale. You postponed the $10,000 gain because you bought a second home in April 1993 for $135,000. Your basis in the second home, as reported on the Form 2119 filed with your 1993 return, was $125,000 ($135,000 cost less the $10,000 postponed gain).

In June 1994 you sold the second home for $142,000 and you moved into an apartment. You purchased a third home in January 1995 for $146,000.

Your replacement home for the first home you sold (in March 1993) is the last main home you bought in the following 2-year period. This is the third home you bought (in January 1995). Since its $146,000 cost is more than the $120,000 sales price of your first home, your $10,000 gain is postponed. Your basis in your third home is $136,000 ($146,000 cost less the $10,000 postponed gain). You must file a new Form 2119 for 1993 to change the information you gave about your replacement home.

You cannot postpone the gain on the June 1994 sale of your second home. This is because it was within 2 years after the March 1993 sale of your first home on which you postponed the gain. Since you no longer treat your second home as the replacement for your first home, the basis of your second home is its $135,000 cost. You must include the $7,000 gain on its sale ($142,000 sales price less the $135,000 basis) in your 1994 income.

Example 2. Assume the same facts as in Example 1 except you purchased your third home in September 1995 rather than in January. Your second home is the replacement home for your first home (sold in March 1993). This is because it was the only home bought in the following 2-year period.

Although you bought another new main home within 2 years after selling your second home, you cannot postpone the gain on the June 1994 sale of your second home. This is because its sale was within 2 years of the March 1993 sale of your first home. You must report the $17,000 gain on the June 1994 sale of your second home ($142,000 sales price minus $125,000 basis) on your 1994 tax return. Your basis in your third home (that you bought in September 1995) is its cost, $146,000.

Exception. The rules for more than one home bought or sold in a 2-year period do

not apply if you sell your main home because of a ***work-related move.*** A "work-related move" is one for which you are allowed a deduction for moving expenses. To qualify for the deduction, the move must be closely related to the start of work, and you must meet the time and distance requirements explained in Chapter 19.

If the exception applies, treat each sale as though the 2-year rule did not apply.

Example. You sell two homes within 2 years as shown below:

January 1994	You sell your house in **Chicago** at a gain.
February 1994	You buy a more expensive house in **Memphis.**
March 1995	You sell your house in **Memphis** due to a transfer required by your employer.
March 1995	You buy a more expensive house in **New York City.** The move meets the requirements for a moving expense deduction.

When you complete the 1994 Form 2119 for the sale of your house in Chicago, compare the cost of the home bought in Memphis with the adjusted sales price of the house in Chicago, even though you bought another new main home within 2 years (New York City in March 1995).

Your 1995 Form 2119 will compare the adjusted sales price of the house in Memphis (sold March 1995) with the cost of the house in New York City.

Continue to postpone gain. If you bought your present home and postponed tax on gain from a prior sale under the postponement-of-gain rules discussed earlier, you continue to postpone the tax if you replace your present home under those rules.

Example. In 1975 you sold your home, which you had owned since 1965, and bought a new one. The tax on the gain was postponed and the basis of the home you bought in 1975 was reduced by the gain you postponed. This year you sold the home you bought in 1975 and bought a more expensive one. You must postpone tax on the gain from selling the home you bought in 1975.

How and When to Report

If you sold your home during the year, report the details of the sale as explained in this section. Report the sale even if you have a loss, you postponed the tax on the entire gain, or you have not purchased a new home.

Form 2119. Use Form 2119, *Sale of Your Home,* to report the sale of your old home and any purchase of a new one. File Form 2119 for the year you sold your old home. You may also have to file a second Form 2119 when you purchase your new home. See Chapter 39 for an example of a filled-in Form 2119.

Keep a copy of Form 2119 with your tax records for the year. Form 2119 is also a supporting document that shows how your new home's basis is decreased by the amount of any postponed gain on the sale of your old home. Therefore, you should also keep a copy of Form 2119 with the records for the basis of your new home.

Reporting a loss. You must report the sale of your main home even if you have a loss on the sale. Complete Part I of Form 2119 for the year in which the sale occurred. The loss does not reduce your income.

If you report a loss on the sale, you do not have to file a second Form 2119 if you later purchase a new home. The loss on the sale has no effect on the basis of your new home.

Schedule D (Form 1040). If you report taxable gain on the sale of your main home, you will also have to file a Schedule D (Form 1040), *Capital Gains and Losses,* with your return.

Maximum tax rate on capital gains. Your net capital gain is taxed at a maximum tax rate of 28%, even if you have ordinary income that is taxed at a higher rate. If you have net taxable gains and your taxable income is taxed at a rate higher than 28%, figure your tax using the *Capital Gain Tax Worksheet* in the Form 1040 instructions.

New home purchased before return filed. If you buy a new home before you file a return for the year of sale of your old home, complete Form 2119 and attach it to your return.

Reporting a gain. If your new home costs as much as or more than the adjusted sales price of your old home, you postpone the tax on the entire gain. You do not need to report the sale on Schedule D (Form 1040).

If the new home costs less than the adjusted sales price of the old home, the gain is taxed to the extent of the difference. Report the taxable gain on Schedule D (Form 1040) for the year of the sale.

New home not yet purchased. If you plan to replace your home but have not done so by the time your return for the year of sale is due, you must still report the sale. Complete Form 2119, Part I only, and attach it to your return for the year of sale.

If you do not plan to replace your home within the replacement period, you must still complete Form 2119 and attach it to your return for the year of sale. If you have a gain on the sale, you will also need to complete Schedule D (Form 1040) and attach it to your return.

New home purchased after return filed. If you postponed gain from the sale of your old home and you buy and live in a new home after you file your return but within the replacement period, you should notify the IRS. File a second Form 2119 giving the date you first lived in the new home and its cost.

If you paid tax on the gain from the sale of your old home, but replaced it within the replacement period, see *Home replaced after tax paid on gain,* later.

New home costs at least as much as adjusted sales price. If you postponed gain from the sale of your old home, and your new home costs at least as much as the adjusted sales price of your old home, file a second Form 2119 by itself. Your address, signature, and the date are required on this Form 2119. If you filed a joint return for the year of sale, both you and your spouse must sign the Form 2119. File it with the Director of the Internal Revenue Service Center where you would file your next tax return.

New home costs less. If you postponed gain from the sale of your old home, and your new home costs less than the adjusted sales price of the old home, you must file an amended return (Form 1040X) for the year of the sale. Attach a second completed Form 2119 and Schedule D (Form 1040) showing the gain you must report. You will have to pay interest on any additional tax due on the amended return. The interest is generally figured from the due date of the return for the year of sale.

Old home not replaced or new home not purchased within replacement period. If you do not plan to replace your old home, you must complete Form 2119 and Schedule D (Form 1040) to report any gain. Attach them to your tax return for the year of the sale. The entire gain is taxable unless you are eligible to exclude all or part of the gain. See *Exclusion of Gain,* later.

You may have postponed gain on the sale of your old home because you planned to replace it. If you do not replace it within the replacement period, you must file a second Form 2119. Attach it to an amended return (Form 1040X) for the year of the sale. Include a Schedule D (Form 1040) to report your gain and any other appropriate schedule. For example, you would have to include Form 6252 to report an installment sale. You will have to pay interest on the additional tax due on your amended return. The interest is generally figured from the due date of the return for the year of sale.

Divorce after sale. If you are divorced after filing a joint return on which you postponed tax on the gain on the sale of your home, but you do not use your share of the proceeds to buy or build a new home (and your former spouse does), you must file an amended joint return to report the tax on your share of the gain. If your former spouse refuses to sign the amended joint return, attach a letter explaining why your former spouse's signature is missing.

Home replaced after tax paid on gain. If you paid tax on the gain from the sale of your old home, and you buy or build and live in a new home within the replacement period, you must file an amended return (Form 1040X) for the year of sale of your old home. Complete a new Form 2119, and include it with your amended return. Report on Schedule D (Form 1040) any gain on which you cannot postpone the tax, and claim a refund of the rest of the tax.

Installment sale. Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called ''installment sales.'' If you finance the buyer's purchase of your home yourself, instead of having the buyer get a loan or mortgage from a bank, you may have an installment sale. If the sale qualifies, you can report the part of the gain you cannot postpone on the installment basis.

Seller-financed mortgage. If you sell your home and hold a note, mortgage, or other financial agreement, the payments you receive generally consist of both interest and principal. You must report the interest you receive as part of each payment separately as interest income. If the buyer of your home uses the property as a personal residence, you must also report the name, address, and social security number of the buyer on line 1 of either Schedule B (Form 1040) or Schedule 1 (Form 1040A). The buyer must give you his or her social security number and you must give the buyer your social security number. Failure to meet these requirements may result in a $50 penalty for each failure. For more information, see Publication 537, *Installment Sales.*

Statute of limitations. The 3-year limit for assessing tax on the gain from the sale of your home begins when you give the IRS information that shows that:

1) You replaced your old home, and how much the replacement home cost,
2) You do not plan to buy a new home within the replacement period, ***or***
3) You did not buy a new home within the replacement period.

This information may be on the Form 2119 attached to your tax return for the year of the sale, or on a second Form 2119 filed later. File the second Form 2119 with the Service Center where you will file your next tax return. If needed, send an amended return for the year of the sale to include in income the gain that you cannot postpone.

Exclusion of Gain

This section discusses how to exclude from gross income all or part of the gain from the sale of your main home if you meet certain age, ownership, and use tests at the time of the sale. This is a one-time exclusion of gain for sales after July 26, 1978.

The decision of when to take the exclusion depends on many factors. You will want to consider your personal tax and financial situation before deciding when to make the choice. If you meet the requirements discussed in this section and you make the choice to exclude gain on the sale of your main home, the excluded gain is not taxed.

If you change your mind after you file the return for the year of sale, you may be able to make or revoke the choice later. You would have to file an amended return for the year of sale within certain time limits. See *How to Make and Revoke a Choice to Exclude Gain* in Publication 523.

Age, Ownership, and Use

You can choose to exclude from income $125,000 of gain on the sale of your main home ($62,500 if you are married on the date of sale and file separate returns) if you meet ***all*** the following requirements.

1) You were ***55 or older*** on the date of the sale.
2) During the ***5-year period*** ending on the date of the sale, you:
   - ***Owned*** your main home for at least ***3 years,*** and
   - ***Lived in*** your main home for at least ***3 years.***
3) Neither you nor your spouse has excluded gain on the sale of a home since July 26, 1978.

For more information and examples, see *Exclusion of Gain* in Publication 523.

17.

Reporting Gains and Losses

Important Reminders

Amount of net capital gain eligible for 28% tax rate. If you include part or all of your net capital gain in investment income when figuring the limit on your investment interest deduction, you must reduce the amount of your net capital gain that is eligible for the 28% maximum capital gains tax rate by the same amount. See *Capital Gain Tax Computation,* later in this chapter.

Schedule D–1 eliminated. Schedule D–1, *Continuation Sheet for Schedule D (Form 1040)*, was eliminated in 1993. If you have too many transactions to list on page 1 of Schedule D, *Capital Gains and Losses,* you can list them on page 2 of Schedule D. Capital loss carryovers are figured using the *Capital Loss Carryover Worksheet* in the Schedule D Instructions. The tax computation using the maximum capital gains rate is figured using the *Capital Gain Tax Worksheet* in the Form 1040 instructions. For more information, see *Capital Losses* and *Capital Gain Tax Computation* later in this chapter.

Introduction

This chapter discusses how to report capital gains and losses from sales, exchanges, and other dispositions of investment property on Schedule D of Form 1040. The discussion includes:

- How to report short-term gains and losses,
- How to report long-term gains and losses,
- How to figure capital loss carryovers,
- How to figure your tax using the 28% maximum tax rate on capital gains, if it applies, and
- An illustrated example of how to complete Schedule D.

If you sell or otherwise dispose of property used in a trade or business or for the production of income, see Publication 544, *Sales and Other Dispositions of Assets,* before completing Schedule D.

Useful Items

You may want to see:

Publication

- ❑ **544** Sales and Other Dispositions of Assets
- ❑ **550** Investment Income and Expenses

Form (and Instructions)

- ❑ **Schedule D (Form 1040)** Capital Gains and Losses
- ❑ **2119** Sale of Your Home
- ❑ **4797** Sales of Business Property
- ❑ **8582** Passive Activity Loss Limitations

Schedule D

Report capital gains and losses on Schedule D (Form 1040). If you have too many transactions to list on page 1 of Schedule D, you can list them on page 2 of Schedule D. You can use the *Capital Loss Carryover Worksheet* in the Schedule D instructions to figure your capital loss carryover. Use the *Capital Gain Tax Worksheet* in the Form 1040 instructions to figure your tax at the maximum capital gains rate of 28%.

Passive activity gains and losses. If you have gains or losses from a passive activity, you may also have to report them on **Form 8582.** In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its separate instructions for more information about reporting capital gains and losses from a passive activity.

Form 1099–B transactions. If you sold property, such as stocks, bonds, or certain commodities, through a broker, you should receive Form 1099–B, *Proceeds From Broker and Barter Exchange Transactions,* or an equivalent statement from the broker. Use the Form 1099–B or equivalent statement to complete Schedule D.

Report the gross proceeds shown in box 2 of Form 1099–B as the ***gross sales price*** in column (d) of either line 1 or line 9 of Schedule D, as applicable. However, if the broker advises you, in box 2 of Form 1099–B, that gross proceeds (gross sales price) less commissions and option premiums were reported to the IRS, enter that ***net sales price*** in column (d) of either line 1 or line 9 of Schedule D, as applicable. If the net amount is entered in column (d), do not include the commissions and option premiums in column (e).

Be sure to add all sales price entries in column (d) on lines 1 and 2 and lines 9 and 10 and enter the totals on lines 3 and 11. Then add these amounts reported to you for 1994 on Forms 1099–B and Forms 1099–S (or on substitute statements):

1) Proceeds from transactions involving stocks, bonds, and other securities, and
2) Gross proceeds from real estate transactions not reported on another form or schedule.

If this total is more than the total of lines 3 and 11, attach a statement to your return explaining the difference.

If the Form 1099–B you receive includes amounts derived from the sale or exchange of section 1256 contracts or straddles, or from hedging transactions, see Publication 550 for more information about reporting these amounts.

Form 1099–S transactions. If you sold or exchanged reportable real estate, you should receive from the real estate reporting person a Form 1099–S, *Proceeds From Real Estate Transactions,* showing the gross proceeds from the sale.

''Reportable real estate'' is defined as any present or future ownership interest in any of the following:

1) Improved or unimproved land, including air space,
2) Inherently permanent structures, including any residential, commercial, or industrial building,
3) A condominium unit and its accessory fixtures and common elements, including land, and
4) Stock in a cooperative housing corporation (as defined in section 216 of the Internal Revenue Code).

A ''real estate reporting person'' could include the buyer's attorney, your attorney, the title or escrow company, a mortgage lender, your broker, the buyer's broker, or the person acquiring the biggest interest in the property.

Your Form 1099–S will show the gross proceeds from the sale or exchange in box 2. Follow the instructions for Schedule D to report these transactions and include them on lines 1 or 9 as appropriate.

Add these amounts reported to you for 1994 on Forms 1099–S and 1099–B (or on substitute statements):

1) Proceeds from transactions involving stocks, bonds, and other securities, and
2) Gross proceeds from real estate transactions not reported on another form or schedule.

If this total is more than the total of lines 3 and 11 of Schedule D, attach a statement to your return explaining the difference.

It is unlawful for any real estate reporting person to separately charge you for complying with the requirement to file Form 1099–S.

Sale of main home. If the building sold or exchanged was your main home, report the sale on **Form 2119.** Follow the Form 2119 instructions to determine whether you report any gain on Schedule D.

If you sell your main home that was purchased or improved with federally-subsidized financing from a mortgage credit certificate issued by a state or local government, you may have to increase your tax for the year of sale by all or part of the tax benefit you received in earlier years. For more information, see *Mortgage Interest Credit* in Chapter 36.

Other transactions. Enter all sales of stocks, bonds, real estate transactions (other than the sale of your main home), etc.,

on line 1 or line 9 of Schedule D as applicable, whether or not you actually received a Form 1099–B or Form 1099–S.

If you had gains or losses from the disposition of ***options,*** including puts and calls, see *Options* under *Capital or Ordinary Gain or Loss* in Publication 550.

Property bought at various times. If you sell a block of stock or other property that you bought at various times, report the short-term gain or loss from the sale on one line in Part I of Schedule D and the long-term gain or loss on one line in Part II. Write ''Various'' in column (b) for the ''Date acquired.'' See the *Comprehensive Example* later in this chapter for an example.

Sale expenses. Add to your cost or basis any expense of sale such as brokers' fees, commissions, state and local transfer taxes, and option premiums. Enter this adjusted amount in column (e) of either Part I or Part II of Schedule D, as applicable, unless you reported the net sales price amount in column (d).

For more information about adjustments to basis, see Chapter 14.

Short-term gains and losses. A capital gain or loss on the sale or trade of investment property held one year or less is a short-term capital gain or loss. Report it in Part I of Schedule D.

You combine your share of short-term capital gains or losses from partnerships, S corporations, and fiduciaries, and any short-term capital loss carryover, with your other short-term capital gains and losses to figure your net short-term capital gain or loss on line 8 of Schedule D.

Property held for personal use. Gain on the sale or exchange of property held for personal use and held for one year or less is a short-term capital gain. Report it in Part I of Schedule D. Losses on sales or exchanges of property held for personal use are not deductible.

Long-term gains and losses. A capital gain or loss on the sale or trade of investment property held more than one year is a long-term capital gain or loss. Report it in Part II of Schedule D.

You also report the following in Part II of Schedule D:

1) All capital gain distributions from regulated investment companies (mutual funds) and real estate investment trusts,
2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries, and
3) Long-term capital loss carryovers.

The result from combining these items with your other long-term capital gains and losses is your net long-term capital gain or loss (line 17 of Schedule D).

Property held for personal use. Gain on the sale or exchange of property held for personal use and held more than one year is a long-term capital gain. Report it in Part II of Schedule D. Loss on the sale or exchange of property held for personal use is not deductible.

Capital gain distributions. You report capital gain distributions on line 14, Part II of Schedule D, regardless of how long you have held your investment. If you do not need Schedule D to report any other capital gains or losses and it would not benefit you to compute your tax using the maximum capital gains rate, enter your capital gain distributions for 1994 on line 13 of Form 1040. Write ''CGD'' on the dotted line next to line 13.

Total net gain or loss. To figure your total net gain or loss, combine your net short-term capital gain or loss (line 8) with your net long-term capital gain or loss (line 17). Enter the result on line 18, Part III of Schedule D. If your losses are more than your gains, see *Capital Losses,* next. If both lines 17 and 18 are gains, see *Capital Gain Tax Computation,* later.

Capital Losses

If your capital losses are more than your capital gains, you can claim a capital loss deduction. You must figure how much of the loss you can deduct in the year of the loss and how much of it you carry over and use in future tax years.

Yearly limit. Your allowable capital loss deduction for any tax year, figured on Schedule D, is limited to the lesser of:

1) $3,000 ($1,500 if you are married and file a separate return), or
2) Your capital loss as shown on line 18 of Schedule D.

Capital loss carryover. If you have a capital loss on line 18 of Schedule D that is more than the yearly limit on capital loss deductions, you can carry over the unused part to later years until it is completely used up. When you carry over a loss, it remains long term or short term. Thus, a short-term capital loss that is carried over to the next tax year is added to short-term losses that occur in that year. A long-term capital loss that is carried over to the next tax year is added to long-term losses that occur in that year.

You can carry over a capital loss that is more than the amount of allowable loss to the next year and treat it as if you had incurred it in that year. When you figure the amount of any capital loss carryover in a later tax year, you must take into account any deductions for capital losses allowed in earlier years.

Use short-term losses first. When figuring how much of your capital loss you can carry over as short term and how much as long term, use your short-term losses first, even if you incurred them after a long-term loss. If you have not reached the limit on the capital loss deduction after using short-term losses, use the long-term losses until you reach the limit.

Figuring your carryover. The amount of your capital loss carryover is the amount of your net capital loss that exceeds the lesser of:

1) Your allowable capital loss deduction for the year, or
2) Your taxable income increased by your allowable capital loss deduction for the year and your deduction for personal exemptions.

If your deductions exceed your gross income for the tax year, use your negative taxable income in computing the amount in item (2).

Complete the *Capital Loss Carryover Worksheet* in the Schedule D (Form 1040) instructions to determine the part of your capital loss for 1994 that you can carry over to 1995.

Example. Bob and Gloria sold securities in 1994. The sales resulted in a capital loss of $7,000. They had no other capital transactions. On their joint 1994 return, they can deduct $3,000. The unused part of the loss, $4,000 ($7,000 – $3,000), can be carried over to 1995.

If their capital loss had been $2,000, their capital loss deduction would have been $2,000. They would have no carryover to 1995.

Joint and separate returns. If you are married and filing a separate return, your yearly capital loss deduction is limited to $1,500. Neither you nor your spouse can deduct any part of the other's loss.

If you and your spouse once filed separate returns and are now filing a joint return, you must combine each of your capital loss carryovers. However, if you and your spouse once filed a joint return and are now filing separately, any capital loss carryover can be deducted only on the return of the person who actually had the loss.

A decedent's capital loss. Capital losses cannot be carried over after a taxpayer's death. They are deductible only on the final income tax return filed for the decedent. The capital loss limits discussed earlier still apply in this situation. This loss cannot be deducted by the decedent's estate or carried over to following years.

Capital Gain Tax Computation

For 1994, your capital gains are taxed at a maximum tax rate of 28% even if you have ordinary income that is taxed at a higher rate. For 1994, the maximum tax rate on ordinary income is 39.6%.

To qualify for the 28% maximum tax rate on capital gains, you must:

1) Have a net long-term capital gain that is more than any net short-term capital loss you may have (this difference is your net capital gain), and
2) Have taxable income that is subject to a tax rate higher than 28%.

If both lines 17 and 18 of Schedule D are net gains and your taxable income, as shown on line 37 of Form 1040, is subject to a tax rate higher than 28%, you can use the *Capital Gain Tax Worksheet* in the Form 1040 instructions to figure your tax.

First complete your Form 1040 through line 37. Then complete the *Capital Gain Tax Worksheet.* If you use the worksheet to figure your tax, be sure to check box c on line 38 of Form 1040 when you enter your tax on that line.

If you have net capital gains and your taxable income (line 37 of Form 1040) is over the amount shown for your filing status in the following table, you should complete the *Capital Gain Tax Worksheet.*

Filing Status	Amount
Single	$55,100
Married filing jointly	$91,850
Married filing separately	$45,925
Head of household	$78,700
Qualifying widow(er)	$91,850

Example. Aretha Johnson, a single taxpayer, had 1994 taxable income of $60,000, including a long-term capital gain of $15,000 on the sale of stock. She had no other capital gains or losses. She enters her $15,000 gain on line 9 of Schedule D, then enters the same amount on lines 16, 17, and 18 of Schedule D and line 13 of Form 1040. Since Aretha's taxable income is more than $55,100, her maximum tax rate will be higher than 28%. To figure her 1994 tax, Aretha completes the *Capital Gain Tax Worksheet.* Her filled-in worksheet is shown in *Table 17–1.*

Investment interest deducted. If you claim a deduction for investment interest, you may have to reduce the amount of your net capital gain that is eligible for the 28% maximum capital gains tax rate. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction. For more information about deducting investment interest, see Chapter 3 of Publication 550.

Comprehensive Example

Emily Jones is single and, in addition to her regular employment, she has income from some stocks and other securities. For the 1994 tax year, she had the following capital gains and losses, which she reports on Schedule D. All the Forms 1099 she received showed net sales prices. Her filled-in Schedule D and *Capital Loss Carryover Worksheet* are shown in this chapter.

Capital gains and losses — Schedule D. Emily sold stock in two different companies that she held for less than a year. In June, she sold 100 shares of Bates Trucking Co. common stock that she had purchased in May. She had an adjusted basis of $650 in the Bates stock and sold it for $900 for a gain of $250. In June, she sold 25 shares of Alpha Computing preferred stock that she bought in March. She had an adjusted basis in the Alpha stock of $2,500 and she sold this stock for $2,000, for a loss of $500. She reports these short-term transactions on Part I of Schedule D.

During the year, Emily also sold securities in two other corporations. In February, she sold 60 shares of Car Motor Co. for $2,100. She had inherited the Car stock from her father. Its fair market value at the time of his death was $700, which became her basis. Her gain on the sale, therefore, was $1,400. Because she had inherited the stock, she reports this as a long-term gain, regardless of how long she and her father actually held the stock.

On June 29, 1994, she sold 500 shares of Weeping Willow Furniture Co. nonconvertible preferred stock for $4,100. She bought 100 of those shares on June 25, 1987, for $7,000. She bought 100 more shares on September 10, 1987, for $9,000, and an additional 300 shares on January 30, 1991, for $18,000. Her total basis in the stock is $34,000. She realized a $29,900 ($34,000 – $4,100) loss on this sale. She reports these long-term transactions on Part II of Schedule D.

Capital loss carryover — Schedule D. Emily has a capital loss carryover to 1994 of $800, of which $300 is short-term capital loss, and $500 is long-term capital loss.

She kept a copy of her 1993 Schedule D, so that she could properly report her loss carryover for the 1994 tax year without refiguring it. She completes the *Capital Loss Carryover Worksheet* to figure her carryover to 1995.

Reconciliation of Forms 1099–B. Emily makes sure that the amounts reported on lines 3 and 11 of Schedule D are not less than the amounts shown on the Forms 1099–B she received from her stockbroker. For 1994, the total of each is $9,100.

Table 17-1. **Filled-in Capital Gain Tax Worksheet**

Use this worksheet to figure your tax **only** if (a) you are filing Schedule D and both lines 17 and 18 of Schedule D are gains, or (b) you reported capital gain distributions on Form 1040, line 13, **and:**

Your filing status is:	AND	Form 1040, line 37, is over:	Your filing status is:	AND	Form 1040, line 37, is over:
Single		$55,100	Married filing separately		$45,925
Married filing jointly or qualifying widow(er)		$91,850	Head of household		$78,700

1. Enter the amount from Form 1040, line 37		1. 60,000
2. **Net capital gain.** If you are filing Schedule D, enter the **smaller** of Schedule D, line 17 or line 18; otherwise enter your capital gain distributions reported on Form 1040, line 13	2. 15,000	
3. If you are filing Form 4952, enter the amount from Form 4952, line 4e	3. –0–	
4. Subtract line 3 from line 2. If zero or less, stop here; you cannot use this worksheet to figure your tax. Instead, use the Tax Table or Tax Rate Schedules, whichever applies		4. 15,000
5. Subtract line 4 from line 1		5. 45,000
6. Enter: $22,750 if single; $38,000 if married filing jointly or qualifying widow(er); $19,000 if married filing separately; or $30,500 if head of household		6. 22,750
7. Enter the **greater** of line 5 or line 6		7. 45,000
8. Subtract line 7 from line 1		8. 15,000
9. Figure the tax on the amount on line 7. Use the Tax Table or Tax Rate Schedules, whichever applies		9. 9,650
10. Multiply line 8 by 28% (.28)		10. 4,200
11. Add lines 9 and 10		11. 13,850
12. Figure the tax on the amount on line 1. Use the Tax Table or Tax Rate Schedules, whichever applies		12. 13,997
13. Enter the **smaller** of line 11 or line 12 here and on Form 1040, line 38. Check the box for Capital Gain Tax Worksheet		13. 13,850

SCHEDULE D (Form 1040)

Department of the Treasury Internal Revenue Service (T)

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).

▶ Use lines 20 and 22 for more space to list transactions for lines 1 and 9.

OMB No. 1545-0074

1994

Attachment Sequence No. **12**

Name(s) shown on Form 1040: EMILY JONES

Your social security number: 458 00 0327

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-3)	(f) LOSS If (e) is more than (d), subtract (d) from (e)	(g) GAIN If (d) is more than (e), subtract (e) from (d)
1 100 SHARES BATES TRUCKING	5-11-94	6-29-94	900	650		250
25 SHARES ALPHA COMPUTING	3-16-94	6-29-94	2,000	2,500	500	
2 Enter your short-term totals, if any, from line 21			2 -0-			
3 **Total short-term sales price amounts.** Add column (d) of lines 1 and 2			3 2,900			
4 Short-term gain from Forms 2119 and 6252, and short-term gain or (loss) from Forms 4684, 6781, and 8824				4		
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5		
6 Short-term capital loss carryover. Enter the amount, if any, from line 9 of your 1993 Capital Loss Carryover Worksheet				6	300	
7 Add lines 1, 2, and 4 through 6, in columns (f) and (g)				7	(800)	250
8 **Net short-term capital gain or (loss).** Combine columns (f) and (g) of line 7 ▶					8	(550)

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

9 60 SHARES CAR MOTOR CO.	INHERITED	2-11-94	2,100	700		1,400
500 SHARES WEEPING WILLOW FURNITURE CO.	VARIOUS	6-29-94	4,100	34,000	29,900	
10 Enter your long-term totals, if any, from line 23			10			
11 **Total long-term sales price amounts.** Add column (d) of lines 9 and 10			11 6,200			
12 Gain from Form 4797; long-term gain from Forms 2119, 2439, and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				12		
13 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				13		
14 Capital gain distributions				14		
15 Long-term capital loss carryover. Enter the amount, if any, from line 14 of your 1993 Capital Loss Carryover Worksheet				15	500	
16 Add lines 9, 10, and 12 through 15, in columns (f) and (g)				16	(30,400)	1,400
17 **Net long-term capital gain or (loss).** Combine columns (f) and (g) of line 16 ▶					17	(29,000)

Part III Summary of Parts I and II

18 Combine lines 8 and 17. If a loss, go to line 19. If a gain, enter the gain on Form 1040, line 13. **Note:** *If both lines 17 and 18 are gains, see the* ***Capital Gain Tax Worksheet*** *on page 25*	18	(29,550)
19 If line 18 is a (loss), enter here and as a (loss) on Form 1040, line 13, the **smaller** of these losses:		
a The (loss) on line 18; or		
b ($3,000) or, if married filing separately, ($1,500)	19	(3,000)
Note: *See the* ***Capital Loss Carryover Worksheet*** *on page D-3 if the loss on line 18 exceeds the loss on line 19 or if Form 1040, line 35, is a loss.*		

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 1994**

Capital Loss Carryover Worksheet (keep for your records)

You may deduct capital losses up to the amount of your capital gains plus $3,000 ($1,500 if married filing separately). Capital losses that exceed this amount are carried forward to later years. Use this worksheet to figure your capital loss carryovers from 1994 to 1995 if Schedule D, line 19, is a loss and **(a)** that loss is a smaller loss than the loss on Schedule D, line 18, **or (b)** Form 1040, line 35, is a loss.

1. Enter the amount from Form 1040, line 35. If a loss, enclose the amount in parentheses			**1.** 34,580
2. Enter the loss from Schedule D, line 19, as a positive amount			**2.** 3,000
3. Combine lines 1 and 2. If zero or less, enter -0-			**3.** 37,580
4. Enter the **smaller** of line 2 or line 3			**4.** 3,000
Note: *If line 8 of Schedule D is a loss, go to line 5; otherwise, enter -0- on line 5 and go to line 10.*			
5. Enter the loss from Schedule D, line 8, as a positive amount			**5.** 550
6. Enter the gain, if any, from Schedule D, line 17	**6.** -0-		
7. Enter the amount from line 4	**7.** 3,000		
8. Add lines 6 and 7			**8.** 3,000
9. **Short-term capital loss carryover to 1995.** Subtract line 8 from line 5. If zero or less, enter -0-			**9.** -0-
Note: *If line 17 of Schedule D is a loss, go to line 10; otherwise, skip lines 10 through 14.*			
10. Enter the loss from Schedule D, line 17, as a positive amount			**10.** 29,000
11. Enter the gain, if any, from Schedule D, line 8	**11.** -0-		
12. Subtract line 5 from line 4. If zero or less, enter -0-	**12.** 2,450		
13. Add lines 11 and 12			**13.** 2,450
14. **Long-term capital loss carryover to 1995.** Subtract line 13 from line 10. If zero or less, enter -0-			**14.** 26,550

Part Five.

Adjustments to Income

The three chapters in this part discuss three deductions that are used to figure adjusted gross income. They are deductions for:

- Payments to an individual retirement arrangement (IRA), Chapter 18,
- Moving expenses you pay, Chapter 19, and
- Alimony you pay, Chapter 20.

Other adjustments to income are discussed in other parts of this publication or in other publications. They are deductions for:

- Self-employment tax — Chapter 24
- Payments to a Keogh retirement plan or self-employed SEP — Publication 560, *Retirement Plans for the Self-Employed*
- Penalty on early withdrawal of savings — Chapter 8

You can also write in certain deductions in figuring adjusted gross income on Form 1040. They are discussed in other parts of this publication or in other publications and instructions. These write-in deductions include the following:

- Amortization of the costs of forestation or reforestation — Publication 535, *Business Expenses,*
- Contributions to Internal Revenue Code Section 501(c)(18) pension plans — Instructions for Form 1040, line 30,
- Expenses from the rental of personal property — Instructions for Form 1040, line 30,
- Expenses of certain performing artists — Chapter 28,
- Certain required repayments of supplemental unemployment benefits — Chapter 6,
- Foreign housing deduction — Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad,*
- Jury duty pay given to your employer — Chapter 13, and
- Part of the cost of qualified clean-fuel vehicle property — Publication 535, *Business Expenses.*

18. Individual Retirement Arrangements (IRAs)

Important Change for 1994

Simplified Employee Pensions (SEPs) — New Compensation Limit. Compensation of a participant that can be taken into account for computing contributions to a SEP-IRA is generally limited to $150,000 for plan years beginning on or after January 1, 1994. See *Simplified Employee Pension (SEP),* later for more information.

Important Reminders

Interest earned. Although interest earned from your IRA(s) is generally not taxed in the year earned, it is ***not tax-exempt*** interest. ***Do not*** report this interest on your tax return as tax-exempt interest.

Penalty for failure to file Form 8606. If you make nondeductible IRA contributions and you do not file Form 8606, *Nondeductible IRAs (Contributions, Distributions, and Basis),* with your tax return, you may have to pay a $50 penalty.

Introduction

This chapter discusses:

- Who can set up an IRA,
- When and how an IRA can be set up,
- How much you can contribute and deduct,
- How retirement plan assets can be transferred,
- When IRA assets can be withdrawn,
- What acts result in penalties, and
- Simplified Employee Pensions (SEPs).

An individual retirement arrangement (IRA) is a personal savings plan that offers you tax advantages to set aside money for your retirement. That means that you may be able to deduct your contributions to your IRA in whole or in part, depending on your circumstances, and that, generally, amounts in your IRA, including earnings and gains, are not taxed until they are distributed.

If you work for yourself, you may be able to deduct contributions to a Simplified Employee Pension (SEP), which involves the use of IRAs (SEP-IRAs). You may also be able to deduct contributions to other retirement plans for the self-employed (sometimes called Keogh or HR–10 plans). Only self-employed individuals can deduct such contributions. For details, get Publication 560, *Retirement Plans for the Self-Employed.*

Useful Items

You may want to see:

Publication

- ❑ **590** Individual Retirement Arrangements (IRAs)

Form (and Instructions)

- ❑ **5329** Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts
- ❑ **8606** Nondeductible IRAs (Contributions, Distributions, and Basis)

Who Can Set Up an IRA?

You can set up and make contributions to an IRA if you received taxable ***compensation*** during the year and have not reached age 70½ by the end of the year.

Compensation includes wages, salaries, commissions, tips, professional fees, bonuses, and other amounts you receive for providing personal services. The IRS treats as compensation any amount properly shown in box 1 of Form W-2, provided that amount is reduced by any amount properly shown in box 11 (nonqualified plans). Compensation also includes taxable alimony and separate maintenance payments.

If you are self-employed (a sole proprietor or a partner), compensation is your net earnings from your trade or business (provided your personal services are a material income-producing factor), reduced by your deduction for contributions on your behalf to retirement plans and the deduction allowed for one-half of your self-employment taxes.

Compensation includes earnings from self-employment that are not subject to self-employment tax because of your religious beliefs. See Publication 533, *Self-Employment Tax,* for more information.

Compensation does ***not*** include:

- 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),
- Foreign earned income and housing cost amounts that are excluded from income, or
- Any other amounts that are excluded from income.

IRA for your spouse. You may be eligible to set up and contribute to an IRA for your spouse, whether or not he or she received compensation. This is called a ***spousal IRA*** and is generally set up for a nonworking spouse. (See *How Much Can I Contribute and Deduct?* later.)

Eligibility requirements. To contribute to a spousal IRA:

- You must be married at the end of the tax year,
- Your spouse must not have reached age 70½ by the end of the tax year,
- You must file a joint return for the tax year,
- You must have taxable compensation for the tax year, and
- Your spouse must either have no compensation or choose to be treated as having no compensation for the tax year.

When and How Can an IRA Be Set Up?

You can set up an IRA at any time during a year. However, the time for making contributions for a year is limited. See *When To Contribute,* later.

You can set up different kinds of IRAs with a variety of organizations. You can set up an IRA at a bank or other financial institution, or with a mutual fund or life insurance company. You can also set up an IRA through your stockbroker. Any plan must meet Internal Revenue Code requirements.

Kinds of IRAs. Your IRA can be an individual retirement account or annuity. It can be either a part of a simplified employee pension (SEP) or a part of an employer or employee association trust account.

Inherited IRAs. If you inherit an IRA from your deceased spouse, you can choose to make it your own. For more information, get Publication 590.

How Much Can I Contribute and Deduct?

Contributions to an IRA must be in the form of money (cash, check, or money order). ***You cannot contribute property.***

Contribution Limits

The most that you can contribute for any year to your IRA is ***the smaller of*** the following:

1) Your compensation (defined earlier) that you must include in income for the year, or
2) $2,000.

This is the most you can contribute regardless of whether your contributions are to one or more IRAs or whether all or part of your contributions are nondeductible. (See *Nondeductible Contributions,* later.)

Example 1. Betty, who is single, earns $24,000 in 1994. Her IRA contributions for 1994 are limited to $2,000.

Example 2. John, a college student working part-time, earns $1,500 in 1994. His IRA contributions for 1994 are limited to $1,500, the amount of his compensation.

Spousal IRA. The total combined contributions you can make each year to your IRA and a spousal IRA (discussed earlier) is ***the smaller of:***

1) Your taxable compensation for the year, or
2) $2,250.

You can divide your IRA contributions between your IRA and the spousal IRA any way you choose, but you cannot contribute more than $2,000 to either IRA. (See examples in the next discussion.)

Spouse has compensation during the year. If your spouse also has taxable compensation during the year and each of you is under age 70½ at the end of the year, you each can have regular IRAs. You each can contribute up to the $2,000 limit, unless your taxable compensation (or your spouse's) is less than $2,000.

However, you or your spouse can choose to be treated as having no compensation for the year and use the rules for spousal IRAs. Generally, if one spouse has compensation of less than $250 for the year, a spousal IRA is more advantageous than a regular IRA.

Example 1. Bill and Linda file a joint return for 1994. He earned $27,000 and she earned $190. She chose to be treated as having no compensation; therefore, he set up a spousal IRA for her. Since he contributed $1,800 to his IRA, the most he can contribute to the spousal IRA is $450 ($2,250 minus $1,800).

Example 2. Assume the same facts as in Example 1 except that Bill's contribution to the spousal IRA is $2,000 (the limit for either IRA). The most he can contribute to his own IRA is $250 ($2,250 minus $2,000).

Spouse under age 70½. You cannot make contributions to your IRA for the year in which you reach age 70½ or any later year. However, for any year you have compensation, you can continue to make contributions of up to $2,000 to a spousal IRA. You can contribute to a spousal IRA until the year your spouse reaches age 70½.

Table 18-1. **Can You Take An IRA Deduction?**

This chart sums up whether you can take a full deduction, a partial deduction, or no deduction as discussed in this chapter.

If Your Modified AGI[1] is:		If You Are Covered by a Retirement Plan at Work and Your Filing Status is:			If You Are Not Covered by a Retirement Plan at Work and Your Filing Status is:			
At Least	But Less Than	•**Single** •**Head of Household** You Can Take	• **Married Filing Jointly** (even if your spouse is not covered by a plan at work) • **Qualifying Widow(er)** You Can Take	**Married Filing Separately**[2] You Can Take	**Married Filing Jointly** (and your spouse is covered by a plan at work) You Can Take	• **Single** • **Head of Household** You Can Take	• **Married Filing Jointly** or **Separately** (and your spouse is not covered by a plan at work) • **Qualifying Widow(er)** You Can Take	**Married Filing Separately** (even if your spouse is covered by a plan at work)[3] You Can Take
$0.01	$10,000.00	Full deduction	Full deduction	Partial deduction	Full deduction	Full Deduction	Full Deduction	Full Deduction
$10,000.00	$25,000.01	Full deduction	Full deduction	No deduction	Full deduction			
$25,000.01	$35,000.00	Partial deduction	Full deduction	No deduction	Full deduction			
$35,000.00	$40,000.01	No deduction	Full deduction	No deduction	Full deduction			
$40,000.01	$50,000.00	No deduction	Partial deduction	No deduction	Partial deduction			
$50,000.00 or over		No deduction	No deduction	No deduction	No deduction			

[1]**Modified AGI** (adjusted gross income) is: (1) for Form 1040A—the amount on line 14 increased by any excluded series EE bond interest shown on Form 8815, *Exclusion of Interest from Series EE U.S. Savings Bonds Issued after 1989,* or (2) for Form 1040—the amount on line 31, figured without taking into account any IRA deduction or any foreign earned income exclusion and foreign housing exclusion (deduction), or any series EE bond interest exclusion from Form 8815.

[2]If you did not live with your spouse at any time during the year, your filing status is considered, for this purpose, as Single (therefore your IRA deduction is determined under the ''Single'' column).

[3]You are entitled to the full deduction only if you did not live with your spouse at any time during the year. If you did live with your spouse during the year, you are, for this purpose, treated as though you are covered by a retirement plan at work (therefore, your IRA deduction is determined under the ''Married Filing Separately'' column in the ''If You Are Covered by a Retirement Plan...'' section of the chart).

Contributions not required. You do not have to contribute to your IRA or a spousal IRA for every tax year, even if you can.

If you and your spouse each contribute to an IRA, the contribution limit for each of you is figured separately.

IRA contributions under community property laws. Contributions cannot be made to your IRA based on the earnings of your spouse (unless your IRA is a spousal IRA). The contributions must be based on your own compensation, even in community property states.

Inherited IRAs. You can make contributions to an IRA that you inherited from your spouse. By doing so, you elect to have the IRA treated as your own account.

If you inherited an IRA from someone who died after December 31, 1983, and you were not the decedent's spouse, you will not be allowed to contribute to that IRA.

When To Contribute

You can make contributions to your IRA (or to a spousal IRA) for a year at any time during the year or by the due date of your return for that year, ***not*** including extensions. For most people, this means that contributions for 1994 must be made by April 17, 1995.

Designating year for which contribution is made. If you contribute an amount to your IRA between January 1, 1995, and April 17, 1995, tell the sponsor (the trustee or issuer) to which year (1994 or 1995) the contribution applies. If you do not tell the sponsor, the sponsor can assume, for reporting to IRS, that the contribution is for 1995, the year the sponsor received it.

Filing before making your contribution. You can file your return claiming an IRA contribution before you actually make the contribution. You must, however, make the contribution by the due date of your return, ***not*** including extensions.

Deductible Contributions

Generally, you can take a deduction for the contributions that you are allowed to make to your IRA. However, if you or your spouse is covered by an ***employer retirement plan*** at any time during the year, your allowable IRA deduction may be less than your contribution. Your deduction may be reduced or eliminated, depending on your filing status and the amount of your income, as discussed later under *Deduction Limits.*

Who Is Covered by an Employer Plan?

The **Form W-2,** *Wage and Tax Statement,* you receive from your employer includes a box to indicate whether you are covered for the year. The form should have a mark in the ''Pension Plan'' box if you are covered.

You are also covered by a plan if you are self-employed and participate in a qualified retirement plan (such as a Keogh plan) or a simplified employee pension (SEP) plan.

If you are not certain whether you are covered by your employer's retirement plan, you should ask your employer.

Employer plans. An employer retirement plan is one that an employer sets up for the benefit of the employees. For purposes of the IRA deduction rules, an employer retirement plan is any of the following:

- A qualified (meets Internal Revenue Code requirements) pension, profit-sharing,

stock bonus, money purchase, etc., plan (including Keogh plans),

- A 401(k) plan (generally a profit-sharing or stock bonus plan to which contributions can be made under an arrangement allowing you to choose to take your income in cash or have your employer pay it into the plan),
- A union plan (a qualified stock bonus, pension, or profit-sharing plan created by a collective bargaining agreement between employee representatives and one or more employers),
- A qualified annuity plan,
- A plan established for employees by a federal, state, or local government, or any of their political subdivisions, agencies, or instrumentalities (other than an eligible state deferred compensation plan (section 457 plan)),
- A tax-sheltered annuity plan for employees of public schools and certain tax-exempt organizations (403(b) plan),
- A simplified employee pension (SEP) plan, or
- A 501(c)(18) trust (a certain type of tax-exempt trust created before June 25, 1959, that is funded only by employee contributions).

Effects of marital status. Generally, you are considered covered by an employer retirement plan if your spouse is covered by one. To determine whether you are considered covered for the year because of your spouse, you must wait until the last day of the year. This is because your filing status (whether you are considered married or single) for the year depends on your marital status on the last day of the tax year.

If you were married to two different spouses during the same year, for this purpose, you are considered married for the year to the spouse to whom you were married at the end of the year.

If your spouse died during the year, and you file a joint return as the surviving spouse, coverage by an employer retirement plan for the year is determined as if your spouse were still alive at the end of the year.

If you are married filing a joint return, both you and your spouse are considered covered by a plan if either of you is covered.

If you are married filing a separate return and you are not covered by an employer retirement plan, but your spouse is, you are considered covered if you and your spouse lived together at any time during the year.

Effect of amounts. Even if your employer sets aside only a very small amount for you under a retirement plan, you are considered covered by a plan for the year.

Nonvested employees. If, for a plan year, an amount is allocated to your plan account in a defined contribution plan, or you accrue a benefit in a defined benefit plan, but you have ***no vested interest*** (legal right) in such account or accrual, you are still an active participant in (covered by) such plan.

Federal judges are considered covered by an employer retirement plan for figuring the IRA deduction.

When Are You Not Covered?

You are not covered by an employer plan if neither you nor your spouse is covered for any part of the year. You are also not covered for this purpose in the following situations.

If you are married filing a separate return and you are not covered by an employer retirement plan, you may not be considered covered by a plan even if your spouse is covered. You would not be considered covered if you and your spouse did not live together at any time during the year.

Coverage under social security or railroad retirement (Tier I and Tier II) does not count as coverage under an employer retirement plan for figuring the IRA deduction.

If you receive retirement benefits from a previous employer's plan, and you are not covered (or considered covered because of your spouse) under your current employer's plan, you are not considered covered.

Reservists and volunteer firefighters. Certain members of the reserve units of the Armed Forces (in general, those members who did not serve more than 90 days during the year) and certain volunteer firefighters (in general, those members whose accrued retirement benefit at the beginning of the year will not exceed $1,800 per year at retirement) are not considered covered by U.S. or local government retirement plans.

Social Security Recipients

If you receive social security benefits, have taxable compensation, contribute to your IRA, and are covered (or considered covered) by an employer retirement plan, complete the worksheets in Appendix B of Publication 590. Use those worksheets to figure your IRA deduction and the taxable portion, if any, of your social security benefits.

Deduction Limits

As discussed under *Deductible Contributions,* earlier, the deduction you can take for contributions made to your IRA depends on whether you or your spouse is covered for any part of the year by an employer retirement plan. But your deduction is also affected by how much income you have and your filing status, as discussed below under *Adjusted Gross Income Limit.*

Full deduction. If neither you nor your spouse was covered for any part of the year by an employer retirement plan, you can take a deduction for your total contributions to one or more IRAs of up to $2,000, or 100% of your compensation, whichever is less. This limit is reduced by any contributions to a 501(c)(18) plan (generally, a plan created before June 25, 1959, funded entirely by employee contributions).

Reduced or no deduction. If either you or your spouse is covered by an employer retirement plan, your deduction may be reduced or eliminated, depending on your income and your filing status. The deduction begins to decrease ***(phase out)*** when your income rises above a certain amount, and is eliminated altogether when it reaches a higher amount. The amounts vary depending on your filing status.

Adjusted Gross Income Limit

The effect of income on your deduction, as just described, is sometimes called the adjusted gross income limit (AGI limit). To compute your ***reduced IRA deduction,*** you must first determine your ***modified adjusted gross income*** and your filing status.

Modified adjusted gross income (modified AGI) is:

- If you file ***Form 1040***—the amount on the page 1 ''adjusted gross income'' line, but modified (changed) by figuring it without taking any:
  - a) IRA deduction,
  - b) Foreign earned income exclusion,
  - c) Foreign housing exclusion or deduction, and
  - d) Exclusion of Series EE bond interest shown on Form 8815, *Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989.*
- If you file ***Form 1040A***—the amount on the page 1 ''adjusted gross income'' line, but modified by figuring it without any IRA deduction, or any exclusion of series EE bond interest shown on Form 8815.

Note. Do not assume modified AGI is the same as your compensation. You will find that your modified AGI may include income in addition to your taxable compensation (discussed earlier), such as interest, dividends, and taxable IRA distributions.

Filing status. Your filing status depends primarily on your marital status. For this purpose, you need to know if your filing status is single (or head of household), married filing jointly (or qualifying widow(er)), or married filing separately. If you need more information on filing status, see Chapter 2.

Married filing separately exception. If you did not live with your spouse at any time during the year and you file a separate return, your filing status is considered, for this purpose, as single.

Deduction phaseout. Your IRA deduction is reduced or eliminated depending on your filing status and modified AGI as follows:

If your ***filing status*** is:	Your deduction is reduced if your ***modified AGI*** is within the ***phaseout range*** of:	Your deduction is eliminated if your ***modified AGI*** is:
Single, or Head of household	$25,000.01 to $35,000	$35,000 or more
Married—joint return, or Qualifying widow(er)	$40,000.01 to $50,000	$50,000 or more
Married—separate return	$0.01 to $10,000	$10,000 or more

Also, see Table 18–1 earlier.

How To Figure Your Reduced IRA Deduction

You can figure your reduced IRA deduction ***for either*** Form 1040 or Form 1040A by using the following worksheet. Also, the instructions for these tax forms include similar worksheets.

Note. If you were married and both you and your spouse worked and you both contributed to IRAs, use separate worksheets to figure your deductions.

If you were divorced or legally separated (and did not remarry) before the end of the year, you cannot deduct any contributions you made to your spouse's IRA. You can deduct only the contributions you made to your own IRA, and your deductions are subject to the adjusted gross income limit rules for single individuals.

Deductible (and nondeductible) IRA contributions for an IRA other than a spousal IRA. Complete lines 1 through 8 to figure your deductible and nondeductible contributions for the year.

Worksheet for Reduced IRA Deduction

(Use only if you are covered or considered covered by an employer retirement plan and your modified AGI is within the applicable phaseout range)

If your *filing status* is:	**And your *modified AGI*** is over:	***Enter*** on line 1 below:
Single, or Head of household	$25,000	$35,000
Married–joint return, or Qualifying widow(er)	$40,000	$50,000
Married–separate return	$ –0–	$10,000

1. Enter applicable amount from above ..... _____
2. Enter your ***modified AGI*** (combined, if married filing jointly) ..... _____

Note: If line 2 is equal to or more than the amount on line 1, **stop here;** your IRA contributions are not deductible. See *Nondeductible Contributions,* later.

3. Subtract line 2 from line 1. (**If line 3 is $10,000 or more, stop here;** you can take a full IRA deduction for contributions of up to $2,000 or 100% of your compensation, whichever is less.) ..... _____
4. Multiply line 3 by .20. If the result is not a multiple of $10, round it to the next highest multiple of $10. (For example, $611.40 is rounded to $620.) However, if the result is less than $200, enter $200 ..... _____
5. Enter your compensation. **Do not** include your spouse's compensation, and, if you file Form 1040, do not reduce your compensation by any losses from self-employment. ..... _____
6. Enter contributions you made, or plan to make, to your IRA for 1994, but **do not** enter more than $2,000. (If contributions are more than $2,000, see *Excess Contributions,* later.) ..... _____
7. **IRA deduction.** Compare lines 4, 5, and 6. Enter the smallest amount (or a smaller amount if you choose) here and on the Form 1040 or 1040A line for your IRA, whichever applies. (If line 6 is more than line 7 and you want to make a nondeductible contribution, go to line 8.) ..... _____
8. **Nondeductible contributions.** Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on line 1 of your Form 8606, *Nondeductible IRAs (Contributions, Distributions, and Basis).* ..... _____

Deductible (and nondeductible) IRA contributions for spousal IRA. The deduction phaseout rules that reduce or eliminate your IRA deduction also apply to a spousal IRA. If you have a spousal IRA, are covered by an employer retirement plan, and your modified AGI is within the applicable phaseout range, you can take only a reduced spousal IRA deduction.

Complete lines 9 through 17 to figure deductible and nondeductible contributions (discussed later) for the year to a spousal IRA (see *IRA for your spouse* and *Spousal IRA,* earlier).

9. Enter the smaller of $2,250 or the amount on line 5 ..... _____
10. Add lines 7 and 8. Enter the total. **If this amount is equal to or more than line 9, stop here;** you cannot make contributions to a spousal IRA. Also, see *Excess Contributions,* later. ..... _____
11. Subtract line 10 from line 9 ..... _____
12. Enter the smallest of: (a) contributions for 1994 to your spouse's IRA; (b) $2,000; or (c) line 11. (If contributions are more than $2,000, see *Excess Contributions,* later.) ..... _____
13. Multiply line 3 by .225. If the result is not a multiple of $10, round it to the next highest multiple of $10. However, if the result is less than $200, enter $200 ..... _____
14. Enter the amount from line 7 ..... _____
15. Subtract line 14 from line 13. Enter the result, but not more than line 12 _____
16. **Spousal IRA deduction.** Compare lines 4, 5, and 15. Enter the smallest amount (or a smaller amount if you choose) here and on your Form 1040 or 1040A. (If line 12 is more than line 16 and you want to make a nondeductible contribution for your spouse, go to line 17) ..... _____
17. **Spousal IRA nondeductible contributions.** Subtract line 16 from line 12. Enter the result here and on line 1 of your spouse's Form 8606. _____

Reporting Deductible Contributions

You do not have to itemize deductions to claim your deduction for IRA contributions. If you file ***Form 1040,*** deduct your IRA contributions for 1994 on line 23a and, if you file a joint return, deduct your spouse's IRA contributions on line 23b.

If you file ***Form 1040A,*** deduct your contributions on line 15a and, if you file a joint return, deduct contributions to your spouse's IRA on line 15b.

You can use either form in most cases. You cannot use ***Form 1040EZ.***

Form 5498. You should receive by May 31, 1995, Form 5498, *Individual Retirement Arrangement Information,* or similar statement, from plan sponsors, showing all the contributions made to your IRA for 1994.

Trustee's fees. Trustee's administrative fees that are billed separately and paid by you in connection with your IRA are deductible. They ***are deductible*** (to the extent they are ordinary and necessary) as a miscellaneous deduction on Schedule A (Form 1040). The deduction is subject to the 2% of adjusted gross income limit (see Chapter 30). These fees ***are not subject to*** the IRA contribution limit.

Broker's commissions that you paid in connection with your IRA ***are subject to*** the

IRA contribution limit. They ***are not deductible*** as a miscellaneous deduction on Schedule A (Form 1040).

Nondeductible Contributions

Although your ***deduction*** for IRA contributions may be reduced or eliminated because of the adjusted gross income limit (see *Deductible Contributions,* earlier), you can still make ***contributions*** of up to $2,000 ($2,250 for a regular IRA and a spousal IRA) or 100% of compensation, whichever is less. Often, the difference between your total permitted contributions and your total deductible contributions, if any, is your ***nondeductible contribution.***

Example. Sonny Jones is single. In 1994, he is covered by a retirement plan at work. His salary is $52,312. His modified AGI is $55,000. Sonny makes a $2,000 IRA contribution for that year. Because he is covered by a retirement plan and his modified AGI is over $35,000, he cannot deduct his $2,000 IRA contribution. However, he may choose to either:

1) Designate this contribution as a ***nondeductible*** contribution by reporting it on his tax return, as explained later under *Reporting Nondeductible Contributions,* or
2) Withdraw the contribution as explained later under *Tax-Free Withdrawal of Contributions.*

As long as your contributions are within the contribution limits just discussed, none of the earnings on those contributions (deductible or nondeductible) or gains will be taxed until they are distributed. See *When Can I Withdraw or Use Assets From an IRA?* later.

Cost basis. You will have a cost basis in your IRA to the extent of your nondeductible contributions. Your ***basis*** is the sum of the nondeductible amounts you have contributed to your IRA less any distributions of those amounts. Using Form 8606, you can withdraw your basis tax free. See *When Can I Withdraw or Use Assets From an IRA?* later.

Reporting Nondeductible Contributions

You must report nondeductible contributions to the IRS, but you do not have to designate a contribution as nondeductible until you file your tax return. When you file, you can also designate otherwise deductible contributions as nondeductible.

To designate contributions as nondeductible, you must file Form 8606, *Nondeductible IRAs (Contributions, Distributions, and Basis).* You must file Form 8606 to report nondeductible contributions even if you do not have to file a tax return for the year.

File Form 8606 if:

- You made nondeductible contributions to your IRA for 1994, or
- You received IRA distributions in 1994 and you have ever made nondeductible contributions to any of your IRAs.

If you receive a distribution from an IRA in the same year that you make an IRA contribution that may be partly nondeductible, use the worksheet in chapter 6 of Publication 590 to figure the taxable portion of the distribution.

If you do not report nondeductible contributions, all of your IRA contributions will be treated as deductible. Thus, when you make withdrawals from your IRA, they will be taxed unless you can show, with satisfactory evidence, that nondeductible contributions were made.

Penalty for overstatement. If you overstate nondeductible contributions on your Form 8606, you must pay a penalty of $100 for each overstatement, unless it was due to reasonable cause.

Penalty for failure to file Form 8606. You will have to pay a $50 penalty if you do not file a required Form 8606, unless you can prove that the failure was due to reasonable cause.

Tax-Free Withdrawal of Contributions

If you made IRA contributions for 1994, you can withdraw them tax free (except for any earnings on them) by April 17, 1995 (or a later date if you have an extension to file your return). ***You can do this if:***

- You did not take a deduction for the contributions you withdraw, ***and***
- You also withdraw any interest or other income earned on the contributions. You must report this income on your 1994 return.

IRA trustees must include these amounts in box 1 and, if applicable, in box 2a of Form 1099-R. You must report these amounts on line 15a, Form 1040. If there is an amount in box 2a of Form 1099-R, include it on line 15b of Form 1040.

Premature withdrawal tax. The 10 percent additional tax on withdrawals made before you reach age 59½ does not apply to these withdrawals of your contributions. However, your withdrawal of interest or other income may be subject to this tax.

Excess Contribution tax. If any part of these contributions is an excess contribution for 1993, it is subject to a 6% excise tax, unless you withdrew it from your IRA by April 15, 1994. An excess contribution for 1994 must be withdrawn by April 17, 1995, to avoid the excise tax. See *Excess Contributions* under *What Acts Result in Penalties?,* later.

Examples – Deductible and Nondeductible Contributions

The following examples illustrate the use of the IRA deduction worksheet shown earlier under *How To Figure Your Reduced IRA Deduction.*

Example 1. For 1994, Tom and Betty Smith file a joint return on Form 1040. They both work and he is covered by a retirement plan at work. His salary is $40,000 and hers is $6,555. They each have an IRA and their combined modified AGI is $46,555. Since their modified AGI is between $40,000 and $50,000 and Tom is covered by an employer plan, each of them is subject to the deduction limits (see *Deduction Limits,* earlier).

For 1994, Tom contributed $2,000 to his IRA and Betty contributed $500 to hers. They must use separate worksheets to figure the reduced IRA deduction for each of them because both had IRAs.

Tom can take a deduction of only $690 (see the worksheet below). Even though he contributed the maximum amount allowable ($2,000), $1,310 ($2,000 minus $690) of his contributions must be treated as nondeductible.

He can choose to treat the $690 as either deductible or nondeductible contributions. He can also either leave the $1,310 of nondeductible contributions in his IRA or withdraw them by April 17, 1995. He decides to treat the $690 as deductible contributions and leave the $1,310 of nondeductible contributions in his IRA.

Betty can treat all or part of her contributions as either deductible or nondeductible. This is because her $500 contribution for 1994 is less than the $690 deduction limit for her IRA contributions that year (see line 4 of her worksheet, later). She decides to treat her $500 IRA contributions as deductible.

Using the *Worksheet for Reduced IRA Deduction,* Tom figures his deductible and nondeductible amounts as follows:

Worksheet for Reduced IRA Deduction

(Use only if you are covered or considered covered by an employer retirement plan and your modified AGI is within the applicable phaseout range)

If your *filing status* is:	**And your *modified AGI*** is over:	***Enter*** on line 1 below:
Single, or Head of household	$25,000	$35,000
Married–joint return, or Qualifying widow(er)	$40,000	$50,000
Married–separate return	$ –0–	$10,000

1. Enter applicable amount from above 50,000

2. Enter your ***modified AGI*** (combined, if married filing jointly) 46,555

Note: If line 2 is equal to or more than the amount on line 1, **stop here;** your IRA contributions are not deductible; see *Nondeductible Contributions,* earlier.

3. Subtract line 2 from line 1. (**If line 3 is $10,000 or more, stop here;** you can take a full IRA deduction for contributions of up to $2,000 or 100% of your compensation, whichever is less.) 3,445
4. Multiply line 3 by .20. If the result is not a multiple of $10, round it to the next highest multiple of $10. (For example, $611.40 is rounded to $620.) However, if the result is less than $200, enter $200 690
5. Enter your compensation. **Do not** include your spouse's compensation, and, if you file Form 1040, do not reduce your compensation by any losses from self-employment. 40,000
6. Enter contributions you made, or plan to make, to your IRA for 1994, but **do not** enter more than $2,000. (If contributions are more than $2,000, see *Excess Contributions,* later.) 2,000
7. **IRA deduction.** Compare lines 4, 5, and 6. Enter the smallest amount (or a smaller amount if you choose) here and on the Form 1040 or 1040A line for your IRA, whichever applies. (If line 6 is more than line 7 and you want to make a nondeductible contribution, go to line 8.) 690
8. **Nondeductible contributions.** Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on line 1 of your Form 8606, *Nondeductible IRAs (Contributions, Distributions, and Basis).* 1,310

Betty figures her IRA deduction as follows:

Worksheet for Reduced IRA Deduction

(Use only if you are covered or considered covered by an employer retirement plan and your modified AGI is within the applicable phaseout range)

If your *filing status* is:	**And your *modified AGI*** is over:	***Enter*** on line 1 below:
Single, or Head of household	$25,000	$35,000
Married–joint return, or Qualifying widow(er)	$40,000	$50,000
Married–separate return	$ –0–	$10,000

1. Enter applicable amount from above 50,000
2. Enter your ***modified AGI*** (combined, if married filing jointly) 46,555

Note: If line 2 is equal to or more than the amount on line 1, **stop here;** your IRA contributions are not deductible; see *Nondeductible Contributions,* earlier.

3. Subtract line 2 from line 1. (**If line 3 is $10,000 or more, stop here;** you can take a full IRA deduction for contributions of up to $2,000 or 100% of your compensation, whichever is less.) 3,445
4. Multiply line 3 by .20. If the result is not a multiple of $10, round it to the next highest multiple of $10. (For example, $611.40 is rounded to $620.) However, if the result is less than $200, enter $200 690
5. Enter your compensation. **Do not** include your spouse's compensation, and, if you file Form 1040, do not reduce your compensation by any losses from self-employment. 6,555
6. Enter contributions you made, or plan to make, to your IRA for 1994, but **do not** enter more than $2,000. (If contributions are more than $2,000, see *Excess Contributions,* later.) 500
7. **IRA deduction.** Compare lines 4, 5, and 6. Enter the smallest amount (or a smaller amount if you choose) here and on the Form 1040 or 1040A line for your IRA, whichever applies. (If line 6 is more than line 7 and you want to make a nondeductible contribution, go to line 8.) 500
8. **Nondeductible Contributions.** Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on line 1 of your Form 8606, *Nondeductible IRAs (Contributions, Distributions, and Basis).* 0

The IRA deductions of $690 and $500 on the joint return for Tom and Betty total $1,190. Betty's unused IRA deduction limit of $190 ($690 – $500) cannot be transferred to Tom to increase his deduction.

Example 2. Assume the facts in Example 1, except that Tom contributed $250 to a spousal IRA because Betty had no compensation for the year and did not contribute to an IRA. Their modified AGI remains at $46,555. Tom uses lines 1 through 8 of his worksheet to complete the spousal IRA portion of the *Worksheet for Reduced IRA Deduction* as follows.

9. Enter the smaller of $2,250 or the amount on line 5 2,250
10. Add lines 7 and 8. Enter the total. **If this amount is equal to or more than line 9, stop here;** you cannot make contributions to a spousal IRA. Also, see *Excess Contributions,* later. 2,000
11. Subtract line 10 from line 9 250
12. Enter the smallest of: (a) contributions for 1994 to your spouse's IRA; (b) $2,000; or (c) line 11. (If contributions are more than $2,000, see *Excess Contributions,* later.) 250
13. Multiply line 3 by .225. If the result is not a multiple of $10, round it to the next highest multiple of $10. However, if the result is less than $200, enter $200 780
14. Enter the amount from line 7 690
15. Subtract line 14 from line 13. Enter the result, but not more than line 12 90
16. **Spousal IRA deduction.** Compare lines 4, 5, and 15. Enter the smallest amount (or a smaller amount if you choose) here and on your Form 1040 or 1040A. (If line 12 is more than line 16 and you want to make a nondeductible contribution for your spouse, go to line 17.) 90
17. **Spousal IRA nondeductible contributions.** Subtract line 16 from line 12. Enter the result here and on line 1 of your spouse's Form 8606. 160

Although Tom contributed the maximum amount (a total of $2,250) to his and Betty's IRAs, because of the adjusted gross income limit, their allowable IRA deductions total only $780 ($690 + $90).

Can Retirement Plan Assets Be Transferred?

IRA rules permit you to transfer, tax free, assets (money or property) from other retirement programs (including IRAs) to an IRA. The rules permit the following kinds of transfers:

- Transfers from one trustee to another,
- Rollovers, and
- Transfers incident to a divorce.

Transfer From One Trustee to Another

A transfer of funds in your IRA from one trustee directly to another, either at your request or at the trustee's request, is ***not a rollover.*** It is, however, a tax-free transfer. As such it is not affected by the one-year waiting period that is required between rollovers, discussed next. For information about direct transfers to

IRAs from retirement programs other than IRAs, see Publication 590.

Rollovers

Generally, a rollover is a tax-free distribution to you of cash or other assets from one retirement plan that you contribute (roll over) to another retirement plan. The amount you roll over tax free, however, is generally taxable later when the new plan pays that amount to you or your beneficiary.

Kinds of rollovers to an IRA. There are two kinds of rollover contributions to an IRA. In one, you put amounts you receive from one IRA into another. In the other, you put amounts from an employer's qualified (meets certain requirements) retirement plan for its employees, such as a qualified pension plan, into an IRA.

You cannot deduct a rollover contribution but you must report the rollover distribution on your tax return as discussed later under *Reporting Your Rollover.*

You must make the rollover contribution by the 60th day after the day you receive the distribution from your IRA or your employer's plan. If the amount distributed to you from an IRA or a qualified employer retirement plan becomes a frozen deposit in a financial institution during the 60-day period allowed for a rollover, a special rule extends the period. For more information, get Publication 590.

Waiting period between rollovers. You can take (receive) a distribution from a particular IRA and make a rollover contribution to another IRA only once in any one-year period. The one-year period begins on the date you receive the IRA distribution, not on the date you roll it over into another IRA.

This rule applies separately to each IRA you own. For example, if you have two IRAs, IRA-1 and IRA-2, and you roll over assets of IRA-1 into a new IRA-3, you may also make a rollover from IRA-2 into IRA-3, or into any other IRA within one year after the rollover distribution from IRA-1. These are both rollovers because you have not received more than one distribution from either IRA within one year. However, you cannot, within the one-year period, again roll over the assets you rolled over into IRA-3 into any other IRA.

Exception. There is an exception to this rule for distributions from certain failed financial institutions. Get Publication 590 for more information.

Partial rollovers. If you withdraw assets from an IRA, you may roll over part of the withdrawal into another IRA and keep the rest of it. The amount you keep is generally taxable (except to the extent it is a return of nondeductible contributions) and may be subject to the 10% additional tax on premature distributions and the 15% tax on excess distributions, discussed later.

If you inherited an IRA from your spouse, you can roll it over into an IRA established for you.

If you inherited an IRA from someone (other than your spouse) who died after December 31, 1983, you cannot roll it over or allow it to receive a rollover contribution. You must withdraw the IRA assets within a certain period. For more information, get Publication 590.

Distributions from qualified employer plans. Special rules apply to distributions made from qualified employer plans that are rolled over or transferred to IRAs. The rules primarily relate to requirements affecting rollovers, income tax withholding, and notices to recipients. Get Publication 590 for more information.

Maximum rollover. If you roll over a distribution from your employer's plan into an IRA, the most that you can roll over is the otherwise taxable part of any ***eligible rollover distribution.*** The distribution you receive generally will be all taxable unless you have made nondeductible employee contributions to the plan.

Eligible rollover distribution. Generally, an eligible rollover distribution is any distribution from a qualified retirement plan ***except:***

1) A required minimum distribution, or
2) Any of a series of substantially equal periodic distributions paid at least once a year over:
   a) Your lifetime or life expectancy,
   b) The lifetimes or life expectancies of you and your beneficiary, or
   c) A period of 10 years or more.

The otherwise taxable parts of most other distributions from qualified retirement plans are eligible rollover distributions.

Reporting Your Rollover

Report a distribution from a qualified plan on line 16a, Form 1040, or line 11a, Form 1040A. If the total distribution was rolled over into an IRA or other qualified plan, enter zero on line 16b, Form 1040, or line 11b, Form 1040A. Otherwise, enter the taxable part of the distribution on line 16b, Form 1040, or line 11b, Form 1040A.

Use lines 15a and 15b, Form 1040, or lines 10a and 10b, Form 1040A, to report distributions from one IRA rolled over into another IRA.

For further information on rollovers, get Publication 590.

Transfers Incident to Divorce

If an interest in an IRA is transferred from your spouse or former spouse to you by a decree of divorce or separate maintenance, or a written document related to such a decree, the interest in the IRA, starting from the date of the transfer, is treated as your IRA. The transfer is tax free. For detailed information, get Publication 590.

When Can I Withdraw or Use Assets From an IRA?

There are rules limiting the withdrawal and use of your IRA assets. Violation of the rules generally results in additional taxes in the year of violation. See *Prohibited Transactions, Premature Distributions (Early Withdrawals), Excess Accumulations (Insufficient Distributions)* and *Excess Distributions,* later.

Age 59½ rule. Generally, until you reach the age of 59½, you cannot withdraw assets (money or other property) from your IRA without having to pay an additional tax. However, there are a number of exceptions to that rule. See *Premature Distributions (Early Withdrawals),* later.

Required Distributions

You cannot keep funds in your IRA indefinitely. You ***must*** eventually withdraw them or pay an excise tax on excess accumulations in your IRA. See *Excess Accumulations (Insufficient Distributions),* later. The requirements for withdrawing IRA funds differ depending on whether you are the IRA owner or the beneficiary of a decedent's IRA.

IRA owners. If you are an IRA owner, you must choose to withdraw the balance in your IRA in one of the following two ways:

1) By withdrawing the ***entire balance*** in your IRA by the required beginning date (defined below), ***or***
2) By starting to withdraw ***periodic distributions*** of the balance in your IRA by the required beginning date.

Required beginning date (age 70½ rule). You must receive the entire balance in your IRA or begin receiving periodic distributions from your IRA by April 1 of the year following the year in which you reach age 70½.

Periodic distributions. If the distributions are to be made over a period of years, you must receive at least the minimum amount required for each year starting with the year you reach age 70½ (your 70½ year). If you did not receive any distributions (or the full required minimum distribution) in your 70½ year, then you must receive the required minimum distribution by April 1 of the next year. Required distributions for later years must be made by December 31 of each year.

For more information, including how to figure your required minimum distribution each year and how to figure your required distribution if you are a beneficiary of a decedent's IRA, get Publication 590.

Tax Treatment of Distributions

In general, include IRA distributions in your gross income in the year you receive them. Exceptions to this general rule are rollovers and timely withdrawals of contributions, discussed earlier, and the return of nondeductible contributions, discussed next under *Distributions Fully or Partly Taxable*.

Failed financial institutions. The general rule (you must include IRA distributions in your gross income unless properly rolled over) applies to distributions made (with or without your consent) by the receiver of a savings institution that is placed in receivership. For an exception to the one-year waiting period rule for rollovers of certain distributions from failed financial institutions, see Publication 590.

Ordinary income. IRA distributions that you must include in income are taxed as ordinary income.

No special treatment. In figuring your tax, you cannot use the special averaging or capital gain treatment that applies to lump-sum distributions from qualified employer plans.

Distributions Fully or Partly Taxable

Your IRA distributions may be fully or partly taxable, depending on whether your IRA includes any nondeductible contributions.

Fully taxable. If only deductible contributions were made to your IRA (or IRAs, if you have more than one) since it was set up, you have ***no basis*** in your IRA. Because you have no basis in your IRA, any distributions are fully taxable when received. See *Reporting taxable distributions on your return,* later.

Partly taxable. If you made nondeductible contributions to any of your IRAs, you have a ***cost basis*** (investment in the contract) to the extent of those contributions. These nondeductible contributions are ***not taxed*** when they are distributed to you. They are a return of your investment in your IRA.

When IRA distributions are made, special rules apply in figuring the tax on the distributions if:

- Only nondeductible IRA contributions were made and there are earnings or gains, or
- If both deductible and nondeductible IRA contributions were made.

Only the part of the distribution that represents nondeductible contributions (your cost basis) is not taxable. Once nondeductible contributions have been made, distributions consist partly of nondeductible contributions (basis) and partly of deductible contributions, earnings, or gains. Until you run out of basis, each distribution is partly taxable and partly nontaxable.

Form 8606. You must complete, and attach to your return, Form 8606 if you receive an IRA distribution and have ever made nondeductible IRA contributions. Using the form, you will figure the nontaxable distributions for 1994, and your total IRA basis for 1994 and earlier years.

Distributions reported on Form 1099–R. You will receive Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc.,* or similar statement, if you receive a distribution from your IRA. IRA distributions are shown in boxes 1 and 2 of Form 1099–R. A number or letter code in box 7 tells you what type of distribution you received from your IRA.

Reporting taxable distributions on your return. Report fully taxable distributions, including taxable premature distributions, on line 15b, Form 1040 (no entry is required on line 15a), or line 10b, Form 1040A. If only part of the distribution is taxable, enter the total amount on line 15a, Form 1040 (or line 10a, Form 1040A), and the taxable part on line 15b, Form 1040 (or line 10b, Form 1040A). You cannot report distributions on Form 1040EZ.

Withholding. Federal income tax is withheld from IRA distributions unless you choose not to have tax withheld. See chapter 5.

Distributions paid outside the United States or its possessions. In general, if you are a U.S. citizen or resident alien and your home address is outside the United States or its possessions, you cannot choose exemption from withholding on your IRA payments.

What Acts Result in Penalties?

The tax advantages of using IRAs for retirement savings can be offset by additional taxes and penalties if you do not follow the rules. For example, there are additions to the regular tax for using your IRA funds in prohibited transactions. There are also additional taxes for:

- Making excess contributions,
- Making early withdrawals (taking premature distributions),
- Allowing excess amounts to accumulate (failing to make required withdrawals), or
- Receiving excess distributions.

There are penalties for overstating the amount of nondeductible contributions and for failure to file a required Form 8606. See *Reporting Nondeductible Contributions,* earlier.

Prohibited Transactions

Generally, a prohibited transaction is any improper use of your IRA by you or any ***disqualified person.***

Some examples of disqualified persons for this purpose are:

Your fiduciary, or

Members of your family (spouse, ancestor, lineal descendent, and any spouse of a lineal descendent).

Some examples of prohibited transactions with an IRA are:

- Borrowing money from it,
- Buying property for personal use (present or future) with IRA funds,
- Selling property to it,
- Receiving unreasonable compensation for managing it, or
- Using the IRA as collateral for a loan.

Effect on an IRA account. Generally, if you or your beneficiary engage in a prohibited transaction at any time during the year with your IRA account, it will not be treated as an IRA as of the first day of the year.

Effect on you (or your beneficiary). If you (or your beneficiary) engage in a prohibited transaction with your IRA account at any time during the year, ***you (or your beneficiary) must*** include the fair market value of all (or part, in certain cases) of the IRA assets in your gross income for that year. The fair market value is the price at which the IRA assets would change hands between a willing buyer and a willing seller, when neither has any need to buy or sell, and both have reasonable knowledge of the relevant facts.

You must use the fair market value of the assets as of the first day of the year you engaged in the prohibited transaction. You may also have to pay the 10% additional tax on premature distributions and the 15% tax on excess distributions, discussed later.

Excise taxes. If someone other than the owner or beneficiary of an IRA engages in a prohibited transaction, that person may be liable for certain excise taxes. In general, there is a 5% tax on the amount of the prohibited transaction and a 100% additional tax if the transaction is not corrected.

Investment in collectibles. If your IRA invests in collectibles, the amount invested is considered distributed to you in the year invested. You may have to pay the 10% additional tax on premature distributions and the excise taxes discussed above may apply.

Collectibles include art works, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, and other tangible personal property if specified by the IRS.

Exception. Your IRA can invest in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins, or one ounce silver coins minted by the Treasury Department.

For more information on prohibited transactions, get Publication 590.

Excess Contributions

Generally, an excess contribution is the amount contributed to your IRA(s) for the year that is more than the smaller of:

- Your taxable compensation for the year, or
- $2,000.

Example. You were single and earned $30,000 in 1994. You contributed $2,500 to your IRA for 1994. Your contribution limit is $2,000. Your reduced IRA deduction, figured using the *Worksheet for Reduced IRA Deduction,* is $1,000. You made an excess contribution for 1994 of $500 ($2,500 minus $2,000).

Tax on excess contributions. You must pay a 6% tax each year on excess amounts that remain in your IRA at the end of your tax year. The excess is taxed for the year the excess contribution is made and for each year after that until you correct it. The tax cannot be more than 6% of the value of your IRA as of the end of your tax year. The tax does not apply to a rollover contribution.

Excess contributions you withdraw by the date your return is due. You will not have to pay the 6% tax if you withdraw an excess contribution made during a tax year ***and*** interest or other income earned on it by the date your return for that year is due, including extensions.

You do not have to include in your gross income an excess contribution that you withdraw from your IRA before your tax return is due if:

1) You did not take a deduction for that excess amount on your return, and
2) The interest or other income earned on the excess was also withdrawn.

However, ***you must include*** in your gross income any interest or other income earned on the excess contribution (whether a deductible or nondeductible contribution). Report it on your return for the year in which the excess contribution was made. Your withdrawal of interest or other income may be subject to an additional 10% tax on early withdrawals, discussed later.

Excess contributions you withdraw after your return is due. If the total contributions (other than rollover contributions) for the year were $2,250 or less, and there were no employer contributions, you may withdraw any excess contribution after the due date for filing your return for that year, including extensions. You do not include the withdrawn contribution in your income. This applies only to the part of the excess for which you did not take a deduction. The 6% tax applies to the excess contribution amount that remains in your IRA at the end of a year (this includes the year of the contribution and any later year).

Premature Distributions (Early Withdrawals)

You must include premature distributions in your gross income and, because they are premature, there will be an ***additional 10% tax*** on them. See the discussion of Form 5329 later to figure and report the tax.

Premature distributions are amounts you withdraw from your IRA before you are 59½.

Exceptions. The 10% tax will not apply to the following distributions:

- Portions of any distributions treated as a return of nondeductible contributions.
- Distributions made after the owner's death,
- Distributions made because you become disabled.
- Distributions that are a part of a series of substantially equal payments over your life (or life expectancy), or over the lives (or life expectancies) of you and your beneficiary . For this exception to apply, you must use an IRS-approved distribution method and take at least one distribution annually. Also, the payments must continue for at least 5 years, or until you reach age 59½, whichever is the longer period. This 5-year rule does not apply if the payment change is because of the death or disability of the IRA owner.
- Distributions that are rolled over, as discussed earlier under *Rollovers.*

For more information on premature distributions, get Publication 590.

Excess Accumulations (Insufficient Distributions)

You cannot keep amounts in your IRA indefinitely. Generally, you must begin receiving distributions by April 1 of the year following the year in which you reach age 70½.

Tax on excess. If distributions from your IRA(s) during the year are less than the required minimum distribution for the year, you may have to pay a ***50% excise tax*** for that year on the excess amount remaining in your IRA.

Request to excuse the tax. If the excess accumulation is due to reasonable error and you have taken, or are taking, steps to remedy the insufficient distribution, you can request that the tax be excused.

Exemption from tax. IRAs invested in contracts issued by insurance companies may be unable to make required distributions because the insurance company is in state insurer delinquency proceedings. In this case, the 50% excise tax for failure to make required IRA distributions will not apply. However, to qualify for this exemption, the conditions and requirements of Revenue Procedure 92-10 must be satisfied.

More information. For more information on excess accumulations, see chapter 7 of Publication 590.

Excess Distributions

If you received ***retirement distributions*** during the year of more than $150,000, you may have to pay a ***15% tax*** on the distributions exceeding that amount. The term ''retirement distributions'' means your distributions from any qualified employer plans, tax-sheltered annuity plans, or IRAs.

This tax is reduced by any tax on premature distributions that applies to the excess distribution. See *Premature Distributions,* discussed earlier.

Excluded distributions. The excess distribution tax does not apply to the following distributions:

- Distributions after the death of the IRA owner (or employee in the case of employer plans),
- Distributions that are rolled over,
- Distributions that represent nondeductible contributions,
- Distributions to an alternate payee under a qualified domestic relations order, if includible in the alternate payee's income,
- Corrective distributions of excess deferrals under a salary reduction arrangement (or a similar qualified plan), and
- Certain other corrective distributions from an employer's qualified retirement plan.

For more information on excess distributions, get Publication 590.

Reporting Additional Taxes

Generally you must use **Form 5329,** *Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts,* to report the tax on excess contributions, premature distributions, excess distributions, and excess accumulations. You must file Form 5329 if you receive excess distributions from a qualified retirement plan, whether or not you owe tax on them.

You do not have to use Form 5329 if:

- Distribution code 1 is shown in box 7 of Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* Instead, multiply the taxable part of the distribution by 10% and enter the result on line 51 of Form 1040. Write 'No' on the dotted line next to line 51 to indicate that you do not have to file Form 5329 ***However,*** if you owe this tax and also owe any other additional tax on a distribution, do not enter this 10% additional tax directly on your Form 1040. You must file Form 5329 to report your additional taxes.
- You qualify for an exception to the tax. You need not report the exception if distribution code 2, 3, or 4 is shown in box 7 of Form 1099-R. ***However,*** if one of those codes is

not shown, or the code shown is incorrect, you must file Form 5329 to report the exception.

If you file Form 1040, complete Form 5329 and attach it to your Form 1040. Enter the total amount of IRA tax due on line 51, Form 1040.

If you do not have to file a Form 1040 but do have to pay one of the IRA taxes mentioned earlier, file the completed Form 5329 with IRS at the time and place you would have filed your Form 1040. Include a check or money order payable to the Internal Revenue Service for the tax you owe, as shown on Form 5329. Write your social security number, tax form number, and tax year on your check or money order.

Simplified Employee Pension (SEP)

A simplified employee pension (SEP) is a written plan that allows an employer to make contributions toward his or her own (if a self-employed individual) and employees' retirement without becoming involved in more complex retirement plans. The contributions are made to IRAs (SEP-IRAs) of the participants in the plan. By choosing a SEP plan, an employer gives up advantages available to Keogh plans. For example, the special averaging treatment that may apply to Keogh plan lump-sum distributions does not apply to SEP-IRA distributions.

The SEP rules permit an employer to contribute (and deduct) each year to each participating employee's SEP-IRA up to 15% of the employee's compensation or $30,000, whichever is less ***(the contribution limit).*** The contributions are funded by the employer.

Figuring the 15% limit. For purposes of determining the 15% limit, ***compensation*** is generally limited to $150,000, ***not including*** your employer's contribution to your SEP-IRA.

Note. For employees in a collective bargaining unit covered by a SEP for which the $150,000 limit is not effective for the plan year beginning in 1994, the compensation limit is $242,280.

Deduction limit for a self-employed person. If you are self-employed and contribute to your own SEP-IRA, special rules apply when figuring your maximum deduction for these contributions.

For determining the 15% limit, discussed above, your ***compensation*** is your net earnings from self-employment. See *Net earnings from self-employment,* later. Note that, for this purpose, your net earnings must take into account your deduction for contributions to your own SEP-IRA. Because the deduction amount and the net earnings amount are each dependent on the other, this adjustment presents a problem.

To solve this problem, you make the adjustment to net earnings indirectly by reducing the contribution rate called for in the plan. Use the following worksheets to find this reduced contribution rate and your maximum deduction. Make no reduction to the contribution rate for any other employees.

Self-Employed Person's Rate Worksheet

1) Plan contribution rate as a decimal (for example, 10½% would be 0.105)	_____
2) Rate in line 1 plus one (for example, 0.105 plus one would be 1.105)	_____
3) Self-employed rate as a decimal (divide line 1 by line 2)	_____

Self-Employed Person's Deduction Worksheet

Step 1 Enter your rate from the *Self-Employed Person's Rate Worksheet*	_____
Step 2 Enter your net earnings from line 3, Schedule C-EZ (Form 1040), line 31, Schedule C (Form 1040), line 36, Schedule F (Form 1040), or line 15a, Schedule K-1 (Form 1065)	$ _____
Step 3 Enter your deduction for self-employment tax from line 25, Form 1040	$ _____
Step 4 Subtract Step 3 from Step 2 and enter the result	$ _____
Step 5 Multiply Step 4 by Step 1 and enter the result	$ _____
Step 6 Multiply $150,000 by your plan contribution rate. Enter the result but not more than $30,000	$ _____
Step 7 Enter the smaller of Step 5 or Step 6. This is your ***maximum deductible contribution.*** Enter your deduction on line 27, Form 1040	$ _____

Example. You are a sole proprietor and have employees. The terms of your plan provide that you contribute 10½% (.105) of your compensation, and 10½% of your common-law employees' compensation. Your net earnings from line 31, Schedule C (Form 1040) is $200,000. In figuring this amount, you deducted your common-law employees' compensation of $100,000 and contributions for them of $10,500 (10½% x $100,000). This net earnings amount is now reduced to $193,565 by subtracting your self-employment tax deduction of $6,435. You figure your self-employed rate and maximum deduction for employer contributions on behalf of yourself as follows:

Self-Employed Person's Rate Worksheet

1) Plan contribution rate as a decimal (for example, 10½% would be 0.105)	0.105
2) Rate in line 1 plus one, (for example, 0.105 plus one would be 1.105)	1.105
3) Self-employed rate as a decimal (divide line 1 by line 2)	0.0950

Self-Employed Person's Deduction Worksheet

Step 1 Enter your rate from the *Self-Employed Person's Rate Worksheet*	0.0950
Step 2 Enter your net earnings from line 3, Schedule C-EZ (Form 1040), line 31, Schedule C (Form 1040), line 36, Schedule F (Form 1040), or line 15a, Schedule K-1 (Form 1065)	$ 200,000
Step 3 Enter your deduction for self-employment tax from line 25, Form 1040	$ 6,435
Step 4 Subtract Step 3 from Step 2 and enter the result	$ 193,565
Step 5 Multiply Step 4 by Step 1 and enter the result	$ 18,389
Step 6 Multiply $150,000 by your plan contribution rate. Enter the result but not more than $30,000	$ 15,750
Step 7 Enter the smaller of Step 5 or Step 6. This is your ***maximum deductible contribution.*** Enter your deduction on line 27, Form 1040.	$ 15,750

Net earnings from self-employment. For SEP purposes, your net earnings are your gross income from your business that has the plan minus your allowable deductions for that business. Your personal services must be a material income-producing factor in that business. Allowable deductions include contributions to the SEP-IRAs of your employees. You must also reduce your earnings by the deduction for one-half of your self-employment tax and the deduction for contributions to your own SEP-IRA. Net earnings do not include tax-free items or deductions related to them, but do include foreign earned income and housing cost amounts. Net earnings include a partner's distributive share of partnership income or loss (other than separately treated items such as capital gains or losses). If paid for services to or for the partnership, net earnings include guaranteed payments to a limited partner. They do not include distributions of income or loss to a limited partner.

The contribution limit (lesser of 15% of compensation or $30,000) discussed earlier ***also applies to*** any amounts you elect to have taken out of your income and contributed to the plan under a *salary reduction arrangement,* discussed later.

The contribution limit discussed above ***does not apply to*** contributions up to your IRA contribution limit that you make during the year to your SEP-IRAs or regular IRAs independent of your employer's contributions. See *How Much Can I Contribute and Deduct?,* earlier.

Salary reduction arrangement. A SEP may include a salary reduction arrangement. Under it, you can elect to have your employer contribute part of your pay to the SEP-IRA. Only the remaining portion of your pay is currently taxable. The tax on the contribution is deferred. This choice is called an elective deferral.

Employer's SEP contributions excluded from your wages on Form W-2. Your employer's contributions to your SEP-IRA are generally excluded from your income rather than deducted from it. Therefore, your employer's contributions should not be included in your Form W–2 wages unless there are contributions in excess of the limit that applies, or unless there are contributions under a salary reduction arrangement. Form W–2 should include contributions under a salary reduction arrangement for social security and Medicare tax purposes only.

Even if your employer makes contributions to your SEP-IRA, ***you may be able to*** deduct the regular IRA contributions you make to your SEP-IRA or another IRA.

Tax treatment by self-employed individuals. If you are self-employed (a sole proprietor or partner) with a SEP, take your deduction for employer contributions to your own SEP-IRA on line 27, Form 1040. If you also make deductible contributions to your SEP-IRA (or any other IRA you own), independent of your employer contributions, take your deduction on line 23, Form 1040.

Excess contributions. If your employer contributes more to your SEP-IRA than 15% of your compensation or $30,000, whichever is less, you will not have to pay the 6% tax on it if you withdraw this excess amount (and interest or other income earned on it) from your SEP-IRA before the due date for filing your tax return, plus extensions. However, you must include the excess contribution in your gross income. Your Form W-2 should include the amount.

For more information on a SEP-IRA, get Publication 590.

19.

Moving Expenses

Important Changes for 1994

No deduction allowed for certain moving expenses. For expenses incurred beginning in 1994, you cannot deduct as moving expenses amounts you pay for:

- Meals while moving from your old residence to your new residence,
- Travel expenses, meals, and lodging for pre-move househunting trips,
- Meals and lodging while occupying temporary quarters in the area of your new job, and
- Qualified residence sale, purchase, and lease expenses.

Distance test. To deduct expenses incurred beginning in 1994, your new main job location must be at least 50 miles farther from your former home than your old main job location.

Moving expenses no longer an itemized deduction. For expenses incurred beginning in 1994, allowable moving expenses are no longer an itemized deduction. You can deduct these expenses in figuring your adjusted gross income.

Reimbursements. If you are reimbursed by your employer for allowable moving expenses incurred beginning in 1994, your employer should exclude these reimbursements from your income. You can only deduct allowable moving expenses that were not reimbursed by your employer.

Important Reminder

Change of address. If you change your mailing address, be sure to notify the IRS using Form 8822, *Change of Address.* Mail it to the Internal Revenue Service Center for your old address (addresses for the Service Centers are on the back of the form).

Introduction

This chapter discusses what expenses you can deduct when you move because of a job. The following topics are covered:

- When moving expenses qualify for a deduction
- Which moving expenses can be claimed
- How to report moving expenses on Form 3903, *Moving Expenses*

This chapter only discusses those expenses incurred beginning in 1994. For information on expenses incurred before 1994, see Chapter 2 of Publication 521, *Moving Expenses.*

You may be able to deduct some of your expenses for moving to a new home because you changed job locations or started a new job. You can qualify for the deduction whether you are self-employed or an employee. However, you must meet the *Requirements,* explained later.

This chapter contains two charts that may help you determine whether your move qualifies for a deduction, and if so, how much you can deduct. The charts are:

- Figure 19–A, *Illustration of Distance Test,* which covers the minimum distance you must move before you qualify to deduct moving expenses, and
- Figure 19–B, *Qualifying Moves Within the U.S.,* which covers general qualifications.

Moves to the United States. If you retire while living and working overseas, you may be able to deduct your expenses of moving back to the U.S. If you are the survivor (spouse or dependent) of a person whose main job location at the time of death was outside the U.S., you may be able to deduct your expenses of moving back to the U.S. See *Retirees or Survivors Who Move to the U.S.,* later.

Moves outside the United States. This chapter does not discuss moves outside the U.S. If you are a U.S. citizen or resident alien who moved outside the U.S. or its possessions because of your job or business, see Publication 521 for special rules that apply to your move.

Useful Items

You may want to see:

Publication

- ❑ **521** Moving Expenses
- ❑ **523** Selling Your Home

Form (and Instructions)

- ❑ **2119** Sale of Your Home
- ❑ **3903** Moving Expenses
- ❑ **3903–F** Foreign Moving Expenses
- ❑ **8822** Change of Address

Requirements

You can deduct your allowable moving expenses if your move is closely related to the start of work and if you meet the distance test and the time test. These two tests are discussed later.

Related to Start of Work

Your move must be closely related, both in time and in place, to the start of work at your new job location.

Closely related in time. In general, moving expenses incurred within one year from the date you first reported to work are considered closely related in time to the start of work at the new location. It is not necessary that you arrange to work before moving to a new location, as long as you actually do go to work.

If you do not move within one year, you ordinarily cannot deduct the expenses unless you can show that circumstances existed that prevented the move within that time.

Example. Your family moved more than a year after you started work at a new location. Their move was delayed because you allowed your child to complete high school. You can deduct your allowable moving expenses.

Closely related in place. A move is generally considered closely related in place to the start of work if the distance from your new home to the new job location is not more than the distance from your former home to the new job location. A move that does not meet this requirement can qualify if you can show that:

1) A condition of employment requires you to live at your new home, or
2) You will spend less time or money commuting from your new home to your new job.

Home defined. Your home means your main home (residence). It may be a house, apartment, or condominium. It also may be a houseboat, house trailer, or similar dwelling. Your home does not include other homes owned or kept up by you or members of your family. It also does not include a seasonal home, such as a summer beach cottage. Your ***former home*** means your home before you left for your new job location. Your ***new home*** means your home within the area of your new job location.

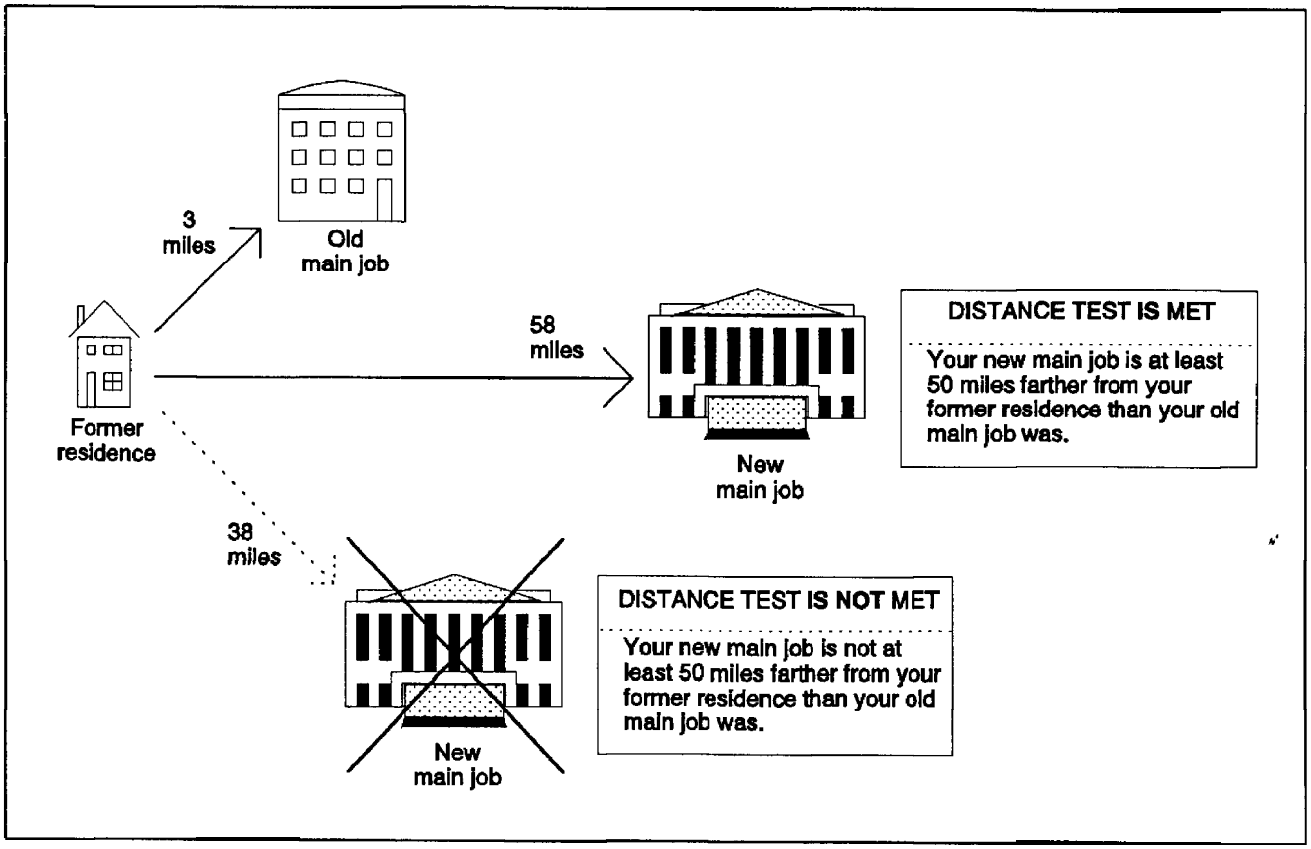
Distance Test

Your move will meet the distance test if your new main job location is ***at least 50 miles*** farther from your former home than your old main job location. For example, if your old job was 3 miles from your former home, your new job must be at least 53 miles from that former home.

The distance between a job location and your home is the shortest of the more commonly traveled routes between them. The distance test considers only the location of your former home. It does not apply to the location of your new home.

Example. You moved to a new home less than 50 miles from your former home because you changed job locations. Your old job was 3 miles from your former home. Your new job is 60 miles from that home. Because

Figure 19-A. Illustration of Distance Test



your new job is 57 miles farther from your former home than the distance from your former home to your old job, you meet the 50-mile distance test.

First job or return to full-time work. If you go to work full time for the first time, your place of work must be at least 50 miles from your former home to meet the distance test.

If you go back to full-time work after a substantial period of part-time work or unemployment, your place of work must also be at least 50 miles from your former home.

Exception for Armed Forces. If you are in the Armed Forces and you moved because of a permanent change of station, you do not have to meet the distance test. See *Members of the Armed Forces,* later.

Main job location. Your main job location is usually the place where you spend most of your working time. A new job location is a new place where you will work permanently or indefinitely rather than temporarily. If there is no one place where you spend most of your working time, your main job location is the place where your work is centered—for example, where you report for work or are otherwise required to "base" your work.

Union members. If you work for a number of employers on a short-term basis and you get work under a union hall system (such as a construction or building trades worker), your main job location is the union hall.

More than one job. If you have more than one job at any time, your main job location depends on the facts in each case. The more important factors to be considered are:

- The total time you spend at each place,
- The amount of work you do at each place, and
- The money you earn at each place.

Time Test

To deduct your moving expenses, you also must meet one of the following time tests.

Time test for employees. If you are an employee, you must work full time for at least ***39 weeks during the first 12 months*** after you arrive in the general area of your new job location. For this time test, count only your full-time work as an employee; do not count any work you do as a self-employed person. You do not have to work for the same employer for the 39 weeks. You do not have to work 39 weeks in a row. However, you must work full time within the same general commuting area. Full-time employment depends on what is usual for your type of work in your area.

Temporary absence from work. You are considered to be working full time during any week you are temporarily absent from work because of illness, strikes, lockouts, layoffs, natural disasters, or similar causes. You are also considered to be a full-time employee during any week you are absent from work for leave or vacation that is provided for in your work contract or agreement.

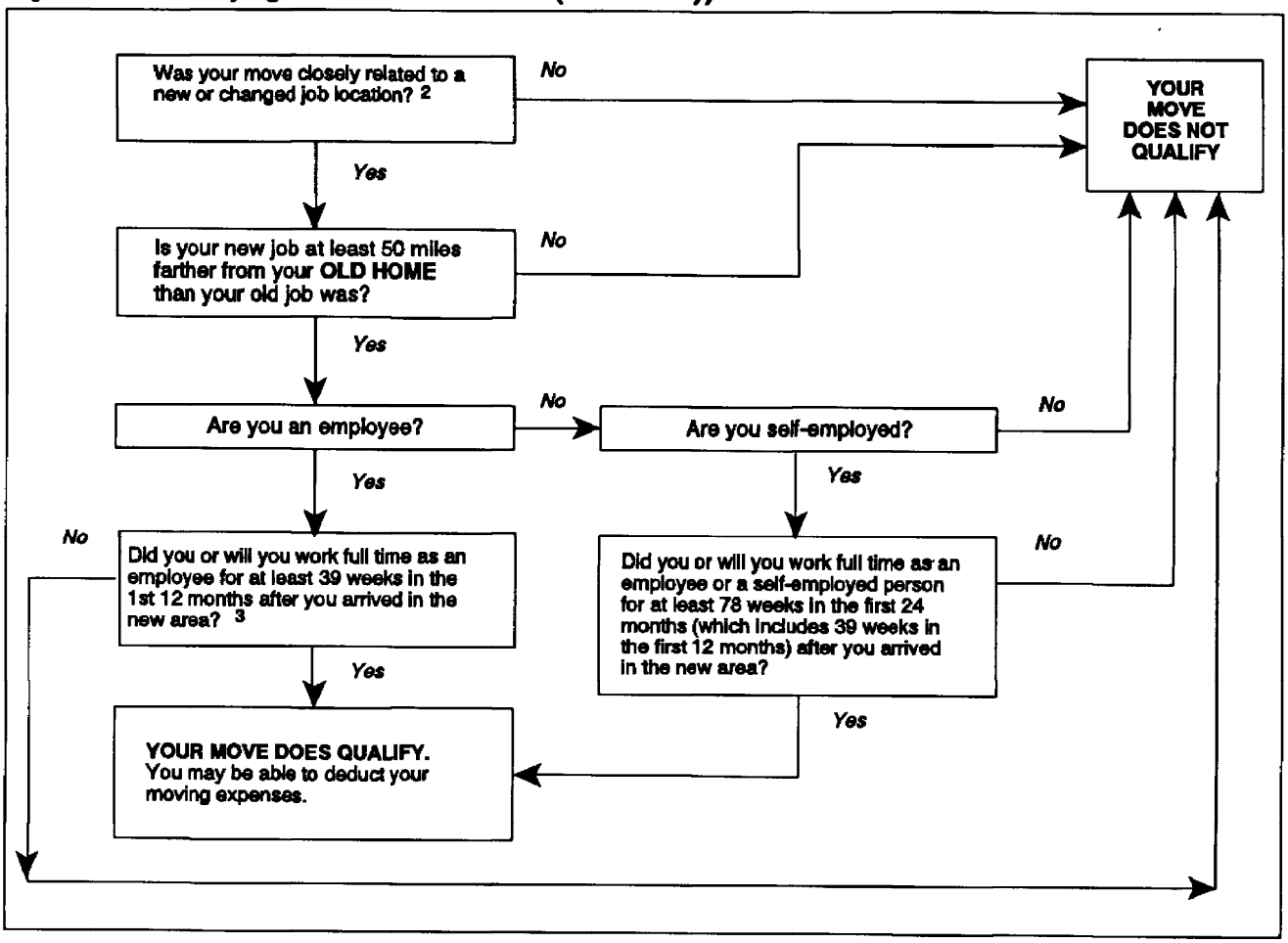
Seasonal work. If your work is seasonal, you are considered to be working full time during the off-season only if your work contract or agreement covers an off-season period and that period is less than 6 months. For example, a school teacher on a 12-month contract who teaches on a full-time basis for more than 6 months is considered a full-time employee for 12 months.

Time test for self-employed persons. If you are self-employed, you must work full time for at least ***39 weeks during the first 12 months AND*** for a total of at least ***78 weeks during the first 24 months*** after you arrive in the area of your new job location. For this time test, count any full-time work you do as an employee or as a self-employed person. You do not have to work for the same employer or be self-employed in the same trade or business for the 78 weeks.

Self-employment. You are self-employed if you work as the sole owner of an unincorporated business or as a partner in a partnership carrying on a business. You are not considered self-employed if you are semiretired, a part-time student, or work only a few hours each week.

Full-time work. Whether you perform services full time during any week depends

Figure 19-B. Qualifying Moves Within the U.S. (Non-Military) [1]



1. Military persons should see "Members of the Armed Forces," in this chapter, for special rules that apply to them.

2. Your move must be closely related to the start of work at your new job location. See "Related to Start of Work," in this chapter.

3. If you deduct expenses and do not meet this test later, you must either file an amended tax return or report your moving expense deduction as other income. See "Time test not yet met," in this chapter.

on what is usual for your type of work in your area.

If you are an employee and become self-employed before satisfying the 39-week test for employees, you meet the time test if you satisfy the 78-week test for self-employed persons. Under the 78-week test, you still have to work full time for 39 weeks during the first 12 months. However, you can count any full-time work you do as an employee or as a self-employed person.

If you are self-employed and become an employee before satisfying the 78-week test, but you work as an employee for at least 39 weeks during the first 12 months after you arrived at the new job location, you will satisfy the time test for employees. If you cannot satisfy that time test, you can use the time spent as a full-time employee to satisfy the 78-week test. Under the 78-week test, you still have to work full time for 39 weeks during the first 12 months. However, you can count any full-time work you do as an employee or as a self-employed person.

If you are both self-employed and an employee, the amount of time you spend as each determines whether you must meet the 78-week test for self-employed persons or the 39-week test for employees. If you spend most of your working time as a self-employed person, you must meet the 78-week test (which includes a requirement to work 39 weeks during the first 12 months). If you spend most of your working time as an employee, you must meet the 39-week test.

For more information, see *Time test for self-employed persons* in Publication 521.

Joint return. If you are married and file a joint return and both you and your spouse work full time, either of you can satisfy the full-time work test. However, you cannot combine the weeks your spouse worked with the weeks you worked to satisfy that test.

Time test not yet met. You can deduct your moving expenses even if you have not yet met the time test by the date your 1994 return is due. You can do this if you expect to meet the 39-week test in 1995 or the 78-week test in 1996. If you deduct moving expenses but do not meet the time test by then, you must either:

- Amend your 1994 return, or
- Report your moving expense deduction as other income on your Form 1040 for the year you cannot meet the test.

Use Form 1040X, *Amended U.S. Individual Income Tax Return,* to amend your return.

If you do not deduct your moving expenses on your 1994 return and you later meet the time test, you can file an amended return for 1994 to take the deduction.

Exceptions to the Time Test

You do not have to meet the time test if one of the following applies:

1) You are in the Armed Forces and you moved because of a permanent change

of station—see *Members of the Armed Forces,* in this chapter,

2) You moved to the United States because you retired—see *Retirees or Survivors Who Move to the U.S.,* later,
3) You are the survivor of a person whose main job location at the time of death was outside the United States—see *Retirees or Survivors Who Move to the U.S.,* later,
4) Your job at the new location ends because of death or disability, or
5) You are transferred for your employer's benefit or laid off for a reason other than willful misconduct. For this exception, you must have obtained full-time employment, and you must have expected to meet the test at the time you started the job.

Members of the Armed Forces

If you are a member of the Armed Forces on active duty and you move because of a permanent change of station, you do not have to meet the ***distance and time tests,*** discussed earlier. You can deduct your unreimbursed allowable moving expenses.

A permanent change of station includes:

- A move from your home to the area of your first post of duty when you begin active duty,
- A move from one permanent post of duty to another, or
- A move from your last post of duty to your home or to a nearer point in the United States. The move must occur within one year of ending your active duty or within the period allowed under the Joint Travel Regulations.

Spouse and dependents. If a member of the Armed Forces deserts, is imprisoned, or dies, a permanent change of station for the spouse or dependent includes a move to the place of enlistment, or to the member's, spouse's, or dependent's home of record, or to a nearer point in the United States.

If the military moves you and your spouse and dependents to or from separate locations, the moves are treated as a single move to your new main job location.

More information. For more information on moving expenses for members of the Armed Forces, and instructions for completing Form 3903, see *Members of the Armed Forces* in Publication 521.

Retirees or Survivors Who Move to the U.S.

You may be able to deduct your moving expenses, subject to certain dollar limits, if you move to the U.S. or to a possession of the U.S. You do not have to meet the ***time test,*** discussed earlier, but you must meet the requirements discussed below.

Retirees. You can deduct moving expenses for a move to a new home in the U.S. when you permanently retire. However, both your former main job location and your former home must have been outside the U.S.

Permanently retired. You are considered permanently retired when you cease gainful full-time employment or self-employment. If at the time you retire, you intend your retirement to be permanent, you will be considered retired even though you later return to work. Your intention to retire permanently will be determined by:

- Your age and health,
- The customary retirement age for people who do similar work,
- Whether you are receiving retirement payments from a pension or retirement fund, and
- The length of time before you will return to full-time work.

Survivors. You can deduct moving expenses for a move to a home in the U.S. if you are the spouse or the dependent of a person whose main job location at the time of death was outside the U.S. The move must begin within 6 months after the decedent's death. It must be from the decedent's former home outside the U.S. That home must also have been your home.

A move begins when:

- You contract for your household goods and personal effects to be moved to your home in the U.S. However, this applies only if the move is completed within a reasonable time,
- Your household goods and personal effects are packed and on the way to your home in the U.S., or
- You leave your former home to travel to your new home in the U.S.

Deductible Expenses

If you meet the *Requirements* discussed earlier, you can deduct the reasonable expenses of:

- Moving your household goods and personal effects (including in-transit or foreign-move storage expenses), and
- Traveling (includes lodging) to your new home.

However, you cannot deduct any part of these expenses that is for meals.

Reasonable expenses. You can deduct only those expenses that are reasonable for the circumstances of your move. For example, the cost of traveling from your former home to your new one should be by the shortest, most direct route available by conventional transportation. If, during your trip to your new home, you make side trips for sightseeing, the additional expenses for your side trips are not deductible as moving expenses.

Travel by car. If you use your car to take yourself, members of your household, or your belongings to your new home, you can figure your expenses by deducting either:

1) Your ***actual expenses,*** such as gas and oil for your car, if you keep an accurate record of each expense, or
2) ***9 cents a mile.***

You can deduct parking fees and tolls you paid in moving. You cannot deduct any part of general repairs, general maintenance, insurance, or depreciation for your car.

Member of household. You can deduct moving expenses you pay for yourself and members of your household. A member of your household is anyone who has both your former and new home as his or her home. It does not include a tenant or employee, unless you can claim that person as a dependent.

Location of move. There are different rules for moving within or to the U.S. than for moving outside the U.S. This chapter only discusses moves within or to the U.S. The rules for moves outside the U.S. can be found in Publication 521.

Household Goods and Personal Effects

You can deduct the cost of packing, crating, and transporting your household goods and personal effects and those of the members of your household from your former home to your new home. If you use your own car to move your things, see *Travel by car,* earlier. You can include the cost of storing and insuring household goods and personal effects ***within any period of 30 consecutive days*** after the day your things are moved from your former home and before they are delivered to your new home.

You can deduct any costs of connecting or disconnecting utilities to move your household goods, appliances or personal effects.

You can deduct the cost of shipping your car and household pets to your new home.

You can deduct the cost of moving household goods and personal effects from a place other than your former home. Your deduction is limited to the amount it would have cost to move them from your former home.

You cannot deduct the cost of moving furniture you buy on the way to your new home.

Travel Expenses

You can deduct the cost of transportation and lodging for yourself and members of your household while traveling from your former home to your new home. This includes expenses for the day you arrive. You can include any lodging expenses you had in the

area of your former home within one day after you could not live in your former home because your furniture had been moved. You can deduct expenses for only one trip to your new home for yourself and members of your household. However, all of you do not have to travel together. If you use your own car, see *Travel by car,* earlier.

Nondeductible Expenses

You cannot deduct the following items as moving expenses:

- Pre-move househunting expenses,
- Temporary living expenses,
- Meal expenses,
- Expenses of buying or selling a home,
- Expenses of getting or breaking a lease,
- Security deposits (including any given up due to the move),
- Home improvements to help sell your home,
- Loss on the sale of your home,
- Mortgage penalties,
- Losses from disposing of memberships in clubs,
- Any part of the purchase price of your new home,
- Real estate taxes,
- Car tags,
- Driver's license,
- Refitting carpets and draperies, and
- Storage charges except those incurred in transit and for foreign moves.

Temporary employment. You cannot take a moving expense deduction and a business expense deduction for the same expenses. You must determine if your expenses are deductible as moving expenses or as business expenses. For example, expenses you have for travel, meals, and lodging while temporarily working at a place away from your regular place of work are deductible as business expenses if you are considered away from home on business. Your work is considered temporary if it does not last more than one year. See *Temporary Assignment or Job* in Chapter 28 for information on deducting your expenses.

How to Report

The following discussions explain how to report your moving expenses and any reimbursements or allowances you received for your move.

Form 3903. Use Part I of Form 3903 to report your moving expenses if your move was within or to the United States or its possessions. A filled-in Form 3903 is shown in Chapter 39.

Where to deduct. Deduct your moving expenses on line 24 of Form 1040. The amount of moving expenses you can deduct is shown on Part I, line 8, Form 3903.

You cannot deduct moving expenses if you file Form 1040A or Form 1040EZ.

Reimbursements. If you received an advance, allowance, or reimbursement for your allowable moving expenses, how you report this amount and your expenses depends on whether the reimbursement was paid to you under an accountable plan or a nonaccountable plan.

For more information on reimbursements, see Publication 521.

Form 4782. Your employer must give you an itemized list of payments, reimbursements, or allowances that have been paid to you for moving expenses. Form 4782, *Employee Moving Expense Information,* may be used for this purpose. See Publication 521 for a filled-in Form 4782.

When to Deduct Expenses

If you were not reimbursed, deduct your allowable moving expenses in the year you had them or paid them.

Example. In December 1994, your employer transferred you to another city in the United States, where you still work. You are single and were not reimbursed for your moving expenses. In 1994 you paid for moving your furniture. You deducted these expenses in 1994. In January 1995, you paid for travel to the new city. You can deduct these additional expenses in 1995.

Note. You cannot deduct any moving expenses for which you received a reimbursement that was excluded from your income. (Reimbursements are discussed in Publication 521.)

Reimbursed expenses—reimbursement included in income. If you incurred allowable moving expenses for which you received a reimbursement that was included in your income, you may be able to deduct the expenses in the year you are reimbursed even though you paid the expenses in a different year.

Choosing when to deduct. If you use the cash method of accounting, which is used by most individuals who are not self-employed, you can choose to deduct moving expenses in the year your employer reimburses you, if:

1) You paid the expenses in a year before the year of reimbursement, or

2) You paid the expenses in the year immediately after the year of reimbursement but by the due date, including extensions, for filing your return for the reimbursement year.

How to make the choice. You can choose to deduct moving expenses in the year you received reimbursement by taking the deduction on your return, or amended return, for that year.

20.

Alimony

Introduction

This chapter discusses the rules that apply to you if you pay or receive alimony and covers the following topics:

- What is alimony
- What payments are not alimony, such as child support
- How to deduct alimony you paid
- How to report alimony income you received
- Whether you must recapture the tax benefits of alimony (Recapture means a deduction was taken in a prior year and part of it had to be added back in your income in 1994.)

Alimony is a payment to or for a spouse or former spouse under a divorce or separation instrument. It does not include voluntary payments that are not required by a divorce or separation instrument.

Alimony is deductible by the payer and must be included in the spouse's or former spouse's income. Although this chapter is generally written for the payer of the alimony, the recipient can use the information to determine whether an amount received is alimony.

To be alimony, a payment must meet certain requirements. Different requirements apply to payments under instruments executed after 1984 and to payments under instruments executed before 1985. This chapter discusses the rules for payments under instruments executed after 1984. For the rules for payments under pre-1985 instruments, see Publication 504, *Divorced or Separated Individuals.*

Use *Table 20–1* in this chapter as a guide to determine whether certain payments are considered alimony.

Definitions. The following definitions apply throughout this chapter.

Spouse or former spouse. Unless otherwise stated in the following discussions about alimony, the term ''spouse'' includes ''former spouse.''

Divorce or separation instrument. The term ''divorce or separation instrument'' means:

1) A decree of divorce or separate maintenance or a written instrument incident to that decree,
2) A written separation agreement, or
3) A decree or any type of court order requiring a spouse to make payments for the support or maintenance of the other spouse, including a temporary decree, an interlocutory (not final) decree, and a decree of alimony *pendente lite* (while awaiting action on the final decree or agreement).

Useful Items

You may want to see:

Publication

❑ **504** Divorced or Separated Individuals

General Rules

The following rules apply to alimony regardless of when the divorce or separation instrument was executed.

Payments not alimony. Not all payments under a divorce or separation instrument are alimony. Alimony does not include:

1) Child support,
2) Noncash property settlements,
3) Payments that are your spouse's part of community income (see *Community Property* in Publication 504),
4) Use of property, or
5) Payments to keep up the payer's property.

Payments to a third party. Payments to a third party on behalf of your spouse under the terms of your divorce or separation instrument may be alimony, if they otherwise qualify. This includes payments for your spouse's medical expenses, housing costs (rent, utilities, etc.), taxes, tuition, etc. The payments are treated as received by your spouse and then paid to the third party.

Life insurance premiums. Premiums you must pay under your divorce or separation instrument for insurance on your life qualify as alimony to the extent your spouse owns the policy.

Payments for jointly-owned home. If your divorce or separation instrument states that you must pay expenses for a home owned by you and your spouse, some of your payments may be alimony.

Mortgage payments. If you must make all the mortgage payments (principal and interest) on a jointly-owned home, and they otherwise qualify, you can deduct one-half of the total payments as alimony. If you itemize deductions and the home is a qualified residence, you can include the other half of the interest in figuring your deductible interest. Your spouse must report one-half of the payments as alimony received. If your spouse itemizes deductions and the home is a qualified residence, he or she can include one-half of the interest on the mortgage in figuring deductible interest.

Taxes and insurance. If you must pay all the real estate taxes or insurance on a home held as ***tenants in common,*** you can deduct one-half of these payments as alimony. Your spouse must report one-half of these payments as alimony received. If you and your spouse itemize deductions, you can each deduct one-half of the real estate taxes.

If your home is held as ***tenants by the entirety*** or ***joint tenants*** (with the right of survivorship), none of your payments for taxes or insurance are alimony. But if you itemize deductions, you can deduct all of the real estate taxes.

Other payments to a third party. If you made other third-party payments, see Publication 504 to see whether any part of the payments qualify as alimony.

Instruments Executed After 1984

The following rules for alimony apply to payments under divorce or separation instruments executed after 1984. They also apply to payments under earlier instruments that were modified after 1984 to:

1) Specify that these rules will apply, or
2) Change the amount or period of payment or add or delete any contingency or condition.

The rules in this section do not apply to divorce or separation instruments executed after 1984 if the terms for alimony are unchanged from an instrument executed before 1985.

Example 1. In November 1984, you and your former spouse executed a written separation agreement. In February 1985, a decree of divorce was substituted for the written separation agreement. The decree of divorce did not change the terms for the alimony you pay your former spouse. The decree of divorce is treated as executed before 1985. Therefore, alimony payments under the decree are not subject to the rules for payments under instruments executed after 1984.

Example 2. Assume the same facts as in Example 1 except that the decree of divorce changed the amount of the alimony. In this example, the decree of divorce is not treated as executed before 1985. Therefore, the alimony payments are subject to the rules for payments under instruments executed after 1984.

Alimony requirements. A payment to or for a spouse under a divorce or separation instrument is alimony if the spouses do not file a joint return with each other and all the following requirements are met.

1) The payment is in cash.
2) The instrument does not designate the payment as not alimony.
3) The spouses are not members of the same household (if separated under a decree of divorce or separate maintenance),

4) There is no liability to make any payment (in cash or property) after the death of the recipient spouse.

5) The payment is not treated as child support.

Each of these requirements is discussed below.

Payment must be in cash. Only cash payments, including checks and money orders, qualify as alimony. Transfers of services or property (including a debt instrument of a third party or an annuity contract), execution of a debt instrument, or the use of property do not qualify as alimony.

Payments to a third party. Cash payments to a third party under the terms of your divorce or separation instrument can qualify as a cash payment to your spouse. See *Payments to a third party* under *General Rules,* earlier.

Also, cash payments made to a third party at the written request of your spouse qualify as alimony if all the following requirements are met.

1) The payments are in lieu of payments of alimony directly to your spouse.

2) The written request states that both spouses intend the payments to be treated as alimony.

3) You receive the written request from your spouse before you file your return for the year you made the payments.

Payments designated as not alimony. You and your spouse may designate that otherwise qualifying payments are not alimony by including a provision in your divorce or separation instrument that the payments are not deductible by you and are excludable from your spouse's income. For this purpose, any writing signed by both of you that makes this designation and that refers to a previous written separation agreement is treated as a written separation agreement. If you are subject to temporary support orders, the designation must be made in the original or a subsequent temporary support order.

To exclude the payments from income, your spouse must attach a copy of the instrument designating them as not alimony to his or her return for each year the designation applies.

Spouses cannot be members of the same household. Payments to your spouse while you are members of the same household are not alimony if you are separated under a decree of divorce or separate maintenance. A home you formerly shared is considered one household, even if you physically separate yourselves in the home.

You are not treated as members of the same household if one of you is preparing to leave the household and does leave not more than one month after the date of the payment.

Exception. If you are not legally separated under a decree of divorce or separate maintenance, a payment under a written separation agreement, support decree or other court order may qualify as alimony even if you are members of the same household when the payment is made.

Liability for payments after death of recipient spouse. If you must continue to make payments for any period after your spouse's death, none of the payments made before or after the death are alimony.

The divorce or separation instrument does not have to expressly state that the payments cease upon the death of your spouse if, for example, the liability for continued payments would end under state law.

Example. You must pay your former spouse $10,000 in cash each year for 10 years. Your divorce decree states that the payments will end upon your former spouse's death. You must also pay your former spouse or your former spouse's estate $20,000 in cash each year for 10 years. The death of your spouse would not terminate the payments under state law.

The $10,000 annual payments are alimony. But because the $20,000 annual payments will not end upon your former spouse's death, they are not alimony.

Substitute payments. If you must make any payments in cash or property after your spouse's death as a substitute for continuing otherwise qualifying payments, the otherwise qualifying payments are not alimony. Substitute payments, can also include, depending on the facts and circumstances, payments to the extent they increase in amount or begin or accelerate as a result of your spouse's death.

Example 1. Under your divorce decree, you must pay your former spouse $30,000 annually. The payments will stop at the end of 6 years or upon your former spouse's death, if earlier.

Your former spouse has custody of your minor children. The decree provides that if any child is still a minor at your spouse's death, you must pay $10,000 annually to a trust until the youngest child reaches the age of majority. The trust income and corpus (principal) are to be used for your children's benefit.

These facts indicate that the payments to be made after your former spouse's death are a substitute for $10,000 of the $30,000 annual payments. Therefore, $10,000 of each of the $30,000 annual payments is not alimony.

Example 2. Under your divorce decree, you must pay your former spouse $30,000 annually. The payments will stop at the end of 15 years or upon your former spouse's death, if earlier. The decree provides that if your former spouse dies before the end of the 15–year period, you must pay the estate the difference between $450,000 ($30,000 × 15) and the total amount paid up to that time. For example, if your spouse dies at the end of the tenth year, you must pay the estate $150,000 ($450,000 – $300,000).

These facts indicate that the lump-sum payment to be made after your former spouse's death is a substitute for the full amount of the $30,000 annual payments. Therefore, none of the annual payments are alimony. The result would be the same if the payment required at death were to be discounted by an appropriate interest factor to account for the prepayment.

Child support. A payment that is specifically designated as child support or treated as specifically designated as child support under your divorce or separation instrument is not alimony. The designated amount or part may vary from time to time. Child support payments are neither deductible by the payer, nor taxable to the payee.

A payment will be ***treated as specifically designated*** as child support to the extent that the payment is reduced either:

1) On the happening of a contingency relating to your child, or

2) At a time that can be clearly associated with the contingency.

A payment may be treated as specifically designated as child support even if other separate payments are specifically designated as child support.

Contingency relating to your child. A contingency relates to your child if it depends on any event relating to that child. It does not matter whether the event is certain or likely to occur. Events relating to your child include the child's:

Reaching a specified age or income level,

Dying,

Marrying,

Leaving school,

Leaving the household, or

Becoming employed.

Clearly associated with a contingency. Payments are presumed to be reduced at a time clearly associated with the happening of a contingency relating to your child only in the following situations.

1) The payments are to be reduced not more than 6 months before or after the date the child will reach 18, 21, or local age of majority.

2) The payments are to be reduced on two or more occasions that occur not more than one year before or after a different child reaches a certain age from 18 to 24. This certain age must be the same for each child, but need not be a whole number of years.

In all other situations, reductions in payments are not treated as clearly associated with the happening of a contingency relating to your child.

Either you or the IRS may overcome the presumption in the two situations above. This is done by showing that the time at which the payments are to be reduced was determined independently of any contingencies relating to your children. For example, if

Table 20-1. **Alimony Requirements (Instruments executed after 1984)**

Payments ARE Alimony if all of the following are true:	**Payments ARE NOT Alimony if any of the following are true:**
Payments are required by a divorce or separation instrument. Payer and recipient spouse do not file a joint return. Payment is in cash (including checks or money orders). Payment is not designated in the instrument as not alimony. Spouses separated under a decree of divorce or separate maintenance are not members of the same household. Payments are not required after death of the recipient spouse. Payment is not designated as child support.	Payment is designated as child support. Payment is a noncash property settlement. Payments are spouse's part of community income. Payments are to keep up the payer's property. Payments are not required by a divorce or separation instrument.
These payments are deductible by the payer and includible in income by the recipient.	*These payments are neither deductible by the payer nor includible in income by the recipient.*

you can show that the period of alimony payments is customary in the local jurisdiction, such as a period equal to one-half of the duration of the marriage, you can treat the amount as alimony.

How to Deduct Alimony Paid

You can deduct alimony you paid, whether or not you itemize deductions on your return. You must file Form 1040; you cannot use Form 1040A or Form 1040EZ.

Enter the alimony on line 29 of Form 1040. In the space provided on line 29, enter your spouse's or former spouse's social security number. If you do not, you may have to pay a $50 penalty and your deduction may be disallowed.

If you paid alimony to more than one person, enter the social security number of one of the recipients. Show the social security number and amount paid for each other recipient on an attached statement. Enter your total payments on line 29.

How to Report Alimony Received

Report alimony you received on line 11 of Form 1040; you cannot use Form 1040A or Form 1040EZ.

You must give the person who paid the alimony your social security number. If you do not, you may have to pay a $50 penalty.

Recapture Rule

If your alimony payments decrease or terminate during the first 3 calendar years, you may be subject to the recapture rule. If you are subject to this rule, you have to include in income in 1994 part of the alimony payments you deducted in 1992 and 1993. Your spouse can deduct in 1994 part of the alimony payments included in income in those previous years.

The 3–year period starts with the first calendar year you make a payment qualifying as alimony under a decree of divorce or separate maintenance, or a written separation agreement. Do not include any time in which payments were being made under temporary support orders. The second and third years are the next 2 calendar years, whether or not payments are made during those years.

The reasons for a reduction or termination of alimony payments can include:

A failure to make timely payments,

A change in your instrument,

A reduction in your spouse's support needs, or

A reduction in your ability to provide support.

Subject to recapture for 1994. You are subject to the recapture rule for 1994, if you answer ''Yes'' to the following questions.

1) Was 1992 the first year in which you made alimony payments to this spouse under a decree of divorce or separate maintenance or a written separation agreement?

2) Did your total payments in 1993 or 1994 decrease by more than $15,000 from the prior year?

In answering the above questions, do not include payments required over a period of at least 3 calendar years of a fixed part of your income from a business or property, or from compensation for employment or self-employment. These payments are not subject to the recapture rule.

Exception. You are not subject to recapture if your payments were reduced because of the death of either spouse or the remarriage of the spouse receiving the payments.

Figuring the recapture. Both you and your spouse can use *Table 20–2,* substituting your own figures, to figure recaptured alimony. Publication 504 has a blank worksheet for your use.

Example. Myrna pays Phil the following amounts of alimony under their 1992 divorce decree:

Year	Amount
1992	$60,000
1993	40,000
1994	20,000

The recaptured alimony is $22,500, as shown in *Table 20–2.*

Myrna shows $22,500 as income on line 11 of her 1994 Form 1040. Phil deducts $22,500 on line 29 of his 1994 Form 1040.

Including the recapture in income. If you must include a recapture amount in income, show it on Form 1040, line 11 (''Alimony received''). Cross out ''received'' and write ''recapture.'' On the dotted line next to the amount, enter your spouse's last name and social security number.

Deducting the recapture. If you can deduct a recapture amount, show it on Form 1040, line 29 (''Alimony paid''). Cross out ''paid'' and write ''recapture.'' In the space provided, enter your spouse's social security number.

Table 20-2. **Worksheet for Recapture of Alimony**

Note: Do not enter less than zero on any line.

1.	Alimony paid in **2nd year**		40,000	
2.	Alimony paid in **3rd year**	20,000		
3.	Floor	$15,000		
4.	Add lines 2 and 3		35,000	
5.	Subtract line 4 from line 1			5,000
6.	Alimony paid in **1st year**		60,000	
7.	Adjusted alimony paid in **2nd year** (line 1 less line 5)	35,000		
8.	Alimony paid in **3rd year**	20,000		
9.	Add lines 7 and 8	55,000		
10.	Divide line 9 by 2	27,500		
11.	Floor	$15,000		
12.	Add lines 10 and 11		42,500	
13.	Subtract line 12 from line 6			17,500
				*
14.	**Recaptured alimony.** Add lines 5 and 13			22,500

***** If you deducted alimony paid, report this amount as income on line 11, Form 1040.
If you reported alimony received, deduct this amount on line 29, Form 1040.

Part Six.

Standard Deduction and Itemized Deductions

After you have figured your adjusted gross income, you are ready to subtract the deductions used to figure taxable income. You can subtract either the standard deduction or itemized deductions. For the most part, itemized deductions are deductions for various kinds of personal expenses that are listed on Schedule A (Form 1040). See Chapter 21 for the factors to consider when deciding whether to subtract the standard deduction or itemized deductions.

The ten chapters in this part discuss the standard deduction, each itemized deduction, and the limit on some of your itemized deductions if your adjusted gross income exceeds certain amounts.

21. Standard Deduction

Important Changes for 1994

Increase in standard deduction. The standard deduction for taxpayers who do not itemize deductions on Schedule A of Form 1040 is higher in 1994 than it was in 1993. The amount depends upon your filing status. See *1994 Standard Deduction Tables,* later.

Itemized deductions. The amount you may deduct for itemized deductions is limited if your adjusted gross income is more than $111,800 ($55,900 if you are married filing separately). See Chapter 22 for more information.

Introduction

This chapter discusses:

- Who can take the standard deduction,
- How to figure the amount of your standard deduction,
- What additional amounts there are for age or blindness,
- How to claim the standard deduction on your return,
- What different rules apply to dependents, and
- Whether to take the standard deduction or to itemize your deductions.

The standard deduction is a dollar amount that reduces the amount of income on which you are taxed.

The standard deduction is a benefit that reduces the need for many taxpayers to itemize actual deductions, such as medical expenses, charitable contributions, or taxes, on Schedule A of Form 1040. If you have a choice, you should use the method that gives you the lower tax.

You benefit from the standard deduction if your standard deduction is more than the total of your allowable itemized deductions.

Figuring the Amount

Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions.

Persons not eligible for the standard deduction. Your standard deduction is ***zero*** and you should itemize any deductions you have if:

1) You are married and filing a separate return, and your spouse itemizes deductions,
2) You are filing a tax return for a short tax year, or
3) You are a nonresident or dual-status alien during the year. You are considered a dual-status alien if you were both a nonresident and resident alien during the year.

   Note. If you are a nonresident alien who is married to a U.S. citizen or resident at the end of 1994, you can choose to be treated as a U.S. resident for 1994. (See Publication 519, *U.S. Tax Guide for Aliens.*) You may take the standard deduction that applies to you.

Dependents may have a limited standard deduction. If you can be claimed as a dependent on another person's return (such as your parents' return), your standard deduction may be limited. See *Standard Deduction for Dependents,* later.

Standard deduction amount. The standard deduction amounts for most taxpayers are shown in *Table 21–1.*

The amount of the standard deduction for a decedent's final return is the same as it would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed.

Higher standard deduction for age (65 or older). If you do not itemize deductions, you are entitled to a higher standard deduction if you are age 65 or older at the end of the year. You are considered 65 on the day before your 65th birthday. Therefore, you may take a higher standard deduction for 1994 if your 65th birthday was on or before January 1, 1995.

See *Table 21–2* to figure the standard deduction amount you are entitled to.

Higher standard deduction for blindness. If you are blind on the last day of the year and you do not itemize deductions, you are entitled to a higher standard deduction as shown in *Table 21–2.* You qualify for this benefit if you are totally or partly blind.

Totally blind. If you are totally blind, attach a statement to this effect to your return.

Partly blind. If you are partly blind, you must submit with your return each year a certified statement from an eye physician or registered optometrist that:

1) You cannot see better than 20/200 in the better eye with glasses or contact lenses, or
2) Your field of vision is not more than 20 degrees.

If your eye condition will never improve beyond these limits, you can avoid having to get a new certified statement each year by having the examining eye physician include this fact in the certification you attach to your return. In later years just attach a statement referring to the certification. You should keep a copy of the certification in your records.

If your vision can be corrected beyond these limits only by contact lenses that you can wear only briefly because of pain, infection, or ulcers, you may take the higher standard deduction for blindness if you otherwise qualify.

Spouse 65 or older or blind. You may take the higher standard deduction if your spouse is age 65 or older or blind and:

1) You file a joint return, or

2) You file a separate return, and your spouse had no gross income and could not be claimed as a dependent by another taxpayer.

Note. You may not claim the higher standard deduction for an individual, other than your spouse, for whom you can claim an exemption.

Example 1. Larry, 46, and Donna, 43, are filing a joint return for 1994. Neither is blind. They decide not to itemize their deductions. They use *Table 21–1.* Their standard deduction is $6,350.

Example 2. Assume the same facts as in Example 1, except that Larry is blind at the end of 1994. Larry and Donna use *Table 21–2.* Their standard deduction is $7,100.

Example 3. Bill and Terry are filing a joint return for 1994. Both are over age 65. Neither is blind. If they do not itemize deductions, they use *Table 21–2.* Their standard deduction is $7,850.

How to report. After you find your standard deduction amount, enter it on line 19 of Form 1040A or line 34 of Form 1040. If you use Form 1040EZ, combine your standard deduction with your personal exemption(s) and check the appropriate box on line 4. If the total of your standard deduction and personal exemptions is more than $6,250 ($11,250 if married filing a joint return), you must file Form 1040A or Form 1040.

Standard Deduction for Dependents

The standard deduction for an individual who can be claimed as a dependent on another person's tax return is generally limited to the greater of (a) $600, or (b) the individual's earned income for the year (but not more than the regular standard deduction amount, generally $3,800).

However, if you are a dependent who is 65 or older or blind, your standard deduction may be higher.

If you are a dependent, use *Table 21–3* to determine your standard deduction.

Earned income defined. Earned income is salaries, wages, tips, professional fees, and other amounts received as pay for work you actually perform.

For purposes of the standard deduction, earned income also includes any part of a ***scholarship or fellowship grant*** that you must include in your gross income. See *Scholarship and Fellowship Grants* in Chapter 13 for more information on what qualifies as a scholarship or fellowship grant.

Where to report your standard deduction. After you find your standard deduction amount, enter it on line 19 of Form 1040A or line 34 of Form 1040. If you use Form 1040EZ, figure your standard deduction on the back of the form and check the appropriate box on line 4. If your standard deduction is more than $3,800 ($6,350 if married filing a joint return), you must file Form 1040A or Form 1040.

Example 1. Michael, who is single, is claimed as a dependent on his parents' 1994 tax return. He has interest income of $700 and wages of $150. He has no itemized deductions. Michael uses *Table 21–3* to find his standard deduction. It is $600 because the greater of $600 or his earned income ($150) is $600.

Example 2. Joe, a 22-year-old full-time college student, is claimed as a dependent on his parents' 1994 tax return. Joe is married and files a separate return. His wife does not itemize deductions on her separate return.

Joe has $1,500 in interest income and wages of $3,200. He has no itemized deductions. Joe finds his standard deduction by using *Table 21–3.* He enters his earned income, $3,200, on line 1. On line 3 he enters $3,200, the larger of his earned income ($3,200) or $600. Since Joe is married filing a separate return, he enters $3,175 on line 4. On line 5a he enters $3,175 as his standard deduction because it is smaller than $3,200, his earned income.

Example 3. Amy, who is single, is claimed as a dependent on her parents' 1994 tax return. She is 18 years old and blind. She has interest income of $1,300 and wages of $3,000. She has no itemized deductions. Amy uses *Table 21–3* to find her standard deduction. She enters her wages of $3,000 on line 1. On line 3 she enters $3,000, the larger of her wages on line 1 and the $600 on line 2. Since she is single, Amy enters $3,800 on line 4. She enters $3,000 on line 5a. This is the smaller of the amounts on lines 3 and 4. Because she checked one box in the top part of the worksheet, she enters $950 on line 5b. She then adds the amounts on lines 5a and 5b and enters her standard deduction of $3,950 on line 5c.

Who Should Itemize

Some taxpayers should itemize their deductions because it will save them money. Others should itemize because they do not qualify for the standard deduction, as discussed earlier under *Persons not eligible for the standard deduction.*

Persons who should itemize deductions. If the total of your itemized deductions is more than the standard deduction to which you otherwise would be entitled, you should itemize your deductions. You should first figure your itemized deductions and compare that amount to your standard deduction to make sure you are using the method that gives you the greater benefit.

Caution: You may be subject to a limit on some of your itemized deductions if your adjusted gross income (AGI) is more than $111,800 ($55,900 if you are married filing separately). See Chapter 22 and the instructions for Schedule A (Form 1040), line 29, for more information on figuring the correct amount of your itemized deductions.

When to itemize. You may benefit from itemizing your deductions on Schedule A of Form 1040 if you:

1) Do not qualify for the standard deduction, or the amount you can claim is limited,

2) Had large uninsured medical and dental expenses during the year,

3) Paid interest and taxes on your home,

4) Had large unreimbursed employee business expenses or other miscellaneous deductions,

5) Had large casualty or theft losses not covered by insurance,

6) Made large contributions to qualified charities, or

7) Have total itemized deductions that are more than the highest standard deduction to which you otherwise are entitled.

These deductions are explained in Chapters 23–30.

If you decide to itemize your deductions, complete Schedule A and attach it to your Form 1040. Enter the amount from Schedule A, line 29, on Form 1040, line 34.

Itemizing for state tax or other purposes. If you choose to itemize even though your itemized deductions are less than the amount of your standard deduction, write "IE" (itemized elected) next to line 34 (Form 1040).

Changing your mind. If you do not itemize your deductions and later find that you should have itemized — or if you itemize your deductions and later find you should not have — you can change your return by filing Form 1040X, *Amended U.S. Individual Income Tax Return.* See *Amended Returns and Claims for Refund* in Chapter 1 for more information on amended returns.

Married persons who filed separate returns. You can change methods of taking deductions only if you and your spouse both make the same changes. Both of you must file a consent to assessment for any additional tax either one may owe as a result of the change.

You and your spouse can use the method that gives you the lowest total tax, even though one of you may pay more tax than the other. You ***both must use the same method*** of claiming deductions. If one itemizes deductions, the other should itemize because he or she will not qualify for the standard deduction (see *Persons not eligible for the standard deduction,* earlier).

1994 Standard Deduction Tables

Caution: If you are married filing a separate return and your spouse itemizes deductions, or if you are a dual-status alien, you cannot take the standard deduction even if you were 65 or older or blind.

Table 21-1. Standard Deduction Chart for Most People*

If Your Filing Status is:	Your Standard Deduction Is:
Single	$3,800
Married filing joint return or Qualifying widow(er) with dependent child	6,350
Married filing separate return	3,175
Head of household	5,600

* DO NOT use this chart if you were 65 or older or blind, OR if someone can claim you as a dependent.

Table 21-2. Standard Deduction Chart for People Age 65 or Older or Blind*

Check the correct number of boxes below. Then go to the chart.

You	65 or older ❑	Blind ❑
Your spouse, if claiming spouse's exemption	65 or older ❑	Blind ❑

Total number of boxes you checked ❑

If Your Filing Status is:	And the Number in the Box Above is:	Your Standard Deduction is:
Single	1 2	$4,750 5,700
Married filing joint return or Qualifying widow(er) with dependent child	1 2 3 4	7,100 7,850 8,600 9,350
Married filing separate return	1 2 3 4	3,925 4,675 5,425 6,175
Head of household	1 2	6,550 7,500

* If someone can claim you as a dependent, use Table 21-3, instead.

Table 21-3. Standard Deduction Worksheet for Dependents*

If you were 65 or older or blind, check the correct number of boxes below. Then go to the worksheet.

You	65 or older ❑	Blind ❑
Your spouse, if claiming spouse's exemption	65 or older ❑	Blind ❑

Total number of boxes you checked ❑

1. Enter your **earned income** (defined below). If none, go on to line 3	**1.**_____
2. Minimum amount	**2.** $600
3. Compare the amounts on lines 1 and 2. Enter the **larger** of the two amounts here.	**3.**_____
4. Enter on line 4 the amount shown below for your filing status. • Single, enter $3,800 • Married filing separate return, enter $3,175 • Married filing jointly or Qualifying widow(er) with dependent child, enter $6,350 • Head of household, enter $5,600	**4.**_____
5. Standard deduction.	
a. Compare the amounts on lines 3 and 4. Enter the **smaller** of the two amounts here. If under 65 and not blind, stop here. This is your standard deduction. Otherwise, go on to line 5b.	**5a.**_____
b. If 65 or older or blind, multiply $950 ($750 if married or qualifying widow(er) with dependent child) by the number in the box above. Enter the result here.	**5b.**_____
c. Add lines 5a and 5b. This is your standard deduction for 1994.	**5c.**_____

Earned income *includes wages, salaries, tips, professional fees, and other compensation received for personal services you performed. It also includes any amount received as a scholarship that you must include in your income.*

* Use this worksheet ONLY if someone can claim you as a dependent.

22.

Limit on Itemized Deductions

Introduction

This chapter discusses an overall limit on itemized deductions. The topics include:

- Who is subject to the limit,
- Which itemized deductions are limited,
- How to figure the limit, and
- How to complete a worksheet on the limit using an illustrated example.

This limit does not apply to you if:

1) Your adjusted gross income (AGI) (line 32 of Form 1040) is $111,800 or less ($55,900 or less if married filing separately), or
2) You are taking the standard deduction.

Useful Items

You may want to see:

Form (and Instructions)

❑ **Schedule A (Form 1040)** Itemized Deductions

Are You Subject to the Limit?

You are subject to the limit on certain itemized deductions if your AGI is more than $111,800 ($55,900 if you are married filing separately). Your AGI is the amount on line 32 of your Form 1040.

This limit does not apply to estates or trusts.

Which Deductions Are Affected

All itemized deductions on Schedule A (Form 1040) are subject to the overall limit, with four exceptions discussed next. These itemized deductions are discussed in Part Five of this publication.

Exceptions

The Schedule A (Form 1040) deductions listed next are not subject to the overall limit on itemized deductions. However, they are still subject to other applicable limits.

- Medical and dental expenses — line 4
- Investment interest expense — line 13
- Nonbusiness casualty and theft losses — line 19
- Gambling losses — line 28

Check the index at the back of this publication to locate discussions of these deductions.

How to Figure the Limit

If your itemized deductions are subject to the limit, they are reduced by the smaller of:

1) 3% of the amount by which your AGI exceeds $111,800 ($55,900 if married filing separately), or
2) 80% of your itemized deductions that are affected by the limit.

Before you figure the overall limit on itemized deductions, you must first complete lines 1 through 28 of Schedule A (Form 1040), including any appropriate forms (such as Form 2106, Form 4684, etc.).

The overall limit on itemized deductions is figured after you have applied all other limits. Other limits figured first include charitable contribution limits (Chapter 26), the limit on certain meals and entertainment (Chapter 28), and the 2% of AGI limit on certain miscellaneous deductions (Chapter 30).

Itemized Deductions Worksheet. After you have completed Schedule A through line 28, you can use the *Itemized Deductions Worksheet* in the *Instructions for Form 1040* to figure your limit. Keep the worksheet for your records.

Note: You should compare the amount of your itemized deductions after applying the limit to the amount of your standard deduction. Use the greater amount when completing line 34 of your Form 1040. See Chapter 21 for information on how to figure your standard deduction.

Example

For tax year 1994, Bill and Terry Willow are filing a joint return and have adjusted gross income of $255,250. Their Schedule A itemized deductions consist of the following.

State income and real estate taxes	$17,900
Home mortgage interest	45,000
Charitable contributions	21,000
Investment interest expense	41,000
Miscellaneous deductions	17,240
Total	$142,140

The Willows' investment interest expense is not subject to the overall limit on itemized deductions. Their deduction for miscellaneous deductions is the total after applying the 2% of AGI limit and does not include any gambling losses.

The Willows figure their overall limit as follows:

Itemized Deductions Worksheet—Line 29
(Keep for your records)

1.	Add the amounts on Schedule A, lines 4, 9, 14, 18, 19, 26, 27, and 28.		142,140
2.	Add the amounts on Schedule A, lines 4, 13, and 19, plus any gambling losses included on line 28.		41,000
3.	Subtract line 2 from line 1. (If the result is zero, stop here; enter the amount from line 1 above on Schedule A, line 29.)		101,140
4.	Multiply the amount on line 3 by 80% (.80).	80,912	
5.	Enter the amount from Form 1040, line 32	255,250	
6.	Enter $111,800 ($55,900 if married filing separately)	111,800	
7.	Subtract line 6 from line 5. (If the result is zero or less, stop here; enter the amount from line 1 above on Schedule A, line 29.)	143,450	
8.	Multiply the amount on line 7 by 3% (.03).	4,304	
9.	Enter the smaller of line 4 or line 8.		4,304
10.	**Total itemized deductions.** Subtract line 9 from line 1. Enter the result here and on Schedule A, line 29		137,836

Of their $142,140 total itemized deductions, the Willows can deduct only $137,836. They enter $137,836 on Schedule A, line 29.

23.

Medical and Dental Expenses

Important Change for 1994

Self-employed health insurance. The special rule that allowed self-employed individuals to deduct 25% of health insurance premiums from gross income expired December 31, 1993. At the time this publication went to print, a bill to extend this deduction was pending in Congress. To find out if this deduction is allowed for 1994, see Publication 553, *Highlights of 1994 Tax Changes.*

Introduction

This chapter discusses how to claim a deduction for your medical and dental expenses. It contains a list of items that you can or cannot include in figuring your deduction. It also explains how to treat insurance reimbursements and other reimbursements you may receive for medical care.

It will help you determine:

- Whose expenses you can include,
- What expenses you can include,
- How to claim expenses of a decedent, and
- How to figure your deduction.

To deduct any medical and dental expenses, you must itemize your deductions on **Schedule A** (Form 1040). You must reduce the amount of your medical expenses by any reimbursement you receive for these expenses.

There are limits on the amount you can deduct. You can deduct only the amount of your medical and dental expenses that is ***more than 7.5%*** of your adjusted gross income shown on line 32, Form 1040. See *How to Figure Your Deduction.*

Useful Items

You may want to see:

Publication

❑ **502** Medical and Dental Expenses

Form (and Instructions)

❑ **Schedule A (Form 1040)** Itemized Deductions

Whose Expenses Can You Include?

You can include medical expenses you pay for yourself and for the individuals discussed in this section.

Spouse. You can include medical expenses you paid for your spouse. To claim these expenses, you must have been married either at the time your spouse received the medical services or at the time you paid the medical expenses.

Example 1. Mary received medical treatment before she married Bill. Bill paid for the treatment after they married. Bill can include these expenses in figuring his medical expense deduction even if Bill and Mary file separate returns.

If Mary had paid the expenses before she and Bill married, Bill could not include Mary's medical expenses on his separate return. Mary would include all the medical expenses she paid during the year on her separate return. If they filed a joint return, the medical expenses both paid during the year would be used to figure their medical expense deduction.

Example 2. During 1994, John paid medical expenses for his wife Louise, who died in 1993. John married Belle in 1994, and they file a joint return. Because John was married to Louise when she incurred the medical expenses, he can include those expenses in figuring his medical deduction for 1994.

Dependents. You can include medical expenses you paid for your dependent. To claim these expenses, the person must have been your dependent at the time the medical services were provided or at the time you paid the expenses. A person generally qualifies as your dependent for purposes of the medical expense deduction if:

1) That person lived with you for the entire year as a member of your household or is related to you, and
2) That person was a U.S. citizen or resident, or a resident of Canada or Mexico for some part of the calendar year in which your tax year began, and
3) You provided over half of that person's total support for the calendar year.

You can include the medical expenses of any person who is your dependent even if you cannot claim an exemption for him or her on your return only because the dependent received $2,450 or more of gross income or filed a joint return.

Example 1. In 1993, your son was your dependent. In 1994, he no longer qualifies as your dependent. However, you paid $800 in 1994 for medical expenses your son incurred in 1993 when he was your dependent. You can include the $800 in figuring your 1994 medical expense deduction. You cannot include this amount on your 1993 return.

Example 2. You provided more than half of your married daughter's support, including her medical expenses of $1,200. She and her husband file a joint return. Although you may not be able to claim an exemption for your daughter, she is still your dependent and you can include in your medical expenses the $1,200 you paid.

Adopted child. You can include medical expenses that you paid for a child before adoption, if the child qualified as your dependent when the medical expenses were provided or when the expenses were paid. If you pay back an adoption agency or other persons for medical expenses they paid under an agreement with you, you are treated as having paid those expenses. But if you pay back medical expenses incurred and paid before adoption negotiations began, you cannot include them as medical expenses.

Child of divorced or separated parents. If either parent can claim a child as a dependent under the rules for divorced or separated parents, each parent can include the medical expenses he or she pays for the child even if an exemption for the child is claimed by the other parent.

Support claimed under a multiple support agreement. A multiple support agreement is used when two or more people provide more than half of a person's support, but no one alone provides more than half. If you are considered to have provided more than half under such an agreement, you can include medical expenses you pay, even if you cannot claim the person because he or she had gross income of $2,450 or more or filed a joint return.

Any medical expenses paid by others who joined you in the agreement cannot be included as medical expenses by anyone. However, you can include the entire unreimbursed amount you paid for medical expenses.

Example. You and your three brothers each provide one-fourth of your mother's total support. Under a multiple support agreement, you claim your mother as a dependent. You paid all of her medical expenses. Your brothers repaid you for three-fourths of these expenses. In figuring your medical expense deduction, you can include only one-fourth of your mother's medical expenses. Your brothers cannot include any part of the expenses.

However, if you and your brothers share the nonmedical support items and you separately pay all of your mother's medical expenses, you can include the amount you paid for her medical expenses in your medical expenses.

Medical Expenses

Medical care expenses include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, and for treatments affecting any part or function of the

Table 23-1. **Medical and Dental Expenses Checklist**

You can include		You cannot include	
• Birth control pills prescribed by your doctor • Capital expenses for equipment or improvements to your home needed for medical care (see Publication 502) • Cost and care of guide dogs or other animals aiding the blind, deaf, and disabled • Cost of lead-based paint removal (see Publication 502) • Expenses of an organ donor • Hospital services fees (lab work, therapy, nursing services, surgery, etc.) • Legal abortion • Legal operation to prevent having children • Meals and lodging provided by a hospital during medical treatment • Medical and hospital insurance premiums (see discussion) • Medical services fees (from doctors, dentists, surgeons, specialists, and other medical practitioners) • Oxygen equipment and oxygen	• Part of life-care fee paid to retirement home designated for medical care • Prescription medicines (those requiring a prescription by a doctor for their use by an individual) and insulin • Psychiatric care at a specially equipped medical center (includes meals and lodging) • Social Security tax, Medicare tax, FUTA, and state employment tax for worker providing medical care (see *Wages for nursing services*, below) • Special items (artifical limbs, false teeth, eye-glasses, contact lenses, hearing aids, crutches, wheelchair, etc.) • Special school or home for mentally or physically disabled persons (see Publication 502) • Transportation for needed medical care (see discussion) • Treatment at a drug or alcohol center (includes meals and lodging provided by the center) • Wages for nursing services (see Publication 502)	• Diaper service • Expenses for your general health (even if following your doctor's advice) such as— —Health club dues —Household help (even if recommended by a doctor) —Social activities, such as dancing or swimming lessons —Stop smoking program —Trip for general health improvement —Weight loss program • Funeral, burial or cremation expenses • Illegal operation or treatment	• Life insurance or income protection policies, or policies providing payment for loss of life, limb, sight, etc. • Maternity clothes • Medical insurance included in a car insurance policy covering all persons injured in or by your car • Medicine you buy without a prescription • Nursing care for a healthy baby • Surgery for purely cosmetic reasons • Toothpaste, toiletries, cosmetics, etc.

body. The expenses must be primarily to alleviate or prevent a physical or mental defect or illness. Expenses for solely cosmetic reasons generally are not expenses for medical care. Also, expenses that are merely beneficial to one's general health (for example, vacations) are not expenses for medical care.

Use *Table 23–1* in this chapter as a guide to determine which medical and dental expenses you can include on Schedule A (Form 1040). See Publication 502, *Medical and Dental Expenses,* for information about other expenses you can include.

Medical Insurance Premiums

You can include in medical expenses premiums you pay for policies that provide payment for:

- Hospitalization, surgical fees, and other medical and dental expenses,
- Prescription drugs,
- Replacement of lost or damaged contact lenses, or
- Membership in an association that gives cooperative or so-called ''free-choice'' medical service, or group hospitalization and clinical care.

If you have a policy that provides more than one kind of payment, you can include the premiums for the medical care part of the policy if the charge for the medical part is reasonable. The cost of the medical portion must be separately stated in the insurance contract or given to you in a separate statement.

Cafeteria plans. Do not include in medical and dental expenses (line 1 of Schedule A) insurance premiums paid by an employer-sponsored health insurance plan (cafeteria plan) unless the premiums are included in box 1 of your Form(s) W–2.

Medicare A. If you are covered under social security (or if you are a government employee who paid Medicare tax), you are enrolled in Medicare A. The tax paid for Medicare A is not a medical expense.

If you are not covered under social security (or were not a government employee who paid Medicare tax), you may voluntarily enroll in Medicare A. In this situation the premiums paid in 1994 for Medicare A can be included as a medical expense on your tax return.

Medicare B. Medicare B is supplemental medical insurance. Premiums you pay for Medicare B are a medical expense. If you applied for it at age 65, you can deduct $41.10 for each month in 1994 for which you paid a premium. If you were over age 65 when you first enrolled, check the information you received from the Social Security Administration to find out your premium.

Prepaid insurance. Premiums you pay before you are 65 for insurance covering medical care for yourself, your spouse, or your dependents after you reach 65 are medical care expenses in the year paid if they are:

1) Payable in equal yearly installments, or more often, and
2) Payable for at least 10 years, or until you reach 65 (but not for less than 5 years).

Unused sick leave used to pay premiums. You must include in gross income cash payments you receive at the time of retirement for unused sick leave.

You must also include in gross income the value of unused sick leave that, at your option, your employer applies to the cost of your continuing participation in your employer's health plan after you retire. You can include this cost of continuing participation in the health plan as a medical expense.

If you participate in a health plan where your employer automatically applies the value of unused sick leave to the cost of your continuing participation in the health plan (and you do not have the option to receive cash), you do not include the value of the unused sick leave in gross income. You cannot deduct this cost of continuing participation in that health plan as a medical expense.

Health Insurance Costs for Self-Employed Persons

Caution. The self-employed health insurance deduction expired at the end of 1993. However, at the time this publication went to print, a bill to extend this deduction was pending in Congress. To see if this deduction is allowed for 1994, see Publication 553. If it is extended, the following rules apply.

If you were self-employed and had a net profit for the year, were a general partner (or a limited partner receiving guaranteed payments) or if you received wages in 1994 from an S corporation in which you were a more than 2% shareholder (who is treated as a partner), you may be able to deduct up to 25% of the amount paid for health insurance on behalf of yourself, your spouse, and dependents. Do this on line 26 of Form 1040. If you itemize your deductions, include the remaining premiums with all other medical care expenses on Schedule A, subject to the 7.5% limit.

You cannot take the deduction for any month in 1994 in which you were eligible to participate in any subsidized health plan maintained by your employer or your spouse's employer.

If you qualify to take the deduction, use the following worksheet to figure the amount you can deduct. But, if either of the following applies, do not use the worksheet. Instead, use the worksheet in Publication 535 to figure your deduction.

- You had more than one source of income subject to self-employment tax.
- You file Form 2555, *Foreign Earned Income,* or Form 2555–EZ.

Worksheet for Self-Employed Health Insurance Deduction

1. Enter the total amount paid in 1994 for health insurance coverage for 1994 for you, your spouse, and dependents. But do not include amounts for any month you were eligible to participate in an employer-sponsored health plan	_____
2. Percentage used to figure the deduction	x .25
3. Multiply line 1 by the percentage on line 2	_____
4. Enter your net profit and any other earned income* from the business under which the insurance plan is established, **minus** any deductions you claim on Form 1040, lines 25 and 27	_____
5. Self-employed health insurance deduction. Enter the **smaller** of line 3 or line 4 here and on Form 1040, line 26. DO NOT include this amount in figuring any medical expense deduction on Schedule A (Form 1040).	_____

*** Earned income** includes net earnings and gains from the sale, transfer, or licensing of property you created. It does not include capital gain income. If you were a more than 2% shareholder in an S corporation, earned income is your wages from that corporation.

Caution. As this publication was being prepared for print, Congress was considering a proposal that would extend the self-employed health insurance deduction. For information on any late legislative changes, see Publication 553, *Highlights of 1994 Tax Changes.*

Meals and Lodging

Payment for meals and lodging provided by a hospital or similar institution as a necessary part of medical care is a medical expense if the main reason for being in the hospital is to receive medical care.

You may be able to include in medical expenses the cost of lodging not provided in a hospital or similar institution. You can include the cost of such lodging while away from home if you meet ***all*** of the following requirements.

1) The lodging is primarily for and essential to medical care.
2) The medical care is provided by a doctor in a licensed hospital or in a medical care facility related to, or the equivalent of, a licensed hospital.
3) The lodging is not lavish or extravagant under the circumstances.
4) There is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

The amount you include in medical expenses cannot exceed $50 for each night for each person. Lodging is included for a person for whom transportation expenses are a medical expense because that person is traveling with the person receiving the medical care. For example, if a parent is traveling with a sick child, up to $100 per night for lodging is included as a medical expense. (Meals are not deductible.)

Nursing home. You can include in medical expenses the cost of medical care in a nursing home or home for the aged for yourself, your spouse, or your dependents. This includes the cost of meals and lodging in the home if the main reason for being there is to get medical care.

Do not include the cost of meals and lodging if the reason for being in the home is personal. You can, however, include in medical expenses the part of the cost that is for medical or nursing care.

Medical trip. You cannot include the cost of your meals and lodging while you are away from home for medical treatment if you do not receive the treatment at a medical facility, or if the lodging is not primarily for or essential to the medical care.

Transportation

Amounts paid for transportation primarily for, and essential to, medical care qualify as medical expenses.

Include:

- Bus, taxi, train, and plane fares,
- Ambulance service,
- Car expenses,

- Transportation expenses of a parent who must go with a child who needs medical care,
- Transportation expenses of a nurse or other person who can give injections, medications, or other treatment required by a patient who is traveling to get medical care and is unable to travel alone, and
- Transportation expenses for regular visits to see a mentally ill dependent, if these visits are recommended as part of treatment.

Do not include:

- Transportation expenses to and from work even if your condition requires an unusual means of transportation, or
- Transportation costs if, for nonmedical reasons only, you choose to travel to another city, such as a resort area, for an operation or other medical care prescribed by your doctor.

Car expenses. You can include out-of-pocket expenses for your car, such as gas and oil. You cannot include depreciation, insurance, general repair, or maintenance expenses.

If you do not want to figure your actual expenses, you can use a standard rate of ***9 cents a mile*** for use of your car for medical reasons.

Either way, you can include the cost of parking fees and tolls.

Disabled Dependent Care Expenses

Some disabled dependent care expenses may qualify as medical expenses or as work-related expenses for purposes of taking a credit for dependent care. (See Chapter 33.) You can choose to apply them either way as long as you do not use the same expenses to claim both a credit and a medical expense deduction.

Impairment-Related Work Expenses

Certain unreimbursed expenses may appear to be deductible as either medical or business expenses. Deduct them as business deductions if they are:

- Necessary for you to do your work satisfactorily,
- For goods or services not required or used, other than incidentally, in your personal activities, and
- Not specifically covered under other income tax laws.

Example. You are blind. To do your work, you must use a reader. You use the reader both during your regular working hours at your place of work and outside your regular working hours away from your place of work. The reader's services are only for your work. You can deduct your expenses for the reader as business expenses.

Decedents

The survivor or personal representative of a decedent can choose to treat certain expenses paid by the decedent's estate for the decedent's medical care as paid by the decedent at the time the medical services were provided. The expenses must be paid within the one-year period beginning with the day after the date of death. If you are the survivor or personal representative making this choice, you must attach a statement to the decedent's Form 1040 (or the decedent's amended return, Form 1040X), saying that the expenses have not been and will not be claimed on the estate tax return.

Amended returns and claims for refund are discussed in Chapter 1.

Example. John filed his 1993 income tax return on April 12, 1994. He died on June 1, 1994. His unpaid medical expenses were $1,500 for 1993 and $2,000 for 1994. His executor paid the $3,500 in medical expenses in January 1995.

The executor can file an amended return for 1993, claiming the $1,500 medical expenses as paid in 1993. The $2,000 for 1994 can be treated as paid in 1994 and included as a medical expense on the return for 1994, which will be the decedent's final return.

Expenses for deceased spouse or dependent. If you paid medical expenses for your deceased spouse or dependent, include them as medical expenses on your Form 1040 in the year paid, whether they are paid before or after the decedent's death. The expenses can be included if the person was your spouse or dependent either at the time the medical services were provided or at the time you paid the expense.

How to Figure Your Deduction

To figure your medical expense deduction, complete Schedule A (Form 1040). If you need more information on itemized deductions or you are not sure whether you can itemize, see Chapters 21 and 22.

Write in the amounts you paid for medical and dental care expenses after reducing the amount by payments you received from insurance and other sources. You can deduct only the amount of your medical and dental expenses that is more than 7.5% of your adjusted gross income shown on line 32, Form 1040.

Write the amount of your unreimbursed medical expenses on line 1, Schedule A (Form 1040). For an example, see *Medical and dental expenses (lines 1–4, Schedule A)* under *Itemized Deductions (Schedule A)* in Chapter 39.

Separate returns. If you and your spouse live in a noncommunity property state and file separate returns, each of you can include only the medical expenses each actually paid. Any medical expenses paid out of a joint checking account in which you and your spouse have the same interest are considered to have been paid equally by each of you, unless you can show otherwise.

Community property states. If you and your spouse live in a community property state and file separate returns, any medical expenses paid out of community funds are divided equally. Each of you should include half the expenses. If medical expenses are paid out of the separate funds of one spouse, only the spouse who paid the medical expenses can include them. If you live in a community property state, are married, and file a separate return, see Publication 555, *Federal Tax Information on Community Property.*

What expenses can you include in 1994? You can include medical expenses only in the year you paid them. (But see *Decedents,* earlier.) If you pay medical expenses by check, the day you mail or deliver the check generally is the date of payment. If you use a ''pay-by-phone'' account, the date reported on the statement of the financial institution showing when payment was made is the date of payment. You can include medical expenses you charge to your credit card in the year the charge is made. It does not matter when you actually pay the amount charged.

Reimbursements

You must reduce your total medical expenses for the year by all reimbursements for medical expenses that you receive from insurance or other sources during the year. This includes payments from Medicare.

Do not reduce medical expenses by any payment you received for loss of earnings or damages for personal injury or sickness.

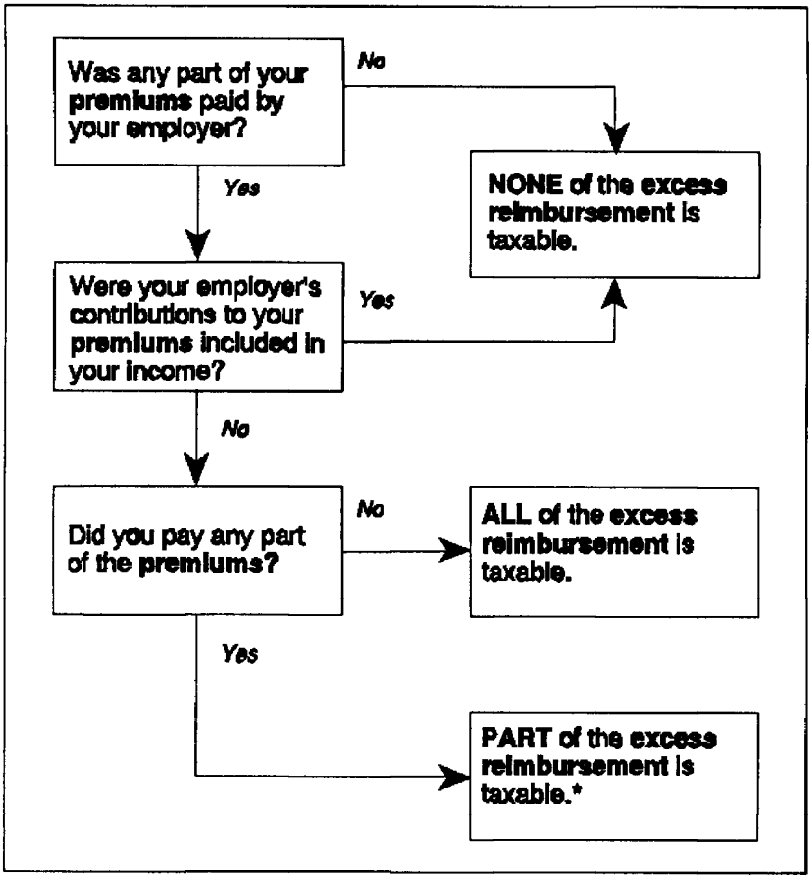
Excess reimbursement. If the total reimbursement you received during the year is the same as or more than your total medical expenses for the year, you cannot take a medical deduction. The following discussions explain whether you need to include excess reimbursement in income.

Premiums paid by you. If you pay the entire premium for your medical insurance or all of the cost of a similar plan, do not include an excess reimbursement in your gross income.

Premiums paid by you and your employer. If both you and your employer contribute to your medical insurance plan and your employer's contributions are not included in your gross income, you must include in your gross income the part of an excess reimbursement that is from your employer's contributions.

Example. You are covered by your employer's medical insurance policy. The annual premium is $2,000. Your employer pays $600 of that amount and the balance of $1,400 is taken out of your wages. The part of any excess reimbursement you receive

Figure 23-A. Is Your Excess Medical Reimbursement Taxable?



* See *Premiums paid by you and your employer* in this chapter.

under the policy that is from your employer's contributions is figured like this:

Total annual cost of policy	$2,000
Amount paid by employer	$ 600
Employer's contribution in relation to the annual cost of the policy ($600 ÷ $2,000)	30%

You must include in your gross income 30% of any excess reimbursement you received for medical expenses under the policy.

Premiums paid by your employer. If your employer or your former employer pays the total cost of your medical insurance plan and your employer's contributions are not included in your income, you must report all excess reimbursements as income.

More than one policy. If you are covered under more than one policy, the costs of which are paid by both you and your employer, you must first divide the medical expense among the policies to figure the excess reimbursement from each policy. Then divide the policy costs to figure the part of any excess reimbursement that is from your employer's contribution.

Example. You are covered by your employer's health insurance policy. The annual premium is $1,200. Your employer pays $300, and the balance of $900 is deducted from your wages. You also paid the entire premium of $250 for a personal health insurance policy.

During the year, you paid medical expenses of $3,600. In the same year, you were reimbursed $2,500 under your employer's policy and $1,500 under your personal policy.

You figure the part of any excess reimbursement you receive that is from your employer's contribution like this:

Reimbursement from employer's policy	$2,500
Reimbursement from your policy	1,500
Total reimbursement	$4,000
Amount of medical expenses from your policy [($1,500 ÷ $4,000) × $3,600 total medical expenses]	$1,350
Amount of medical expenses from your employer's policy [($2,500 ÷ $4,000) × $3,600 total medical expenses]	2,250
Total medical expenses	$3,600
Excess reimbursement from your employer's policy ($2,500 – $2,250)	$ 250

Because both you and your employer contribute to the cost of this policy, you must divide the cost to determine the excess reimbursement from your employer's contribution.

Employer's contribution in relation to the annual cost of the policy ($300 ÷ $1,200)	25%
Amount to report as income (25% × $250)	$62.50

Reimbursement in a later year. If you are reimbursed in a later year for medical expenses you deducted in an earlier year, you must report as income the amount you received from insurance or other sources that is equal to, or less than, the amount you previously deducted as medical expenses. However, you do not have to report the reimbursement you received up to the amount of your medical deductions that did not reduce your tax for the earlier year. For more information about the recovery of an amount that you claimed as an itemized deduction in an earlier year, see *Itemized Deduction Recoveries* in Chapter 13.

Medical expenses not deducted. If you did not deduct a medical expense in the year you paid it because you did not itemize deductions or because your medical expenses were not more than 7.5% of your adjusted gross income, do not include in income the reimbursement for this expense that you receive in a later year. However, if the reimbursement is more than the expense, see *Excess reimbursement,* earlier.

Example. In 1994, you have medical expenses of $500. You cannot deduct the $500 because it is not more than 7.5% of your adjusted gross income. If, in a later year, you are reimbursed for any of the $500 medical expenses, you do not include that amount in your gross income.

Damages. If you receive an amount in settlement of a personal injury suit, the part that is for medical expenses deducted in an earlier year is included as income in the later year if your medical deduction in the earlier year reduced your income tax in that year. See *Reimbursement in a later year,* earlier.

Future medical expenses. If you receive an amount in settlement of a damage suit for personal injuries that is properly allocable or determined to be for future medical expenses, you must reduce any medical expenses for these injuries until the amount you received has been completely used.

Table 24-1. **Which Taxes Can You Deduct?**

	You Can Deduct	You Cannot Deduct
Income Taxes	State and local income taxes Foreign income taxes Employee contributions to state funds listed under *State benefit funds*	Federal income taxes Employee contributions to private or voluntary disability plans
Real Estate Taxes	State and local real estate taxes Foreign real estate taxes Tenant's share of real estate taxes paid by cooperative housing corporation	Taxes for local benefits Trash and garbage pickup fees Rent increase due to higher real estate taxes Homeowners association charges
Personal Property Taxes	State and local personal property taxes	
Other Taxes	Taxes that are expenses of your trade or business or producing income One-half of self-employment tax paid Taxes on property producing rent or royalty income Occupational taxes	Many taxes, such as state and local sales taxes and federal excise taxes, generally are not deductible. See *Taxes and Fees You Cannot Deduct*, later.
Fees and Charges		Fees and charges, such as for driver's licenses or water bills, generally are not deductible. See *Taxes and Fees You Cannot Deduct*, later.

24.

Taxes

Important Reminder

Limit on itemized deductions. If your adjusted gross income is more than $111,800 ($55,900 if you are married filing separately), the overall amount of your itemized deductions may be limited. See Chapter 22 for more information about this limit.

Introduction

This chapter discusses which taxes you can deduct if you itemize deductions on Schedule A (Form 1040). It also explains which taxes you can deduct on other schedules or forms, and which taxes you cannot deduct.

The chapter covers:

- Income taxes (state, local, or foreign)
- Real estate taxes (state, local, or foreign)
- Personal property taxes (state or local)
- Taxes that are expenses of business or producing income
- Taxes and fees you cannot deduct

The end of the chapter explains which form you use to deduct the different types of taxes.

Table. Use *Table 24–1* as a guide to determine which taxes you can deduct.

State or local taxes. These are taxes imposed by the 50 states, U.S. possessions, or any of their political subdivisions (such as a county or city), or by the District of Columbia.

Indian tribal government. An Indian tribal government that is recognized by the Secretary of the Treasury as performing substantial government functions will be treated as a state for this purpose. Income taxes, real estate taxes, and personal property taxes imposed by that Indian tribal government (or by any of its subdivisions that are treated as political subdivisions of a state) are deductible.

Foreign taxes. These are taxes imposed by a foreign country or any of its political subdivisions.

Useful Items

You may want to see:

Publication

- ❑ **514** Foreign Tax Credit for Individuals

Form (and Instructions)

- ❑ **Schedule A (Form 1040)** Itemized Deductions
- ❑ **Schedule E (Form 1040)** Supplemental Income and Loss
- ❑ **Form 1116** Foreign Tax Credit

Tests to Deduct Any Tax

The following two tests must be met for any tax to be deductible by you.

1) The tax must be imposed on you.
2) The tax must be paid during your tax year.

The tax must be imposed on you. Generally, you can deduct only taxes that are imposed on you.

Generally, you can deduct property taxes only if you are the property owner. If real estate taxes are paid by your spouse who owns a home, they are deductible on your spouse's separate return or on your joint return.

The tax must be paid during your tax year. If you are a cash basis taxpayer, you can deduct only those taxes paid during the calendar year for which you file a return. If you pay your taxes by check, the day you mail or deliver the check is generally the date of payment. If you use a pay-by-phone account, the date reported on the statement of the financial institution showing when payment was made is the date of payment.

If you question a tax liability and use the cash method of accounting, you can deduct the tax only in the year you actually pay it. If you use an accrual method of accounting, you must use special rules for determining when you can deduct the tax liability you are questioning. See *Contested Liabilities* in Publication 538, *Accounting Periods and Methods,* for more information.

Income Taxes

This section discusses the deductibility of state and local income taxes, employee contributions to state benefit funds, and foreign income taxes.

State and local income taxes. You can deduct state and local income taxes. However, you cannot deduct state and local income

taxes you pay on income that is exempt from federal income tax, unless the exempt income is interest income. For example, you cannot deduct the part of a state's income tax that is on a cost-of-living allowance that is exempt from federal income tax.

Deduct state and local income taxes withheld from your salary in the year they are withheld. For 1994, these taxes will be shown in boxes 18 and 21 of your Form W-2. You may also have state or local income tax withheld on Form 1099-MISC (box 11) or Form 1099-R (boxes 10 and 13). Deduct payments made on taxes for an earlier year in the year they are paid.

Deduct estimated tax payments you make under a pay-as-you-go plan of a state or local government. However, you must have a reasonable basis for making the estimated tax payments. Any estimated state or local tax payments you make that are not reasonably determined in good faith at the time of payment are not deductible. For example, if you made an estimated state income tax payment, but the estimate of your state tax liability for the year shows that you will get a refund of the full amount of your estimated payment, then you had no reasonable basis to believe you had any additional liability to make the payment, and you cannot deduct it.

Also deduct any part of a refund of prior-year state or local income taxes that you chose to have credited to your 1994 estimated state or local income taxes.

Do not reduce your deduction by either of the following:

- Any state or local income tax refund (or credit) you expect to receive for 1994, or
- Any refund of (or credit for) prior year state and local income taxes you actually received in 1994.

Refund (or credit). If you receive a refund of (or credit for) state or local (or foreign) income taxes in a year after the year in which you paid them, you may have to include all or part of the refund in income on line 10 of Form 1040, in the year you receive it. This includes refunds resulting from taxes that were overwithheld, applied from a prior year return, not figured correctly, or figured again as a result of an amended return. However, if you did not itemize your deductions in the previous year, you do not have to include the refund in income. For a discussion of how much to include, see *Recoveries* in Chapter 13.

Separate returns. If you and your spouse file separate state, local, and federal income tax returns, you each can deduct on your federal return only the amount of your own state and local income tax.

If you file separate state and local returns and a joint federal return, you can deduct on your joint federal return the sum of the state and local income taxes both of you pay.

If you and your spouse file joint state and local returns and separate federal returns, each of you can deduct on your separate federal return part of the state and local income taxes. You can deduct only the amount of the total taxes that is proportionate to your gross income compared to the combined gross income of you and your spouse. But you cannot deduct more than the amount you actually paid during the year. If you and your spouse are jointly and individually liable for the full amount of the state and local income taxes, you and your spouse can deduct on your separate federal returns the amount you each actually paid.

State benefit funds. As an employee, you can deduct mandatory contributions to state benefit funds that provide protection against loss of wages. Payments made to the following funds are deductible as state income taxes on line 5 of Schedule A (Form 1040).

California Nonoccupational Disability Benefit Fund

New Jersey Nonoccupational Disability Benefit Fund

New York Nonoccupational Disability Benefit Fund

Rhode Island Temporary Disability Benefit Fund

Washington State Supplemental Workmen's Compensation Fund

Note. Employee contributions to private or voluntary disability plans are not deductible.

Foreign income taxes. Generally, you can take either a deduction or a credit for income taxes imposed on you by a foreign country or a U.S. possession. However, you cannot take a deduction or credit for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion. For information, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.*

Eligible foreign income taxes are either deducted on line 8 of Schedule A (Form 1040) under ''Other taxes,'' or taken as a credit on Form 1116.

Real Estate Taxes

Deductible real estate taxes are any state, local, or foreign taxes on real property levied for the general public welfare. The taxes must be based on the assessed value of the real property and must be charged uniformly against all property under the jurisdiction of the taxing authority. Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of the property. See *Real Estate Items You Cannot Deduct,* later.

An itemized charge for services to specific property or people is not a tax, even if the charge is paid to the taxing authority. You cannot deduct the charge as a real estate tax if it is:

1) A unit fee for the delivery of a service (such as a $5 fee charged for every 1,000 gallons of water you use),
2) A periodic charge for a residential service (such as a $20 per month or $240 annual fee charged to each homeowner for trash collection), or
3) A flat fee charged for a single service provided by your government (such as a $30 charge for mowing your lawn because it was allowed to grow higher than permitted under your local ordinance).

Caution: You must look at your real estate tax bill to determine if any nondeductible itemized charges, such as those just listed, are included in the bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it.

Tenant-shareholders in a cooperative housing corporation. Generally, you can deduct your share of the real estate taxes the corporation paid or incurred on the property. The corporation should provide you with a statement showing you your share of the taxes. For more information, see *Special Rules for Cooperatives* in Publication 530.

Purchase or sale of real estate. If you bought or sold real estate during the year, the real estate taxes must be divided between the buyer and the seller.

The buyer and the seller must divide the real estate taxes according to the number of days in the ***real property tax year*** (the period to which the tax imposed relates) that each owned the property. The seller is treated as paying the taxes up to the date of the sale, and the buyer is treated as paying the taxes beginning with the date of the sale, regardless of the lien dates under local law. Generally, this information is included on the settlement statement provided at closing.

If you (the seller) cannot deduct taxes until they are paid because you use the cash method of accounting, and the buyer of your property is personally liable for the tax, you are considered to have paid your part of the tax at the time of the sale. This lets you deduct the part of the tax to the date of sale even though you did not actually pay it, but you must also include the amount of that tax in the selling price of the property.

You figure your deduction for taxes on each property bought or sold during the real property tax year as follows.

1. Enter the total real estate taxes for the real property tax year ..... _____
2. Enter the number of days in the real property tax year that you owned the property ..... _____
3. Divide line 2 by 365 ..... _____
4. Multiply line 1 by line 3. This is your deduction. Claim it on line 6 of Schedule A (Form 1040) ..... _____

Note. Repeat steps 1 through 4 for each property you bought or sold during the real property tax year.

Delinquent taxes. Delinquent taxes are not divided between the buyer and seller if the taxes are for any real property tax year before the real property tax year in which the property is sold. Even if the buyer agrees to pay the delinquent taxes, the buyer cannot deduct them but must add them to the cost of the property. The seller can deduct these taxes but also must include them in the selling price on the sale of the property.

The following examples illustrate how real estate taxes are divided between buyer and seller.

Example 1. Dennis and Beth White's real property tax year for both their old home and their new home is the calendar year, with payment due August 1. The tax on their old home, sold on May 5, was $620. The tax on their new home, bought on May 4, was $732. Dennis and Beth are considered to have paid a proportionate share of the real estate taxes on the old home even though they did not actually pay them to the taxing authority. On the other hand, they can claim only a proportionate share of the taxes they paid on their new property even though they paid the entire amount.

Dennis and Beth owned their old home during the real property tax year for 124 days (January 1 to May 4, the day before the sale). They figure their deduction for taxes on their old home as follows.

TAXES ON OLD HOME

1.	Enter the total real estate taxes for the real property tax year	$620
2.	Enter the number of days in the real property tax year that you owned the property	124
3.	Divide line 2 by 365	.34
4.	Multiply line 1 by line 3. This is your deduction. Claim it on line 6 of Schedule A (Form 1040)	$211

Since the buyers of their old home paid all of the taxes, Dennis and Beth also include the $211 in the selling price of the home. (The buyers add the $211 to their cost of the home.)

Dennis and Beth owned their new home during the real property tax year for 242 days (May 4 to December 31, including their date of purchase). They figure their deduction for taxes on their new home as follows.

TAXES ON NEW HOME

1.	Enter the total real estate taxes for the real property tax year	$732
2.	Enter the number of days in the real property tax year that you owned the property	242
3.	Divide line 2 by 365	.66
4.	Multiply line 1 by line 3. This is your deduction. Claim it on line 6 of Schedule A (Form 1040)	$483

Since they paid all of the taxes, Dennis and Beth add $249 ($732 paid less $483 deduction) to their basis of the new home. (The sellers add this $249 to their selling price and deduct the $249 as a real estate tax.)

Dennis and Beth's real estate tax deduction for their old and new homes is the sum of $211 and $483, or $694. They will enter this amount on line 6 of Schedule A (Form 1040).

Example 2. George and Helen Brown bought a home on May 3, 1994. Their real property tax year is the calendar year. Real estate taxes for 1993 were assessed in their state on January 1, 1994. The taxes became due on May 31, 1994, and October 31, 1994. Under state law, the tax became a lien on May 31, 1994.

George and Helen agreed to pay all taxes due after the date of purchase. Real estate taxes for 1993 were $680. George and Helen paid $340 tax on May 31, 1994, and $340 tax on October 31, 1994. These taxes were for the 1993 real property tax year. The Browns cannot deduct them since they did not own the property until 1994. Instead, they must add $680 to the basis (cost) of their home.

In January 1995, George and Helen receive their property tax statement for 1994 taxes of $752, which they will pay in 1995. George and Helen owned their new home during the 1994 real property tax year for 243 days (May 3 to December 31). They will figure their 1995 deduction for taxes as follows.

1.	Enter the total real estate taxes for the real property tax year	$752
2.	Enter the number of days in the real property tax year that you owned the property	243
3.	Divide line 2 by 365	.67
4.	Multiply line 1 by line 3. This is your deduction. Claim it on line 6 of Schedule A (Form 1040)	$504

The remaining $248 of taxes paid in 1995, along with the $680 paid in 1994, is added to the cost of their home.

Because the taxes up to the date of sale are considered paid by the seller on the date of sale, the person who sold the Browns their home is entitled to a 1994 tax deduction of $928. This is the sum of the $680 for 1993 and the $248 for the 122 days the seller owned the home in 1994. The seller must also include the $928 in the selling price when he or she completes **Form 2119,** *Sale of Your Home,* (which must be attached to the seller's 1994 tax return). The seller should contact the Browns in January 1995 to find out how much real estate tax is due for 1994.

Form 1099–S. For certain sales or exchanges of real estate, the person responsible for closing the sale (generally the settlement agent) prepares Form 1099–S, *Proceeds From Real Estate Transactions,* to report certain information to the IRS and to the seller of the property. The gross proceeds from the sale appears in box 2 of the form. Generally, gross proceeds includes cash, notes, and liabilities assumed by the buyer, such as any portion of the seller's real estate tax liability that the buyer will pay after the date of sale. The buyer includes this amount in the cost basis of the property, and the seller both deducts this amount as a tax expense and includes it in the sales price of the property.

For a real estate transaction that involves a residence and that occurs after 1992, any real estate tax that the seller paid in advance but that is the liability of the buyer appears in box 5 of Form 1099–S. The buyer deducts this amount as a tax expense, and the seller reduces his or her tax expense by the same amount. See *Refund (or rebate),* later.

Taxes placed in escrow. If your monthly mortgage payment includes an amount placed in escrow (put in the care of a third party) for real estate taxes, you cannot deduct the total of these amounts included in your payments for the year. You can deduct only the real estate tax that the lender actually paid to the taxing authority. If the lender does not notify you of the amount of real estate tax that was paid for you, contact the lender or the taxing authority to find the proper amount to show on your return.

Married filing separate return. If you and your spouse held property as tenants by the entirety and you file separate returns, each of you can deduct only the taxes each of you paid on the property.

Divorced individuals. If your divorce or separation instrument states that you must pay the real estate taxes for a home owned by you and your spouse, part of your payments may be deductible as alimony and part as real estate taxes. See Publication 504, *Divorced or Separated Individuals,* for information.

Minister's and military personnel housing allowances. If you are a minister or a member of the uniformed services and receive a housing allowance that you can exclude from income, you still can deduct all of the real estate taxes you pay on your home.

Refund (or rebate). If you receive a refund or rebate in 1994 of real estate taxes you paid in 1994, you must reduce your deduction by the amount refunded to you. If you receive a refund or rebate in 1994 of real estate taxes you deducted in an earlier year, you generally must include the refund or rebate in income in the year you receive it. However, you only need to include the amount of the deduction that reduced your tax in the earlier year.

For more information, see *Recoveries* in Chapter 13. If you did not itemize deductions in the year you paid the tax or you filed Form 1040A or Form 1040EZ, do not report the refund as income.

Real Estate Items You Cannot Deduct

The following are not deductible as real estate taxes:

- Taxes for local benefits,

- Trash and garbage pickup fees,
- Transfer taxes (or stamp taxes),
- Rent increases due to higher real estate taxes, and
- Homeowners association charges.

Taxes for local benefits. Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of your property. These include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities, and similar improvements. You should increase the basis of your property by the amount of the assessment.

Local benefit taxes are deductible only if they are for maintenance, repair, or interest charges related to those benefits. If only a part of the taxes is for maintenance, repair, or interest, you must be able to show the amount of that part to claim the deduction. If you cannot determine what part of the tax is for maintenance, repair, or interest, none of it is deductible.

Taxes for local benefits may be included in your real estate tax bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it. You should use the rules above to determine if the local benefit tax is deductible.

Trash and garbage pickup fees. Fees charged for trash and garbage pickup services are not deductible as taxes, even if the fees are paid to your local taxing authority. However, service charges used to maintain or improve services (such as trash collection or police and fire protection) are deductible as real estate taxes if the taxes are imposed at a like rate against all property in the taxing jurisdiction.

Transfer taxes (or stamp taxes). Transfer taxes and other taxes and charges on the sale of a personal home are not deductible. If they are paid by the seller, they are expenses of the sale and reduce the amount realized on the sale. If paid by the buyer, they are included in the cost basis of the property.

Note: If you bought your home before 1994 and claimed moving expenses, you were allowed to deduct these taxes and charges as a moving expense. If you did so, you cannot use them either to reduce the amount realized on the sale of your home or to increase the cost basis of your new home.

Rent increase due to higher real estate taxes. If your landlord increases your rent in the form of a tax surcharge because of increased real estate taxes, you cannot deduct the increase as taxes.

Homeowners association charges. These charges are not deductible because they are imposed by the homeowners association, rather than the state or local government.

Personal Property Taxes

Personal property tax is deductible if it is a state or local tax that is:

1) Charged on personal property,
2) Based ***only*** on the value of the personal property, and
3) Charged on a yearly basis, even if it is collected more than once a year, or less than once a year.

A tax that meets the above requirements can be considered charged on personal property even if it is for the exercise of a privilege. For example, a yearly tax based on value qualifies as a personal property tax even if it is called a registration fee and is for the privilege of registering motor vehicles or using them on the highways.

Example. Your state charges a yearly motor vehicle registration tax of 1% of value plus 50 cents per hundredweight. You paid $32 based on the value ($1,500) and weight (3,400 lbs.) of your car. You can deduct $15 (1% × $1,500) as a personal property tax, since it is based on the value. The remaining $17 ($.50 × 34), based on the weight, is not deductible.

Taxes And Fees That Are Expenses of Business or Producing Income

You can deduct certain taxes not previously listed in this chapter only if they are ordinary and necessary expenses of your trade or business or of producing income. For a discussion of business taxes, see Chapter 9 of Publication 535, *Business Expenses.* In some cases, these taxes are not deducted on Schedule A, but are deducted on other schedules or forms. See *Where to Deduct,* later.

Taxes and fees that may be deductible only as business or income-producing expenses include the following items.

Car registration fees, inspection fees, and license plates. However, see *Personal Property Taxes,* earlier.

Excise taxes or customs duties. These include the federal taxes on telephone service, air transportation, gasoline and other motor fuels, and luxury cars.

Occupational taxes. You can deduct as a business expense an occupational tax charged at a flat rate by a locality for the privilege of working or conducting a business in the locality.

Sales taxes. If you buy supplies or other items for your trade or business and can deduct their cost as a business expense, you can deduct the sales tax as part of the cost. Sales tax on the purchase of property whose cost you cannot deduct as a business expense is added to the property's cost. See *Cost Basis* in Chapter 14.

Self-employment tax. If you work for yourself, you can deduct half of the self-employment tax you figured on your 1994 Schedule SE (Form 1040), *Self-Employment Tax.*

Tax connected with purchase or sale. Generally, any tax paid in connection with the purchase or sale of property must be treated as part of the cost basis of the property or, in the case of a sale, as a reduction in the amount realized. But if the cost of the property is deductible as a business expense, such as the cost of supplies, any tax paid is deductible as part of the business expense.

Tolls for bridges and roads, and parking fees.

Utility taxes and fuel adjustment charges.

Water bills, sewer, and other service charges.

Taxes and Fees You Cannot Deduct

You cannot deduct any tax or fee unless it is in one of the categories of taxes that are specifically allowable as a deduction. The categories include:

State, local, or foreign income or real estate taxes,

State or local personal property taxes, or

Expenses of a business or income-producing activity.

These categories are all discussed earlier in this chapter.

Many federal, state, and local government taxes are not deductible because they do not fall within the categories listed above. (Examples are sales taxes and excise taxes that are treated as part of the cost of personal-use property.) Other taxes and fees are not deductible because they are specifically denied a deduction. (Examples are federal income taxes and employee social security taxes that are personal, nondeductible expenses.)

Listed next are certain taxes and fees that are generally not deductible. This is followed by a second list of certain taxes and fees that are only deductible if they are incurred in a business or income-producing activity.

Nondeductible taxes and fees include:

Estate, inheritance, legacy, or succession taxes. These taxes are generally

not deductible. However, you generally can deduct the estate tax attributable to income in respect of a decedent if you must include that income in gross income. In that case, the estate tax can be deducted as a miscellaneous deduction that is not subject to the 2% of adjusted gross income limit. For more information, see *Estate Tax Deduction* in Publication 559, *Survivors, Executors, and Administrators.*

Federal income taxes, including those withheld from your pay.

Fines (such as for parking or speeding) and collateral deposits.

Gift taxes.

License fees for personal purposes (such as marriage, driver's, dog, etc.).

Social security, Medicare, or railroad retirement taxes withheld from your pay.

Social security and other employment taxes for household workers. You generally cannot deduct the social security or other employment taxes you pay on the wages of a household worker. However, you may be able to include them in medical or child care expenses. For more information, see Chapters 23 and 33.

Taxes for local benefits. Local benefit taxes that are for improvements to property are not deductible. See *Real Estate Items You Cannot Deduct,* earlier.

Transfer taxes (or stamp taxes). Transfer taxes and other taxes and charges on the sale of a personal home are not deductible. See *Real Estate Items You Cannot Deduct,* earlier.

Taxes and fees that may be deductible if incurred in a business or income-producing activity include:

Car registration fees, inspection fees, and license plates. However, see *Personal Property Taxes,* earlier.

Cigarette, tobacco, liquor, beer, wine, etc., taxes.

Excise taxes or customs duties. These include taxes on telephone service, air transportation, gasoline and other motor fuels, and luxury cars.

Sales taxes.

Tolls for bridges and roads, and parking fees.

Utility taxes and fuel adjustment charges by a municipally-owned electric utility company.

Water bills, sewer, and other service charges.

Where to Deduct

You deduct taxes on the following schedules:

State and local income taxes. These taxes are deducted only on line 5 of Schedule A (Form 1040), even if your only source of income is from business, rents, or royalties.

Foreign income taxes. Generally, income taxes you pay to a foreign country or U.S. possession can be claimed as an itemized deduction on line 8 of Schedule A (Form 1040), or as a credit against your U.S. income tax on Form 1116. For more information, get Publication 514.

Real estate taxes and personal property taxes. These taxes are deducted on lines 6 and 7 of Schedule A (Form 1040), unless they are paid on property used in your business or on property that produces rent or royalty income. See *Business taxes,* next, and *Taxes on property producing rent or royalty income,* later.

Business taxes. Taxes that you must pay in operating your business, or on your property used in your business, are generally deducted on Schedule C or C-EZ (Form 1040) or Schedule F (Form 1040).

Taxes that are employee business expenses. Taxes you paid that are deductible as employee business expenses are generally claimed on line 20 of Schedule A (Form 1040) as a miscellaneous itemized deduction subject to the 2% of adjusted gross income limit. If you also deduct certain other employee business expenses or if you are reimbursed by your employer, you may also have to file Form 2106 or 2106–EZ. See the instructions for line 20 of Schedule A (Form 1040) for more information.

Self-employment tax. Deduct one-half of your self-employment tax on line 25, Form 1040.

Taxes on property producing rent or royalty income. These taxes generally are deducted on Schedule E (Form 1040).

Other taxes. All other deductible taxes are deducted on line 8 of Schedule A (Form 1040).

25.

Interest Expense

Important Change for 1994

Points paid by seller. You may be able to deduct points paid on your mortgage by the person who sold you your home. See *Points* later in this chapter.

Important Reminders

Personal interest. Personal interest is not deductible. Examples of personal interest include interest charged on credit cards, car loans, and installment plans.

Points shown on Form 1098. The Form 1098, *Mortgage Interest Statement,* you receive will include the amount of points you paid on most mortgage loans during 1994. For more information, see *Points* and *Mortgage Interest Statement,* later.

Limit on itemized deductions. Certain itemized deductions (including home mortgage interest) are limited if your adjusted gross income is more than $111,800 ($55,900 if you are married filing a separate return). For more information, see Chapter 22.

Seller-financed mortgage interest. If you paid home mortgage interest to the person from whom you bought your home, show that person's name, address, and social security number (SSN) or employer identification number (EIN) on the dotted lines next to line 11 of Schedule A (Form 1040). That person must give you his or her SSN or EIN. You must also let that person know your SSN. For more information, see *Where to Deduct,* later.

Introduction

This chapter contains general information on interest expense. It also discusses:

- Limits on the deduction of home mortgage interest,
- The mortgage interest statement,
- Points, and
- Interest payments and expenses similar to interest that are not deductible.

Use *Table 25–1* to see where to deduct various types of interest. This table also shows which publication contains more information on each type of interest listed.

Useful Items

You may want to see:

Publication

- ❑ **936** Home Mortgage Interest Deduction

Form (and Instructions)

- ❑ **1098** Mortgage Interest Statement
- ❑ **8396** Mortgage Interest Credit

General Rules

Interest is an amount paid for the use of borrowed money. To be deductible, the interest you pay must reflect the true (economic) cost of the indebtedness for the payment period. This chapter, except where noted, assumes that interest paid is the true cost.

Legally liable. To deduct interest on a debt, you must be legally liable for that debt. You cannot deduct payments you make for someone else if you are not legally liable to make them. Both the lender and the borrower must intend that the loan be repaid. In addition, there must be a true debtor-creditor relationship between the lender and the borrower.

Interest paid in advance. If you pay interest for a period that goes beyond the end of the tax year, you must spread this interest paid in advance over the tax years to which it applies. You can deduct in each year only the interest for that year. However, see *Points,* later.

Refunds of interest. If you receive a refund of interest in the same tax year you pay it, you must reduce your interest expense by the amount refunded to you. If you receive a refund of interest you deducted in an earlier year, you generally must include the refund in income in the year you receive it. But you only need to include the amount of the deduction that reduced your tax in the earlier year.

If you received a refund of interest you overpaid in an earlier year, you generally will receive a Form 1098, *Mortgage Interest Statement,* showing the refund in box 3. For information about Form 1098, see *Mortgage Interest Statement,* later.

For more information on how to treat refunds of interest deducted in earlier years, see *Recoveries* in Chapter 13.

Home Mortgage Interest

Generally, home mortgage interest is any interest you pay on a loan secured by your home (main home or a second home). These loans include: a mortgage, a second mortgage, a line of credit, and a home equity loan.

To deduct home mortgage interest, you must file Form 1040 and itemize deductions on Schedule A. If the interest is deductible home mortgage interest, report it on lines 10–12 of Schedule A (Form 1040).

Limit on the Deduction of Mortgage Interest

In most cases, you will be able to deduct all of your home mortgage interest. Whether it is all deductible depends on the date you took out the mortgage, the amount of the mortgage, and your use of its proceeds.

If all of your mortgages fit into one or more of the following three categories, you can deduct ALL of the interest on those mortgages. If any one mortgage fits into more than one category, add the parts of the mortgage that fit in each category to your other mortgages in the same category. (If one or more of your mortgages does not fit into any of these three categories, get Publication 936 to figure the amount of interest you can deduct.)

- Mortgages you took out on or before October 13, 1987 (called grandfathered debt).
- Mortgages you took out after October 13, 1987, to buy, build, or improve your home (called home acquisition debt), but only if these mortgages plus any grandfathered debt totaled $1 million or less throughout 1994.
- Mortgages you took out after October 13, 1987, other than to buy, build, or improve your home (called home equity debt), but only if these mortgages totaled $100,000 or less throughout 1994.

If you are married and file a separate return, the home acquisition debt limit is $500,000 and the home equity debt limit is $50,000.

If the total amount of all mortgages exceeds the fair market value of the home, an additional limit may apply. For more information, get Publication 936.

Note. You cannot deduct this interest if you use the proceeds of the mortgage to purchase securities or certificates that produce tax-free income.

You can use *Figure 25–A* to check whether your interest is fully deductible.

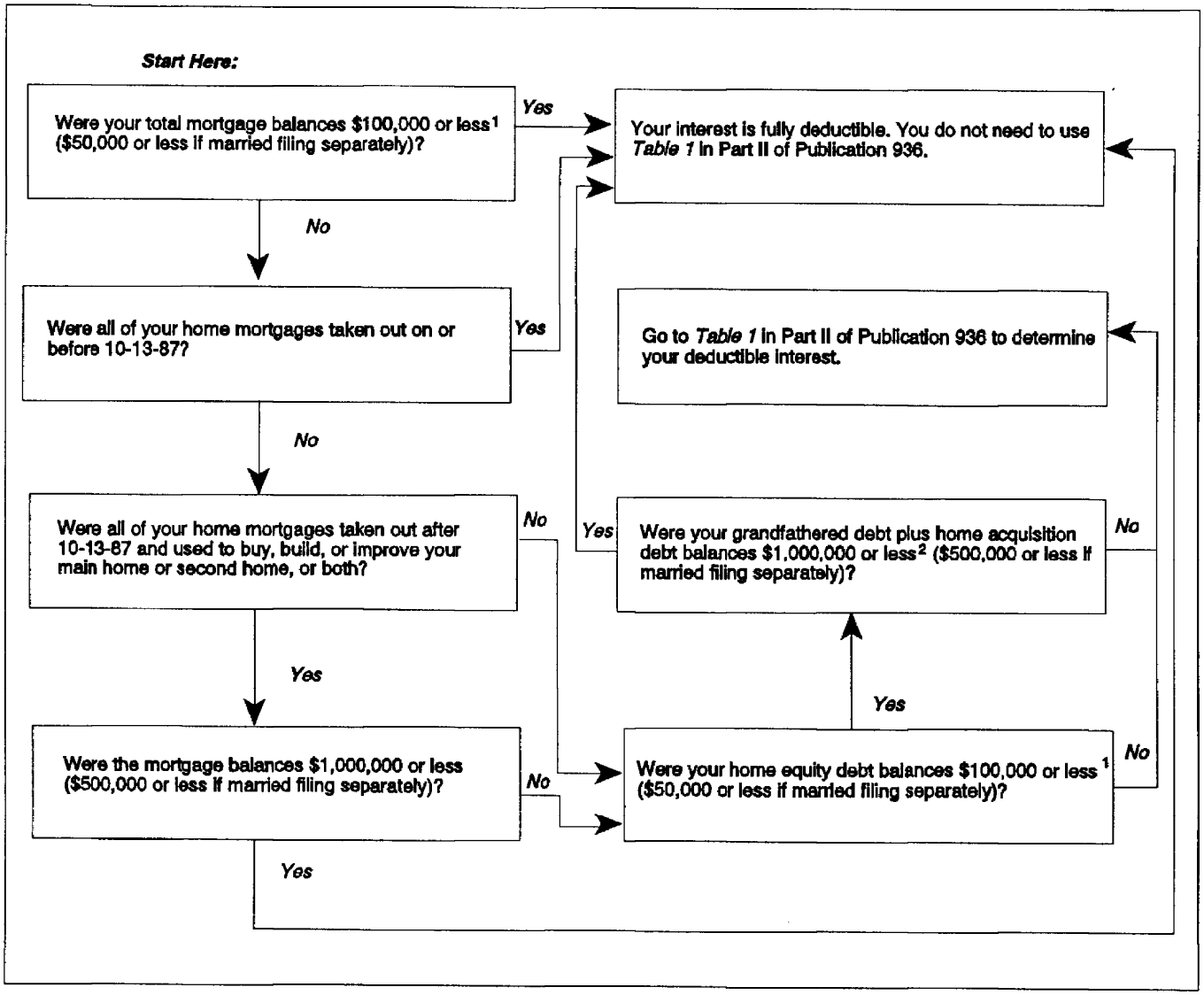
Which Category Your Mortgage Fits In

This section further discusses which of the three categories of mortgage (grandfathered debt, home acquisition debt, or home equity debt) your mortgage fits in. Remember that grandfathered mortgages were taken out on or before October 13, 1987, and that home acquisition and home equity mortgages were taken out after October 13, 1987.

Refinanced grandfathered debt. If you refinance grandfathered debt after October 13, 1987, for an amount that is not more than the mortgage principal left on the debt, then

Figure 25-A. Is My Interest Fully Deductible?

(Instructions: Include balances of ALL mortgages secured by your main home and second home. Answer YES only if the answer is true at ALL times during the year.)



1 If all mortgages on your first or second home exceed the home's fair market value, a lower limit may apply. See *Home equity debt limit* in Publication 936.

2 Amounts over the $1,000,000 limit ($500,000 if married filing separately) qualify as home equity debt if they are not more than the total home equity debt limit. See Publication 936 for more information about grandfathered debt, home acquisition debt, and home equity debt.

you still treat it as grandfathered debt. However, any amount that is more than that mortgage principal is treated as home acquisition or home equity debt, and the mortgage is a mixed-use mortgage (discussed later). The debt must be secured by the qualified home.

You treat grandfathered debt that was refinanced after October 13, 1987, as grandfathered debt only for the term left on the debt being refinanced. After that, you treat it as home acquisition debt or home equity debt, depending on how you used the proceeds.

Exception. If the debt before refinancing is like a balloon note (the principal on the debt is not amortized over the term of the debt), then you treat the refinanced debt as grandfathered debt for the term of the first refinancing. This term cannot be more than 30 years.

Example. Chester acquired a $200,000 first mortgage on his home in 1985. The mortgage was a 5-year balloon note and the entire balance on the note was due in 1990. Chester refinanced the debt in 1990 with a new 20-year mortgage. The refinanced debt is treated as grandfathered debt for its entire term (20 years).

Line-of-credit mortgage. If you had a line-of-credit mortgage on October 13, 1987, and borrowed additional amounts against it after that date, then the additional amounts are either home acquisition debt or home equity debt depending on how you used the proceeds. This is also considered a mixed-use mortgage. The balance on the mortgage before you borrowed the additional amounts is grandfathered debt. The newly borrowed amounts are not grandfathered debt because the funds were borrowed after October 13, 1987.

Mixed-use mortgages. If you took out a mortgage after October 13, 1987, and parts of the mortgage are within more than one of the three categories of debt (i.e., home equity debt, grandfathered debt, home acquisition debt), it is a mixed-use mortgage. If the mixed-use mortgage added to your other home mortgages exceed the loan limits discussed earlier, under *Limit on the Deduction of Mortgage Interest,* be sure to get Publication 936.

More than one home. If you had a main home and a second home, the home acquisition and home equity debt dollar limits explained above apply to the total mortgages on both homes. Your main home is the property you live in most of the time. It may be a house, condominium, cooperative, mobile home, boat, or similar property. It must provide basic living accommodations including sleeping space, toilet facilities, and cooking facilities. Your second home is similar property that you select to be your second home.

Mortgage Interest Statement

If you paid mortgage interest of $600 or more during the year on any one mortgage, you generally will receive a **Form 1098,** *Mortgage Interest Statement,* or a similar statement. You will receive the statement if you pay interest to a person (including a financial institution or a cooperative housing corporation) in the course of that person's trade or business. A governmental unit is a person for purposes of furnishing the statement.

The statement will show the total interest you paid during the year. If you purchase a main home during 1994, it will also show the deductible points you paid during the year. However, it should not show housing assistance payments under section 235 of the National Housing Act.

If you received a refund of interest you overpaid in an earlier year, you generally will receive a Form 1098 showing the refund in box 3. See *Refunds of interest,* earlier.

Note. Form 1098 will not include points paid for:

1) Home improvement loans on your main home,
2) Purchase or home improvement loans on your second home, vacation property, investment property, or trade or business property,
3) Refinancing, home equity loans, and lines of credit secured by your main home, and
4) Amounts that are more than the points generally charged in your area.

However, certain points not included on Form 1098 may be deductible. See *Points,* later, for more information.

You should receive the statement by January 31, 1995. The mortgage interest information will also be sent to the IRS.

If you prepaid interest in 1994 that accrued in full by January 15, 1995, this prepaid interest may be included in box 1 of Form 1098. However, even though the prepaid amount may be included in box 1, you cannot deduct the prepaid amount in 1994. You will have to figure the interest that accrued for 1995 and subtract it from the amount in box 1. You will include the interest for 1995 with the other interest you pay for 1995. See *Where to Deduct,* later.

If your home mortgage interest payments are more than the amount shown on the mortgage interest statement, you can deduct the amount of the interest that you ***actually paid.*** Attach a statement to your return explaining why you are deducting more than the amount reported on Form 1098. The interest must be for the tax year you are claiming the deduction.

You can deduct only your share of the mortgage interest you paid. If your mortgage payments were subsidized by a government agency, do not deduct the amount paid for you.

If you and at least one other person (other than your spouse if you file a joint return) were liable for, and paid, interest on a mortgage that was for your home and the other person received a Form 1098 showing the interest that was paid during 1994, attach a statement to your return explaining this, showing how much of the interest each of you paid, and giving the name and address of the person who received the form. In the far left margin, next to line 11, Schedule A, write ''see attached.''

If you are the payer of record on a mortgage on which there are other borrowers entitled to a deduction for the interest shown on the Form 1098 you received, you should furnish the other borrowers with information about the proper distribution of the amounts shown on the form you received.

Points

The term ''points'' is used to describe certain charges paid, or treated as paid, by a borrower to obtain a home mortgage. The term also describes certain charges that a home seller pays to a lender for the buyer's mortgage. Points may also be called loan origination fees, maximum loan charges, loan discount, or discount points.

General rule. You cannot deduct the full amount of points in the year paid. You must spread the points over the life (term) of the mortgage. Generally, you can deduct an equal portion in each year of the mortgage.

Exception 1. You can fully deduct in 1994 the amount paid on your loan as points if all the following are true:

1) Your loan is secured by your main home. (Your main home is the one you live in most of the time.)
2) Paying points is an established business practice in the area where the loan was made.
3) The points paid were not more than the points generally charged in this area.
4) You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them. (If you want more information about this method, see *Accounting Methods* in Chapter 1.)
5) You use your loan to buy or improve your main home.
6) The points were for the use of money, not for other services.
7) The points were paid with funds you did not borrow from your lender or mortgage broker.

Exception 2. You can fully deduct in 1994 the amount paid on your loan as points if all the following are true:

1) Statements (1) through (4) under *Exception 1* are true.
2) You use your loan to buy your main home.
3) The points were computed as a percentage of the principal amount of the mortgage.
4) The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
5) The amount is clearly shown on the settlement statement (for example, Form HUD–1) as points charged for the mortgage. The points may be shown as paid from either your funds or the seller's.
6) At least one of the following is true:
   a) You pay an amount from your own funds that is at least as much as the points. This amount may not be borrowed from your lender or mortgage broker. You do not have to pay the points with these funds. You can apply the funds to a down payment, escrow deposit, earnest payment, or pay them over for any purpose at the closing.
   b) The points were paid by the seller, and you reduce your basis in the home by the amount of seller-paid points. (See Chapter 14 for information about basis.)

Funds provided are less than points. If you meet all the tests in *Exception 2* except that the funds you provided were less than the points, you can deduct the points in the year paid up to the amount of funds you provided. In addition, you can deduct any points paid by the seller.

Example 1. When you took out a $100,000 mortgage loan to buy your home in December 1994, you were charged one point ($1,000). You meet all the tests for deducting points in *Exception 2* except the only funds you provided were a $750 down payment. Of the $1,000 charged for points, you can deduct $750 in 1994.

Example 2. The facts are the same as in Example 1, except that the person who sold you your home also paid one point ($1,000) to help you get your mortgage. In 1994, you can deduct $1,750 ($750 of the amount you were charged plus the $1,000 paid by the seller). You must reduce the basis of your home by the $1,000 paid by the seller.

Note. *Exception 2* also applies to a loan origination fee charged for services for getting a conventional, VA, or FHA loan to buy your main home.

Figure 25–B. You can use *Figure 25–B* as a quick check to see if points are fully deductible in the year paid.

Form 1098. You should receive a Form 1098, *Mortgage Interest Statement,* or a similar statement from your lender or mortgage broker by January 31, 1995. It will show not only the interest you paid, but also any deductible points you paid in 1994 to get a loan to buy your main home. You may also be entitled to a deduction for other points that you paid, but which your lender is not required to include on Form 1098 (such as points paid on a loan used to improve your main home).

Excess points. If the points paid were more than are generally paid in your area, your deduction in 1994 is limited to the points generally charged. Any additional amount of points paid is interest paid in advance and the deduction must be spread over the life of the mortgage.

Second home. The exceptions do not apply to points you pay on loans secured by your second home. You can deduct these points only over the life of the loan.

Mortgage ending early. If you spread your deduction for points over the life of the mortgage, you can deduct any remaining balance in the year the mortgage ends. A mortgage may end early due to a prepayment, refinancing, foreclosure, or similar event.

Example. Dan refinanced his mortgage in 1989 and paid $3,000 in points that he had to spread out over the life of the mortgage. He had deducted $1,000 of these points through 1993.

Dan prepaid his mortgage in full in 1994. He can deduct the remaining $2,000 of points in 1994.

Refinancing. Generally, points you pay to refinance a mortgage are not deductible in full in the year you pay them. This is true even if the new mortgage is secured by your main home. However, if you use part of the refinanced mortgage proceeds to ***improve your main home*** and you meet the seven conditions listed under *Exception 1,* earlier, you can fully deduct the part of the points related to the improvement in the year paid. You can deduct the remainder of the points over the life of the loan.

For more information on refinancing, see Publication 936.

Amounts charged for specific services by the lender for the borrower's account are not interest. Examples of fees for services not considered interest are the lender's appraisal fee, preparation costs for the mortgage note or deed of trust, settlement fees, and notary fees. An amount listed on your settlement statement as a loan origination fee is interest (even if it is charged for the lender's services), but only if the amount otherwise falls within *Exception 2,* earlier.

Points paid by a seller. The term ''points'' also is used to describe loan placement fees that the seller may have to pay to the lender to arrange financing for the buyer. The seller ***cannot*** deduct these amounts as interest. But these charges are a selling expense that reduces the seller's amount realized. See Chapter 16 for information on selling your home. The buyer may be able to deduct the points paid by the seller, as explained earlier in this discussion.

Points paid by seller in 1991, 1992, or 1993. You can deduct seller-paid points on an amended return, if:

1) The person who sold you your home paid points for your mortgage in 1991, 1992, or 1993,
2) You did not deduct the points on your original return for the year paid, and
3) You meet the tests for deducting the points described under *Exception 1* or *Exception 2,* earlier.

File an amended return for the year the points were paid. Use Form 1040X, *Amended U.S. Individual Income Tax Return.* Write ''Seller-Paid Points'' in the top right margin of the amended return and attach a copy of the settlement statement (for example, Form HUD–1) showing the points.

Generally, you must file the amended return within 3 years from the date your original return was filed or within 2 years from the date the tax was paid, whichever is later. For details, see *Amended Returns and Claims for Refund* in Chapter 1.

Limits on deduction. You cannot fully deduct points on a mortgage that exceeds the limits discussed earlier. See Publication 936 for details.

Special Rules

This section contains other information you may need to know about home mortgage interest.

Closing costs. Expenses that you pay at settlement or closing in connection with buying your home, such as commissions, abstract fees, and recording fees, are capital expenses. You cannot deduct these expenses either as interest or as current business expenses. Add these to the basis of the property.

There are certain settlement fees or closing costs that you cannot deduct or add to the basis of your property. These include:

1) Fire insurance premiums.
2) FHA mortgage insurance premiums and VA funding fees.
3) Charges for utilities or other services related to occupancy of the house before closing.
4) Rent for occupancy before closing.
5) The cost of repairs.
6) Any item that you deducted as a moving expense (settlement fees and closing costs incurred after 1993 cannot be deducted as moving expenses).

Sale of home. If you sell your home, you can deduct your allowable home mortgage interest paid up to, but not including, the date of sale.

Example. John and Peggy Harris bought a new home on May 4. They sold their old home on May 7. During the year they made home mortgage interest payments of $122 on the old home and $2,864 on the new home. The settlement sheet for the sale of the old home showed $5 interest for the 6–day period in May up to, but not including, the date of sale. Their mortgage interest paid for the year is $2,991 ($122 + $2,864 + $5).

Late payment charge on mortgage payment. You can deduct as home mortgage interest a late payment charge if it was not for a specific service performed by your mortgage holder.

Mortgage prepayment penalty. If you pay off your qualified home mortgage early, you may have to pay a penalty. You can include that penalty as home mortgage interest. If the proceeds of the loan were used for business or investment purposes, you may be able to deduct it under the rules for those expenses.

Mortgage interest credit. You may be able to claim a mortgage interest credit if you were issued a qualified mortgage credit certificate (MCC) by a state or local government. Figure the credit on **Form 8396,** *Mortgage Interest Credit.* If you take this credit, you must reduce your mortgage interest deduction by the amount of the credit.

Generally, to figure your credit, multiply the certificate credit rate shown on the MCC by the lesser of:

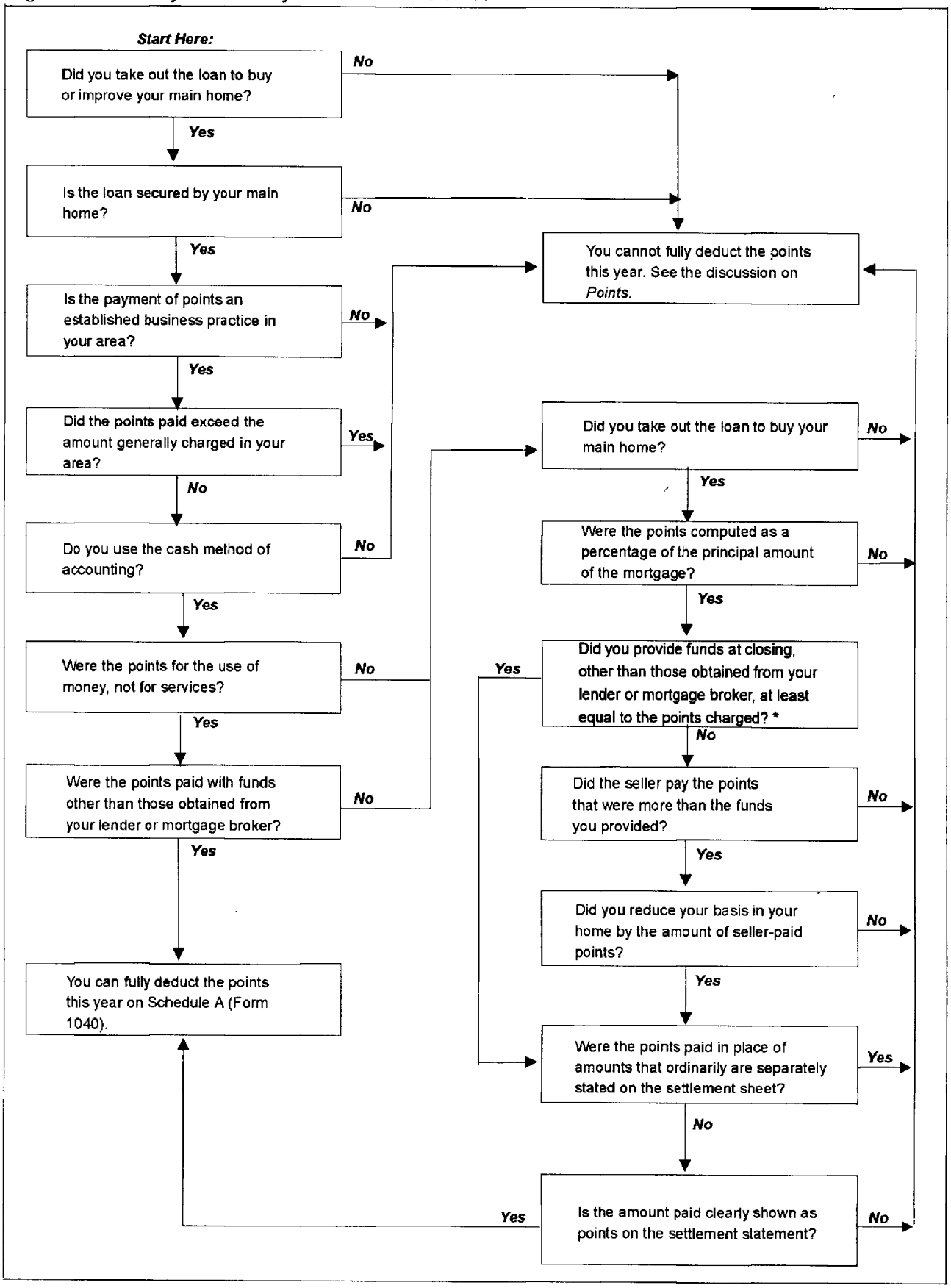
1) The interest you paid during the year on your actual loan amount (mortgage), or
2) The interest you paid on the loan amount shown on your MCC.

If the credit rate is more than 20%, your credit is limited to $2,000. For information on how to figure the credit, see Chapter 36.

Ministers' and military housing allowance. If you are a minister or a member of the uniformed services and receive a housing allowance that is not taxable, you can still deduct all of the deductible interest on your home mortgage.

Graduated payment mortgages (GPM). GPMs under section 245 of the National Housing Act provide that monthly payments increase every year for a number of years and then stay the same. During the early

Figure 25-B. **Are My Points Fully Deductible This Year?**



* The funds you provide do not have to be applied to the payment of points. They can be applied as down payments, escrow deposits, earnest money applied at the closing, and funds actually paid at closing.

years, payments are less than the amount of interest owed on the loan. The interest that is not paid becomes part of the principal. Future interest is figured on the increased unpaid mortgage loan balance.

Subject to any limits that apply, you can deduct the interest you actually paid during the year if you are a cash method taxpayer. For example, if the interest owed is $2,551 but your payment for the year is $2,517, you can deduct $2,517. Add $34 to the loan principal.

Mortgage assistance payments. If you qualify for mortgage assistance payments under section 235 of the National Housing Act, part or all of the interest on your mortgage may be paid for you. You cannot deduct any interest that is paid for you. You do not include these payments in your income. These payments do not reduce other deductions, such as taxes.

Redeemable ground rents. If you make annual or periodic rental payments on a redeemable ground rent, you can deduct them as mortgage interest.

Payments made to terminate the lease and to buy the lessor's entire interest in the land are not ground rents. You cannot deduct them. For more information, see Publication 936.

Nonredeemable ground rent. Payments on a nonredeemable ground rent are not interest. You can deduct them as rent if they are a business expense or if they are for rental property held to produce income.

Rental payments. If you live in a house before your final settlement, any payments you make for that period are rent, not interest, even if the settlement papers call them interest. You cannot deduct these payments.

Reverse mortgage loans. A reverse mortgage loan is a loan that is based on the value of your home and is secured by a mortgage on your home. The lending institution pays you the proceeds of the loan in installments over a period of months or years. The loan agreement may provide that interest will be added to the outstanding loan balance monthly as it accrues. If you are a cash method taxpayer, you deduct the interest on a reverse mortgage loan when you actually pay it, not when it is added to the outstanding loan balance.

Items You Cannot Deduct

Some interest payments are not deductible. Certain expenses similar to interest also are not deductible. These items include:

- Personal interest
- "Points" if you are a seller
- Nonredeemable ground rent
- Service charges (however, see *Other Expenses* in Chapter 30)
- Annual fees for credit cards
- Loan fees
- Credit investigation fees
- Interest relating to tax-exempt income
- Interest to purchase or carry tax-exempt securities
- Interest to purchase or carry certain straddle positions
- Premium due to the conversion feature of a convertible bond

Penalties. You cannot deduct fines and penalties for violations of law, regardless of their nature.

Personal Interest

Personal interest is not deductible. Personal interest is any interest that is not home mortgage interest, investment interest, or business interest.

Personal interest includes such items as:

- Interest on car loans,
- Interest on income tax,
- Installment plan interest,
- Credit card finance charges,
- Retail installment contract finance charges,
- Revolving charge account finance charges,
- Late payment charge by a public utility, and
- Interest on certain below-market loans (see Chapter 1 of Publication 550).

Allocation of Interest

If you use the proceeds of a loan for more than one purpose (for example, personal and business), you must allocate the interest on the loan to each use. However, you do not have to allocate home mortgage interest if it is fully deductible regardless of how the funds are used.

You allocate interest (other than fully deductible home mortgage interest) on a loan in the same way as the loan itself is allocated. You do this by tracing disbursements of the debt to specific uses. For details on how to do this, see Chapter 8 of Publication 535.

Where to Deduct

You must file Form 1040 to deduct any interest expense on your tax return. Where you deduct your interest expense generally depends on how you use the loan proceeds. See *Table 25–1* for a summary of where to deduct your interest expense.

Home mortgage interest and points. Deduct fully deductible home mortgage interest and points reported to you on Form 1098 on line 10 of Schedule A (Form 1040).

Deduct fully deductible home mortgage interest that was ***not*** reported to you on Form 1098 on line 11 of Schedule A (Form 1040). If you paid home mortgage interest to the person from whom you bought your home, show that person's name, address, and social security number (SSN) or employer identification number on the dotted lines next to line 11. The seller must give you this number

Table 25-1. **Where to Deduct Your Interest**

Type of interest	Where to deduct	Where to find information
Deductible home mortgage interest and points reported on Form 1098	Schedule A (Form 1040), line 10	Publication 936
Deductible home mortgage interest *not* reported on Form 1098	Schedule A (Form 1040), line 11	Publication 936
Points *not* reported on Form 1098	Schedule A (Form 1040), line 12	Publication 936
Investment interest (other than interest incurred to produce rents or royalties)	Schedule A (Form 1040), line 13	Publication 550
Business interest (non-farm)	Schedule C (Form 1040)	Publications 334 and 535
Farm business interest	Schedule F (Form 1040)	Publications 225 and 535
Interest incurred to produce rents or royalties	Schedule E (Form 1040)	Publications 527 and 535
Personal Interest	Not Deductible	

and you must give the seller your SSN. Failure to meet any of these requirements may result in a $50 penalty for each failure.

Deduct points paid on a mortgage that were ***not*** reported to you on Form 1098 on line 12 of Schedule A (Form 1040).

If the mortgage interest is not fully deductible home mortgage interest because you used the proceeds of the loan for other purposes, then you may be able to deduct it as investment, business, or passive activity interest, subject to the rules for those deductions.

Investment interest. Deduct investment interest, subject to certain limits discussed in Publication 550, on line 13, Schedule A (Form 1040).

Amortization of bond premium. There are various ways to treat the premium you pay to buy taxable bonds. See *Bond Premium Amortization* in Publication 550.

Non-farm business interest. Deduct interest on non-farm business loans on Schedule C (Form 1040).

Farm business interest. Deduct interest on farm business loans on Schedule F (Form 1040).

Income-producing rental or royalty interest. Deduct interest on a loan for income-producing rental or royalty property that is not used in your business in Part I of Schedule E (Form 1040).

Example. You rent out part of your home and borrow money to make repairs. You can deduct only the interest payment for the rented part in Part I of Schedule E (Form 1040). Deduct the rest of the interest payment on Schedule A (Form 1040) if it is deductible home mortgage interest.

26.

Contributions

Important Changes for 1994

Written acknowledgement required. You can claim a deduction for a contribution of $250 or more only if you have a written acknowledgement of your contribution from the qualified organization. For more information, see *Records To Keep,* later in this chapter.

Payment partly for goods or services. A qualified organization that receives a payment from you must give you a written statement if the payment is more than $75 and is partly a contribution and partly for goods or services. The statement must tell you that you can deduct only the amount of your payment that is more than the value of the goods or services you received. See *Contributions From Which You Benefit,* later in this chapter, for more information.

Important Reminders

Limit on itemized deductions. Certain itemized deductions (including charitable contributions) are limited if your adjusted gross income is more than $111,800 ($55,900 if you are married filing separately). See Chapter 22.

Disaster relief. You can deduct contributions earmarked for ''Earthquake Disaster Relief'' or other disaster relief to a qualified organization (defined later under *Organizations That Qualify To Receive Deductible Contributions*). However, you cannot deduct contributions earmarked for relief of a particular individual or family.

Introduction

This chapter discusses:

- What a charitable contribution is,
- Organizations that are qualified to receive charitable contributions,
- The types of contributions you can deduct,
- What records to keep, and
- How to report your charitable contributions.

A charitable contribution is a contribution or gift to, or for the use of, a qualified organization.

To deduct a charitable contribution, you must file Form 1040 and itemize deductions on Schedule A. You report your contributions on lines 15–18 of Schedule A under the heading ''Gifts to Charity.'' The amount of your deduction may be limited if certain rules and limits explained in this chapter apply to you.

Useful Items

You may want to see:

Publication

- ❑ **526** Charitable Contributions
- ❑ **561** Determining the Value of Donated Property

Form (and Instructions)

- ❑ **Schedule A (Form 1040)** Itemized Deductions

Organizations That Qualify To Receive Deductible Contributions

You can deduct your contributions only if you make them to a ***qualified organization.*** To become a qualified organization, most organizations other than churches must apply to the IRS.

How to find out whether an organization qualifies. You may ask any organization whether it is a qualified organization, and most will be able to tell you. Or you may check IRS Publication 78, *Cumulative List of Organizations,* which lists most qualified organizations. To check Publication 78, go to your local library's reference section or call the IRS toll-free tax help telephone number for your area. These numbers are listed in your tax forms package.

Types of Qualified Organizations

Generally, only the five following types of organizations can be qualified organizations:

1) 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.

   Note: To be able to deduct your contribution to this type of organization, you must make it for public purposes only.

2) A community chest, corporation, trust, fund, or foundation organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the United States (including Puerto Rico). It must be organized and operated only for charitable, religious, educational, scientific, or literary purposes, or for the prevention of cruelty to children or animals. This includes the Red Cross, the United Way, Boy Scouts, and Girl Scouts. Certain organizations that foster national or international amateur sports competition also qualify.

3) War veterans' organizations, including posts, auxiliaries, trusts, or foundations, organized in the United States or any of its possessions.

4) Domestic fraternal societies, orders, and associations operating under the lodge system.

   Note: Your contribution to this type of organization is deductible only if it is to be used only for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

5) Certain nonprofit cemetery companies or corporations.

   Note: Your contribution to this type of organization is not deductible if it can be used for the care of a specific lot or mausoleum crypt.

Examples. Qualified organizations that fit into one of the above categories include:

- Churches, a convention or association of churches, temples, synagogues, mosques, and other religious organizations.
- Civil defense organizations.
- Most nonprofit charitable organizations.
- Most nonprofit educational organizations, including day care centers if substantially all the child care provided is to enable individuals (the parents) to be gainfully employed and the services are available to the general public. However, if your contribution is a substitute for tuition or other enrollment fee, it is not deductible as a charitable contribution, as explained later under *Contributions You Cannot Deduct.*
- Nonprofit hospitals and medical research organizations.
- Nonprofit volunteer fire companies.
- Public parks and recreation facilities.
- Utility company emergency energy programs, if the utility company is an agent for a charitable organization that assists individuals with emergency energy needs.

Canadian charities. You can deduct contributions to certain Canadian charitable organizations covered under an income tax treaty with Canada. See Publication 597, *Information on the United States–Canada Income Tax Treaty,* for information on how to figure your deduction.

Mexican charities. Beginning in 1994, you may be able to deduct contributions to certain Mexican charitable organizations under an income tax treaty with Mexico. The organization must meet tests essentially the same as the tests that qualify U.S. organizations to receive deductible contributions. To deduct your contribution, you must have income

from sources in Mexico. If you need more information, see Publication 526.

Contributions You Can Deduct

Generally, you can deduct your contributions of money or property that you make to, or for the use of, a qualified organization. A gift or contribution is ''for the use of'' a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement.

If you give property to a qualified organization, you generally can deduct the fair market value of the property at the time of the contribution. See *Contributions of Property,* later in this chapter.

Your deduction for charitable contributions is generally limited to 50% of your adjusted gross income, but in some cases 20% and 30% limits may apply. See *Limit on Deductions,* later.

Table 26–1 lists some examples of contributions you can deduct and some that you cannot deduct.

Contributions From Which You Benefit

If you receive a benefit as a result of making a contribution to a qualified organization, you can deduct only the amount of your contribution that is more than the value of the benefit you receive.

If you pay more than fair market value to a qualified organization for merchandise, goods, or services, the amount you pay that is more than the value of the item may be a charitable contribution.

Example 1. You pay $75 for a dinner-dance at a church. All of the proceeds of the function go to the church. The dinner, plus any entertainment or other services provided, has a fair market value of $25. Subtract the value of the benefit you received ($25) from your total payment ($75). You can deduct $50 as a contribution to the church.

Example 2. At a fund-raising auction conducted by a charity, you pay $600 for a week's stay at a beach house. The amount you pay is no more than the fair rental value. You have not made a deductible charitable contribution.

Athletic events. If you make a payment to, or for the benefit of, a college or university and, as a result, you receive the right to buy tickets to an athletic event in the athletic stadium of the college or university, you can deduct 80% of the payment as a charitable contribution.

If any part of your payment is for tickets (rather than the right to buy tickets), that part is not deductible. In that case, subtract the price of the tickets from your payment. 80% of the remaining amount is a charitable contribution.

Table 26-1. **Examples of Charitable Contributions—A Quick Check**

Use the following lists for a **quick check** of contributions you can or cannot deduct. See the rest of this chapter for more information and additional rules and limits that may apply.

Deductible As Charitable Contributions	**Not Deductible As Charitable Contributions**
Money or property you give to:	Money or property you give to:
• Churches, synagogues, temples, mosques, and other religious organizations	• Civic leagues, social and sports clubs, labor unions, and chambers of commerce
• Federal, state, and local governments, if your contribution is solely for public purposes (for example, a gift to reduce the public debt)	• Foreign organizations (except certain Canadian and Mexican charities)
• Nonprofit schools and hospitals	• Groups that are run for personal profit
• Public parks and recreation facilities	• Groups whose purpose is to lobby for law changes
• Salvation Army, Red Cross, CARE, Goodwill Industries, United Way, Boy Scouts, Girl Scouts, Boys and Girls Clubs of America, etc.	• Homeowners' associations
• War veterans' groups	• Individuals
Costs you pay for a student living with you, sponsored by a qualified organization	• Political groups or candidates for public office
Out-of-pocket expenses when you serve a qualified organization as a volunteer	Cost of raffle, bingo, or lottery tickets
	Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups
	Tuition
	Value of your time or services
	Value of blood given to a blood bank

Example 1. You pay $300 a year for membership in an athletic scholarship program maintained by a university (a qualified organization). The only benefit of membership is that you have the right to buy one season ticket for a seat in a designated area of the stadium at the university's home football games. You can deduct $240 (80% of $300) as a charitable contribution.

Example 2. The facts are the same as in Example 1 except that your $300 payment included the purchase of one season ticket for the stated ticket price of $120. You must subtract the usual price of a ticket ($120) from your $300 payment. The result is $180. $144 (80% of $180) is a charitable contribution.

Charity benefit events. If you pay a qualified organization more than fair market value for the right to attend a charity ball, banquet, show, sporting event, or other benefit event, you can deduct only the amount that is more than the value of the privileges or other benefits you receive.

If there is an established charge for the event, that charge is the value of your benefit. If there is no established charge, your contribution is that part of your payment that is more than the reasonable value of the right to attend the event. Whether you use the tickets or other privileges has no effect on the amount you can deduct. However, if you return the ticket to the qualified organization for resale, you can deduct the entire amount you paid for the ticket.

Even if the ticket or other evidence of payment indicates that the payment is a ''contribution,'' this does not necessarily mean you can deduct the entire amount. If the ticket shows the price of admission and the amount of the contribution, you can deduct the contribution amount.

Example. You pay $40 to see a special showing of a movie for the benefit of a qualified organization. Printed on the ticket is ''Contribution—$40.'' If the regular price for the movie is $8, your contribution is $32 ($40 payment – $8 regular price).

Membership fees or dues. You may be able to deduct membership fees or dues you

pay to a qualified organization. However, you can deduct only the amount that is more than the value of the benefits you receive. You cannot deduct dues, fees, or assessments paid to country clubs and other social organizations. They are not qualified organizations.

Token items. You can deduct your entire payment to a qualified organization as a charitable contribution, if both the following are true:

1) You receive:
   a) As a result of the payment, low-value or low-cost items such as bookmarks, calendars, mugs, or caps that have on them the organization's name or logo, or
   b) A low-cost item that you did not order and can keep even if you do not make a contribution.
2) The qualified organization correctly informs you that the value of the item you received is not substantial and that you can deduct your payment in full.

Written statement. Beginning in 1994, a qualified organization must give you a written statement if you make a payment to it that is more than $75 and is partly a contribution and partly for goods or services. The statement must tell you that you can deduct only the amount of your payment that is more than the value of the goods or services you received. It must also give you a good faith estimate of the value of those goods or services.

The organization can give you the statement either when it solicits or when it receives the payment from you.

An organization will not have to give you this statement if one of the following is true:

1) The organization is:
   a) The type of organization described in (1) under *Types of Qualified Organizations,* earlier, or
   b) Formed only for religious purposes, and the only benefit you receive is an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in commercial transactions outside the donative context.
2) You receive only low-value or low-cost items as described under *Token items,* earlier.

Expenses Paid for Student Living With You

You may be able to deduct some expenses of having a student live with you. You can deduct expenses for a foreign or American student who:

1) Lives in your home under a written agreement between you and a "qualified organization" as part of a program of the organization to provide educational opportunities for the student,
2) Is not your dependent or relative, and
3) Is a full-time student in the twelfth or any lower grade at a school in the United States.

You can deduct up to $50 a month for each full calendar month the student lives with you. Any month when conditions (1) through (3) above are met for 15 days or more counts as a full month.

You cannot deduct the costs of a foreign student living in your home under a mutual exchange program through which your child will live with a family in a foreign country.

For additional information, see *Expenses Paid for Student Living With You* in Publication 526, *Charitable Contributions*.

Out-of-Pocket Expenses in Giving Services

You may be able to deduct some amounts you pay in giving services to a qualified organization. The amounts must be:

Unreimbursed,

Directly connected with the services,

Expenses you had only because of the services you gave, and

Not personal, living, or family expenses.

Table 26–2 contains questions and answers that apply to some individuals who volunteer their services.

Conventions. If you are a chosen representative attending a convention of a qualified organization, you can deduct actual unreimbursed expenses for travel and transportation, including a reasonable amount for meals and lodging, while away from home overnight in connection with the convention. However, see *Travel,* later.

You cannot deduct personal expenses for sightseeing, fishing parties, theater tickets, or nightclubs. You also cannot deduct travel, meals and lodging, and other expenses for your spouse or children.

You cannot deduct your expenses in attending a church convention if you go only as a member of your church rather than as a chosen representative. You can deduct unreimbursed expenses that are directly connected with giving services for your church during the convention.

Uniforms. You can deduct the cost and upkeep of uniforms that are not suitable for everyday use and that you must wear while performing donated services for a charitable organization.

Foster parents. You can deduct some of the costs of being a foster parent (foster care

Table 26-2. **Volunteers' Questions and Answers**

If you do volunteer work for a qualified organization, the following questions and answers may apply to you. All of the rules explained in this chapter also apply. See, in particular, Out-of-Pocket Expenses in Giving Services.

Question	Answer
I do volunteer work 6 hours a week in the office of a qualified organization. The receptionist is paid $6 an hour to do the same work I do. Can I deduct $36 a week for my time?	No, you cannot deduct the value of your time or services.
The office is 30 miles from my home. Can I deduct any of my car expenses for these trips?	Yes, you can deduct the costs of gas and oil that are directly related to getting to the qualified organization where you are a volunteer. If you don't want to figure your actual costs, you can deduct 12 cents for each mile.
I am a Red Cross nurse's aide at a hospital. Can I deduct the cost of uniforms that I must wear?	Yes, you can deduct the cost of buying and cleaning your uniforms if the hospital is a qualified organization, the uniforms are not suitable for everyday use, and you must wear them when volunteering.
I pay a babysitter to watch my children while I do volunteer work for a qualified organization. Can I deduct these costs?	No, you cannot deduct payments for child care expenses as a charitable contribution, even if they are necessary so you can do volunteer work for a qualified organization. (If you have child care expenses so you can work for pay, see Chapter 33.)

provider) if you have no profit motive in providing the foster care and are not, in fact, making a profit.

You can deduct expenses that are:

1) Greater than any nontaxable payments you receive to provide foster care for individuals placed in your home by a charitable organization, and
2) Spent to provide support for those individuals.

For more information, see *Foster-care providers* under *Income Not Taxed* in Chapter 13.

Car expenses. You can deduct unreimbursed out-of-pocket expenses, such as the cost of gas and oil, that are directly related to the use of your car in giving services to a charitable organization. You cannot deduct any part of general repair and maintenance expenses, depreciation, registration fees, or the costs of tires or insurance.

If you do not want to deduct your actual expenses, you can use a standard rate of ***12 cents a mile*** to figure your contribution.

You can deduct parking fees and tolls, whether you use your actual expenses or the standard rate.

You must keep reliable written records of your car expenses. For more information, see *Car Expenses* under *Records To Keep,* later.

Travel. You can claim a charitable contribution deduction for travel expenses necessarily incurred while you are away from home performing services for a charitable organization only if there is ***no significant element*** of personal pleasure, recreation, or vacation in such travel. This applies whether you pay the expenses directly or indirectly. You are paying the expenses indirectly if you make a payment to the charitable organization and the organization pays for your travel expenses.

The deduction will not be denied simply because you enjoy providing services to the charitable organization.

Example 1. You are a troop leader for a tax-exempt youth group and take the group on a camping trip. You can take a charitable contribution deduction for your own travel expenses if you are on duty in a genuine and substantial sense throughout the trip, even though you enjoyed the trip. However, if you have only nominal duties relating to the performance of services for the charity, or for significant portions of the trip you are not required to render services, you cannot deduct your travel expenses.

Example 2. You sail from one island to another and spend 8 hours a day counting whales and other forms of marine life. The project is sponsored by a charitable organization. In most circumstances, you cannot deduct your expenses.

Example 3. You work for several hours each morning on an archaeological excavation sponsored by a charitable organization. The rest of the day is free for recreation and sightseeing. You cannot take a charitable contribution deduction even though you work very hard during those few hours.

Example 4. You spend the entire day attending a charitable organization's regional meeting as a chosen representative. In the evening you go to the theater. You can claim your travel expenses as charitable contributions.

Daily allowance (per diem). If you provide services for a charitable organization and receive a daily allowance to cover reasonable travel expenses, including meals and lodging while away from home overnight, include in income the amount that is more than your actual travel expenses. You can deduct your necessary travel expenses that are more than the allowance.

Deductible travel expenses. These include:

- Air, rail, and bus transportation,
- Out-of-pocket expenses for your car,
- Taxi fares or other costs of transportation between the airport or station and your hotel,
- Lodging costs, and
- The cost of meals.

For additional information, see *Travel Expenses* in Chapter 28.

Contributions You Cannot Deduct

There are some contributions that you cannot deduct. You can deduct only part of other contributions.

Contributions to individuals. You cannot deduct contributions to specific individuals, including:

- ***Contributions to fraternal societies*** made for the purpose of paying medical or burial expenses of deceased members.
- ***Contributions to individuals who are needy or worthy.*** This includes contributions to a qualified organization if you indicate that your contribution is for a specific person. But you can deduct a contribution that you give to a qualified organization that in turn helps needy or worthy individuals if you do not indicate that your contribution is for a specific person.
- ***Payments to a member of the clergy*** that can be spent as he or she wishes, such as for personal expenses.
- ***Expenses you paid for another person*** who provided services to a qualified organization.

  Example. Your son does missionary work. You pay his expenses. You cannot claim a deduction for your son's unreimbursed expenses related to his contribution of services.
- ***Payments to a hospital*** that are for a specific patient's care or for services for a specific patient. You cannot deduct these payments even if the hospital is operated by a city, a state, or other qualified organization.

Contributions to nonqualified organizations. You cannot deduct contributions to organizations that are not qualified to receive tax-deductible contributions, including:

- ***Certain state bar associations,*** if:
  a) The state bar is not a political subdivision of a state,
  b) The bar has private, as well as public, purposes, such as promoting the professional interests of members, and
  c) Your contribution is unrestricted and can be used for private purposes.
- ***Chambers of commerce*** and other business leagues or organizations.
- ***Civic leagues and associations***.
- ***Communist organizations.***
- ***Country clubs*** and other social clubs.
- ***Foreign organizations.*** But you can deduct contributions you make to:
  a) A U.S. organization that transfers funds to a charitable foreign organization if the U.S. organization controls the use of the funds, or if the foreign organization is only an administrative arm of the U.S. organization, or
  b) Certain Canadian or Mexican charitable organizations. See *Canadian charities* and *Mexican charities* under *Organizations That Qualify To Receive Deductible Contributions,* earlier.
- ***Homeowners' associations.***
- ***Labor unions.*** (But you may be able to deduct union dues as a miscellaneous itemized deduction, subject to the 2% of adjusted gross income limit, on Schedule A (Form 1040). See Chapter 30.)
- ***Political organizations and candidates.***

Contributions from which you benefit. You cannot deduct contributions that you give to qualified organizations if, as a result, you receive or expect to receive a financial or economic benefit equal to the contribution. These include:

- ***Contributions for lobbying***. This includes amounts that you earmark for use in or in connection with influencing specific legislation.
- ***Contributions to a retirement home*** that are clearly for room, board, maintenance, or admittance. Also, if the amount of your contribution depends on the type or size of apartment you will occupy, it is not a charitable contribution.
- ***Costs of raffles, bingo, lottery, etc.*** You cannot deduct as a charitable contribution amounts you pay to buy raffle or lottery tickets or to play bingo or other games of

chance. For more information on how to report gambling winnings and losses, see *Gambling Losses to the Extent of Gambling Winnings* in Chapter 30.

- ***Dues to fraternal orders*** and similar groups.
- ***Tuition,*** or amounts you pay instead of tuition, even if you pay them for children to attend parochial schools or qualifying nonprofit day care centers. You also cannot deduct any fixed amount you may be required to pay in addition to the tuition fee to enroll in a private school, even if it is designated as a ''donation.''

Value of time or services. You cannot deduct the value of your time or services, including:

- ***Blood donations*** to the Red Cross or to blood banks.
- ***The value of income lost*** while you work as an unpaid volunteer for a qualified organization.

Personal expenses. You cannot deduct personal, living, or family expenses, such as:

- ***Adoption expenses,*** including fees paid to an adoption agency and the costs of keeping a child in your home before adoption is final. However, you may be able to claim an exemption for the child. See *Adoption* in Chapter 3.
- ***The cost of meals*** you eat while you perform services for a qualified organization, unless it is necessary for you to be away from home overnight while performing the services.

Appraisal fees. Fees that you pay to find the fair market value of donated property are not deductible as contributions. You can claim them, subject to the 2% of adjusted gross income limit, as miscellaneous deductions on Schedule A (Form 1040). See Chapter 30.

Contributions of Property

If you contribute property to a qualified organization, the amount of your charitable contribution is generally the fair market value of the property at the time of the contribution. However, if the property has increased in value, you may have to make some adjustments. See *Giving Property That Has Increased in Value,* later.

For information about the records you must keep and the information you must furnish with your return if you donate property, see *Records To Keep* and *How To Report,* later.

Partial interest in property. Generally, you cannot deduct a charitable contribution, not made by a transfer in trust, of less than your entire interest in property. A contribution of the right to use property, not made by a transfer in trust, is a contribution of less than your entire interest in that property and is not deductible. For exceptions and more information, see *Partial Interest in Property* in Publication 561.

Future interests in tangible personal property. You can deduct the value of a charitable contribution of a future interest in tangible personal property only after all intervening interests in and rights to the actual possession or enjoyment of the property have either expired or been turned over to someone other than yourself, a related person, or a related organization.

A future interest is any interest that is to begin at some future time, regardless of whether it is designated as a future interest under state law.

Determining Fair Market Value

This section discusses general guidelines for determining the fair market value of various types of donated property. Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the relevant facts. Publication 561, *Determining the Value of Donated Property,* contains a more complete discussion.

Used clothing and household goods. Generally, the fair market value of used clothing and household goods is far less than its original cost.

For used clothing, you should claim as the value the price that buyers of used items actually pay in used clothing stores, such as consignment or thrift shops.

See *Household Goods* in Publication 561 for information on the valuation of household goods, such as furniture, appliances, and linens.

Cars, boats, and aircraft. If you contribute a car, boat, or aircraft, you must determine its fair market value.

Certain commercial firms and trade organizations publish guides, commonly called ''blue books,'' containing complete dealer sale prices or dealer average prices for recent model years. The guides may be published monthly or seasonally, and for different regions of the country. These guides also provide estimates for adjusting for unusual equipment, unusual mileage, and physical condition. The prices are not ''official'' and these publications are not considered an appraisal of any specific donated property. But they do provide clues for making an appraisal and suggest relative prices for comparison with current sales and offerings in your area.

Example. You donate your car to a local high school for use by their students studying automobile repair. Your credit union told you that the ''blue book'' value of the car is $1,600. However, your car needs extensive repairs and, after some checking, you find that you would not be able to sell it for more than $750. You can deduct $750, the ***true*** fair market value of the car, as a charitable contribution.

Large quantities. If you contribute a large number of the same item, fair market value is the price at which comparable numbers of the item are being sold.

Giving Property That Has Decreased in Value

If you contribute property with a fair market value that is less than your basis in it, your deduction is limited to fair market value. You cannot claim a deduction for the difference between the property's basis and its fair market value.

Giving Property That Has Increased in Value

If you contribute property with a fair market value that is more than your basis in it, you may have to reduce the fair market value by the amount of appreciation (increase in value) when you figure your deduction.

Your ''basis'' in property is generally what you paid for it. See Chapter 14 if you need more information about basis.

Different rules apply to figuring your deduction, depending on whether the property is:

1) Ordinary income property, or
2) Capital gain property.

Ordinary income property. Property is ordinary income property if its sale at fair market value on the date it was contributed would have resulted in ordinary income or in short-term capital gain. Examples of ordinary income property are inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held one year or less.

The amount you can deduct for a contribution of ordinary income property is its fair market value less the amount that would be ordinary income or short-term capital gain if you sold the property for its fair market value. Generally, this rule limits the deduction to your basis in the property.

Example. You donate stock that you held for 5 months to your church. The fair market value of the stock on the day you donate it is $1,000, but you paid only $800 (your basis). Because the $200 of appreciation would be short-term capital gain if you sold the stock, your deduction is limited to $800 (fair market value less the appreciation).

Capital gain property. Property is capital gain property if its sale at fair market value on the date of the contribution would have resulted in long-term capital gain. It includes capital assets held more than one year, as well as certain real property and depreciable property used in your trade or business and, generally, held more than one year.

When figuring your deduction for a gift of capital gain property, you usually can use the fair market value of the gift. However, in certain situations, you must reduce the fair market value to the property's cost or other basis.

Bargain sales. A bargain sale of property to a qualified organization (a sale or exchange for less than the property's fair market value) is partly a charitable contribution and partly a sale or exchange. A bargain sale may result in a taxable gain.

For more information on donated appreciated property, see *Giving Property That Has Increased in Value* in Publication 526.

When To Deduct

You can deduct your contributions only in the year you actually make them in cash or other property (or in a later carryover year, as explained later under *Carryovers*). This applies whether you use the cash or an accrual method of accounting.

Usually, you make a contribution at the time of its unconditional delivery. For example, a check that you mail to a charity is considered delivered on the date you mail it. Contributions charged on your bank credit card are deductible in the year you make the charge. If you use a pay-by-phone account, the date you make a contribution is the date the financial institution pays the amount. This date should be shown on the statement the financial institution sends to you.

The gift to a charity of a properly endorsed stock certificate is completed on the date of mailing or other delivery to the charity or to the charity's agent. However, if you give a stock certificate to your agent or to the issuing corporation for transfer to the name of the charity, your gift is not completed until the date the stock is transferred on the books of the corporation.

If you issue and deliver a promissory note to a charitable organization as a contribution, it is not a contribution until you make the note payments. Similarly, if you grant an option to buy real property at a bargain price to a charitable organization, you cannot take a deduction until the organization exercises the option.

If you make a contribution with borrowed funds, you can deduct the contribution in the year you make it, regardless of when you repay the loan.

Limit on Deductions

If your total contributions for the year are 20% or less of your adjusted gross income (line 32, Form 1040), you do not need to read this section. The limits discussed here do not apply to you.

The amount of your deduction may be limited to either 20%, 30%, or 50% of your adjusted gross income, depending on the type of property you give and the type of organization you give it to. These limits are described below.

If your contributions are more than any of the limits that apply, see *How To Figure Your Deduction When Limits Apply,* in Publication 526.

50% limit. This limit applies to the total of all charitable contributions you make during the year. This means that your deduction for charitable contributions cannot be more than 50% of your adjusted gross income for the year (line 32, Form 1040).

The 50% limit is the only limit that applies to gifts ***to*** organizations listed below under *50% limit organizations.* But there is one exception. A special 30% limit also applies to such gifts if they are gifts of capital gain property for which you figure your deduction using fair market value without reduction for appreciation. (See *Special 30% limit,* later.)

50% limit organizations. The following are 50% limit organizations:

1) Churches, and conventions or associations of churches,
2) All public charities,
3) All private operating foundations,
4) Private nonoperating foundations that make qualifying distributions of 100% of contributions within 2½ months following the year they receive the contribution, and
5) Certain private foundations whose contributions are pooled in a common fund, the income and principal of which are paid to public charities.

The organization will be able to tell you if the contributions you make to it qualify for the 50% limit.

30% limit. This limit applies to:

- Gifts ***for the use of*** any organization, and
- Gifts (other than capital gain property) to all qualified organizations other than 50% limit organizations. This includes gifts to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations.

Special 30% limit. This limit applies to gifts of capital gain property to 50% limit organizations.

There is one exception to this general rule. The special 30% limit does not apply when you choose to reduce the fair market value of the property by the amount that would have been long-term capital gain if you had sold the property. Instead, only the 50% limit applies. For more information, see the rules for electing the 50% limit for capital gain property under *How To Figure Your Deduction When Limits Apply* in Publication 526.

20% limit. This limit applies to gifts of capital gain property to all qualified organizations other than 50% limit organizations.

Carryovers. You can carry over your contributions that you are not able to deduct in the current year because they exceed your adjusted gross income limit. You can deduct the excess in each of the next 5 years until it is used up, but not beyond that time. For more information, see *Carryovers* in Publication 526.

Records To Keep

You must keep records to prove the amount of the cash and noncash contributions you make during the year. The kind of records you must keep depends on the amount of your contributions and whether they are cash or noncash contributions.

Note. An organization generally must give you a written statement if it receives a payment from you that is more than $75 and is partly a contribution and partly for goods or services. (See *Contributions From Which You Benefit* under *Contributions You Can Deduct,* earlier.) Keep the statement for your records. It may satisfy all or part of the recordkeeping requirements explained in the following discussions.

Cash Contributions

Cash contributions include those paid by cash, check, credit card, or payroll deduction. They also include your out-of-pocket expenses when donating your services.

For a contribution made in cash, the records you must keep depend on whether the contribution is:

1) Less than $250, or
2) $250 or more.

Contributions of Less Than $250

For each cash contribution that is less than $250, you must keep one of the following:

1) A canceled check, ***or*** a legible and readable account statement that shows:
   a) If payment was by check – the check number, amount, date posted, and to whom paid.
   b) If payment was by electronic funds transfer – the amount, date posted, and to whom paid.
   c) If payment was charged to a credit card – the amount, transaction date, and to whom paid.
2) A receipt (or a letter or other written communication) from the charitable organization showing the name of the organization, the date of the contribution, and the amount of the contribution.
3) Other reliable written records that include the information described in (2). Records may be considered reliable if they were made at or near the time of the contribution, were regularly kept by you, or if, in the case of small donations,

you have emblems, buttons, or other tokens that are regularly given to persons making small cash contributions.

Contributions of $250 or More

Beginning in 1994, you can claim a deduction for a contribution of $250 or more only if you have an acknowledgement of your contribution from the qualified organization or adequate payroll deduction records.

Amount of contribution. In figuring whether your contribution is $250 or more, do not combine separate contributions. However, two checks written on the same date to the same qualified organization may be considered one contribution.

If contributions are made by payroll deduction, the deduction from each paycheck is treated as a separate contribution.

Acknowledgement. The acknowledgement must meet these tests:

1) It must be written.
2) It must include:
   a) The amount of cash you contributed,
   b) Whether the qualified organization gave you any goods or services (other than token items of little value) as a result of your contribution, and
   c) A description and good faith estimate of the value of any goods or services described in (b). If the only benefit you received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgement must say so and does not need to describe or estimate the value of the benefit.
3) You must get it on or before the earlier of:
   a) The date you file your return for the year you make the contribution, or
   b) The due date, including extensions, for filing the return.

Payroll deduction records. If you make a contribution by payroll deduction, you do not need an acknowledgement from the qualified organization. But if your employer deducted $250 or more from a single paycheck, you must keep:

1) A pay stub, Form W–2, or other document furnished by your employer that proves the amount withheld, and
2) A pledge card or other document from the qualified organization that states the organization does not provide goods or services in return for any contribution made to it by payroll deduction.

Car Expenses

If you claim expenses directly related to use of your car in giving services to a qualified organization, you must keep reliable written records of your expenses. Whether your records are considered reliable depends on all the facts and circumstances. Generally, they may be considered reliable if you made them regularly and at or near the time you had the expenses.

Your records must show the name of the organization you were serving each time you used your car for a charitable purpose. If you use the standard mileage rate, your records must show the miles you drove your car for the charitable purpose. If you deduct your actual expenses, your records must show the costs of operating the car that are directly related to a charitable purpose.

See *Car expenses,* earlier under *Out-of-Pocket Expenses in Giving Services,* for the expenses you can deduct.

Noncash Contributions

For a contribution not made in cash, the records you must keep depend on whether your deduction for the contribution is:

1) Less than $250,
2) At least $250 but not more than $500,
3) Over $500 but not more than $5,000, or
4) Over $5,000.

Deductions of Less Than $250

If you make any noncash contribution, you must get and keep a receipt from the charitable organization showing:

1) The name of the charitable organization,
2) The date and location of the charitable contribution, and
3) A reasonably detailed description of the property.

A letter or other written communication from the charitable organization acknowledging receipt of the contribution and containing the information in (1), (2), and (3) will serve as a receipt.

You are not required to have a receipt where it is impractical to get one (for example, if you leave property at a charity's unattended drop site).

Additional records. You must also keep reliable written records for each item of donated property. Your written records must include the following:

1) The name and address of the organization to which you contributed.
2) The date and location of the contribution.
3) A description of the property in detail reasonable under the circumstances. For a security, keep the name of the issuer, the type of security, and whether it is regularly traded on a stock exchange or in an over-the-counter market.
4) The fair market value of the property at the time of the contribution, and how you figured the fair market value. If it was determined by appraisal, keep a signed copy of the appraisal.
5) The cost or other basis of the property if you must reduce its fair market value by appreciation. Your records should also include the amount of the reduction and how you figured it. If you choose the 50% limit instead of the special 30% limit on certain capital gain property, you must keep a record showing the years for which you made the choice, contributions for the current year to which the choice applies, and carryovers from preceding years to which the choice applies. See *How To Figure Your Deduction When Limits Apply* in Publication 526 for information on how to make the capital gain property election.
6) The amount you claim as a deduction for the tax year as a result of the contribution, if you contribute less than your entire interest in the property during the tax year. Your records must show the amount you claimed as a deduction in any earlier years for contributions of other interests in this property. They must also include the name and address of each organization to which you contributed the other interests, the place where any such tangible property is located or kept, and the name of the person who has possession of the property, if it is someone other than the organization to which you contributed.
7) The terms of any conditions attached to the gift of property.

If the gift was a ''qualified conservation contribution,'' your records must also include the fair market value of the underlying property before and after the gift and the conservation purpose furthered by the gift. See *Qualified conservation contribution* in Publication 561 for more information.

Deductions of At Least $250 But Not More Than $500

If you claim a deduction of at least $250 but not more than $500 for a noncash charitable contribution, you must get and keep an acknowledgement of your contribution from the qualified organization. This acknowledgement must contain the information in items (1) through (3) listed under *Deductions of Less Than $250,* earlier, and your written records must include the information listed in that discussion under *Additional records.*

The acknowledgement must also meet these tests:

1) It must be written.
2) It must include:
   a) A description (but not the value) of any property you contributed,
   b) Whether the qualified organization gave you any goods or services (other

than token items of little value) as a result of your contribution, and

c) A description and good faith estimate of the value of any goods or services described in (b). If the only benefit you received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgement must say so and does not need to describe or estimate the value of the benefit.

3) You must get it on or before the earlier of:

a) The date you file your return for the year you make the contribution, or

b) The due date, including extensions, for filing the return.

Deductions Over $500

You are required to give additional information if you claim a deduction over $500 for noncash charitable contributions. See *Records To Keep* in Publication 526 for more information.

How To Report

Enter your cash contributions (including out-of-pocket expenses) on line 15, Schedule A (Form 1040).

Enter your noncash contributions on line 16 of Schedule A (Form 1040).

If your total deduction for all noncash contributions for the year is over $500, you must also file **Form 8283,** *Noncash Charitable Contributions*. See *How To Report* in Publication 526 for more information.

27.

Nonbusiness Casualty and Theft Losses

Introduction

This chapter discusses how you treat casualty and theft losses for tax purposes when the losses are personal and not business related.

You have a casualty loss if you suffer damage to your property as a result of disasters such as hurricanes, fires, car accidents, and similar events. You have a theft loss if someone steals your property. This chapter will cover the following types of losses:

- Loss on deposits,
- Casualty loss, including disasters, and
- Theft loss.

This chapter will also provide information on what you should do once you determine you have a casualty or theft loss. The following information is provided in this chapter:

- How to figure the amount of your loss,
- When to deduct your loss subject to certain limits,
- How to treat insurance and other reimbursements you receive for casualty losses, and
- Which form to use to report your loss.

How to claim a loss. You must file Form 1040 and itemize your deductions on **Schedule A** (Form 1040) to be able to claim a casualty or theft loss of nonbusiness property. You cannot claim these losses if you file Form 1040A or Form 1040EZ.

Publication 584 is available to help you make a list of your damaged goods and figure your loss. That publication can serve as an inventory of your personal goods. It includes schedules to help you figure the loss on your home and its contents, and on your motor vehicles.

Deduction for casualty and theft losses is limited. You must reduce each casualty or theft loss on nonbusiness property by $100. You must further reduce the total of your casualty and theft losses for the year on nonbusiness property by 10% of your adjusted gross income. If these amounts are more than your losses, you do not have a casualty or theft loss deduction.

Disaster area. If you have a casualty loss in a federally declared disaster area, special rules apply. See *Disaster Area Losses* in Publication 547.

Other sources of information. For information on a casualty, theft, or condemnation concerning business or income-producing property, see Chapter 26 in Publication 334, *Tax Guide for Small Business.*

For information on a condemnation of your home, see *Involuntary Conversions* in Publication 544.

Useful Items

You may want to see:

Publication

- ❑ **544** Sales and Other Dispositions of Assets
- ❑ **547** Nonbusiness Disasters, Casualties, and Thefts
- ❑ **550** Investment Income and Expenses
- ❑ **551** Basis of Assets
- ❑ **584** Nonbusiness Disaster, Casualty, and Theft Workbook

Form (and Instructions)

- ❑ **4684** Casualties and Thefts

Loss on Deposits

A loss on deposits can occur when a bank, credit union, or other financial institution becomes insolvent or bankrupt. If you incurred such a loss, you have three choices of how to deduct the loss:

1) As a nonbusiness bad debt,
2) As a casualty loss, or
3) As an ordinary loss.

Note. You cannot choose (2) or (3) if you own at least 1% of the financial institution, are an officer of the financial institution, or are related to that owner or officer.

Choice of loss deduction. If you qualify to choose the kind of deduction as explained above, the following information may help you choose the one best for you.

Nonbusiness bad debt. A nonbusiness bad debt is deducted as a short-term capital loss on Schedule D (Form 1040). The capital loss that can be deducted after offsetting capital gains is limited to $3,000 ($1,500 if married filing separately) for each year. For more details, see *Nonbusiness Bad Debts* in Chapter 4 of Publication 550.

Casualty loss. A casualty loss deduction has no maximum limit. But in figuring the deduction, reduce the loss by $100 and your total losses by 10% of adjusted gross income, as explained later. You must itemize deductions on Schedule A (Form 1040).

Ordinary loss. An ordinary loss deduction for a loss on deposits at a particular financial institution is limited to $20,000 ($10,000 if married filing separately) reduced by any expected state insurance proceeds. Further, the deduction is taken as a miscellaneous itemized deduction on Schedule A (Form 1040) and is subject to the 2% of adjusted gross income limit for that year. See Chapter 30 for information on this limit. It may also be affected by the overall limit on itemized deductions that is explained in Chapter 22.

Note. You cannot choose the ordinary loss deduction if any part of the deposits related to the loss is federally insured (example — FDIC).

When to choose. You can choose to deduct a loss on deposits as a casualty or an ordinary loss for any year in which you can reasonably estimate how much of your deposits you have lost in an insolvent or bankrupt financial institution. The choice is generally made on the return you file for that year. Once you treat the loss as a casualty or ordinary loss, you cannot treat the same amount of the loss as a nonbusiness bad debt when it actually becomes worthless. Also, the choice applies to all your losses on deposits for the year in the particular financial institution.

If you do not make a choice, you must wait until the actual loss is determined before you can deduct the loss as a nonbusiness bad debt. Once you make this choice, you cannot change it without permission from the Internal Revenue Service.

How to report. The kind of deduction you choose for loss on deposits determines how you report your loss.

- Nonbusiness bad debt — report on Schedule D (Form 1040), Part I, line 1.
- Casualty loss — report on Form 4684 first and then on Schedule A (Form 1040), line 19.
- Ordinary loss — report on Schedule A (Form 1040), line 22.

Get the Form 1040 instructions for more information.

Deducted loss recovered. If you recover an amount you already deducted in an earlier year as a loss, you may have to include the amount recovered in your income for the year of receipt. If any part of the original deduction did not reduce your tax in the earlier year, you do not have to include that part of the recovery in your income. For more information, see *Recoveries* in Chapter 13.

Casualty

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

- A ***sudden*** event is one that is swift, not gradual or progressive.
- An ***unexpected*** event is one that is ordinarily unanticipated and unintended.

- An ***unusual*** event is one that is not a day-to-day occurrence and that is not typical of the activity in which you were engaged.

A casualty can also include a government-ordered demolition or relocation of a home unsafe to use because of a disaster. For more information, see *Disaster Area Losses* in Publication 547.

Casualty losses. Deductible casualty losses may result from a number of different causes, including:

Earthquakes

Hurricanes

Tornadoes

Floods

Storms

Volcanic eruptions

Shipwrecks

Mine cave-ins

Sonic boom

Vandalism

Fires. If you willfully set the fire, or pay someone else to set it, you cannot deduct the resulting loss.

Car accidents. The loss from an accident to your car is not a casualty loss if your willful negligence or willful act caused the accident. The same is true if the willful act or willful negligence of someone acting for you caused the accident.

Other accidents. A loss due to the accidental breakage of articles such as glassware or china under normal conditions is not a casualty loss. Neither is a loss due to damage done by a family pet.

Nondeductible losses. There is no casualty loss deduction if the damage or destruction is caused by:

Termites or moths.

Disease. The progressive damage or destruction of trees, shrubs, or other plants by a fungus, disease, insects, worms, or similar pests is not a deductible casualty loss. But, a sudden destruction due to an unexpected or unusual infestation by beetles or other insects may result in a casualty loss. If a storm, flood, or fire damages trees and shrubs, the loss is a casualty.

Progressive deterioration. If a steadily operating cause or a normal process damages your property, it is not considered a casualty. Thus, the steady weakening of a building due to normal wind and weather conditions is not a casualty. The rust and water damage to rugs and drapes caused by the bursting of a water heater qualifies as a casualty. The deterioration and damage to the water heater itself does not qualify.

Drought. When drought causes damage or loss through progressive deterioration, it is not a casualty loss.

Theft

A theft is the unlawful taking and removing of money or property with the intent to deprive the owner of it. It includes, but is not limited to, larceny, robbery, and embezzlement.

If money or property is taken as the result of extortion, kidnapping, threats, or blackmail, it may also be a theft. In these instances, you need to show that the taking of your property was illegal under the law of the state where it occurred, and that it was done with criminal intent.

Mislaid or lost property. The simple disappearance of money or property is not a theft. However, an accidental loss or disappearance of property may qualify as a casualty, if it results from an identifiable event that is sudden, unexpected, or unusual.

Example. A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

Proof of Loss

To take a deduction for a casualty or theft loss, you must be able to show that there was a casualty or theft. You also must be able to support the amount you take as a deduction.

For a casualty loss, you should be able to show:

- The type of casualty (car accident, fire, storm, etc.) and when it occurred,
- That the loss was a direct result of the casualty, and
- That you were the owner of the property or, if you leased the property from someone else, that you were contractually liable to the owner for the damage.

For a theft loss, you should be able to show:

- When you discovered that your property was missing,
- That your property was stolen, and
- That you were the owner of the property.

Amount of Loss

Figure your casualty or theft loss by subtracting any insurance or other reimbursement you receive or expect to receive from the ***smaller*** of the following two amounts:

1) The ***decrease in fair market value*** of the property as a result of the casualty or theft, or
2) Your ***adjusted basis*** in the property before the casualty or theft.

The decrease in fair market value is the difference between the property's value immediately before and immediately after the casualty or theft.

Fair market value (FMV). FMV is the price for which you could sell your property to a willing buyer when neither of you have to sell or buy and both of you know all the relevant facts.

Adjusted basis. Adjusted basis is your basis (usually cost) increased or decreased by various events, such as improvements and casualty losses.

Theft. The FMV of property immediately after a theft is considered to be zero, since you no longer have the property. Figure your theft loss using the smaller of the stolen property's FMV or adjusted basis.

Example. Several years ago, you purchased silver dollars at face value for $150. This is your adjusted basis in the property. Your silver dollars were stolen this year. The FMV of the coins was $1,000 when stolen, and insurance did not cover them. Your theft loss is $150.

The cost of protection. The cost of protecting your property against a casualty or theft is not part of a casualty or theft loss. For example, you cannot deduct what you spend on insurance or to board up your house against a storm.

If you make permanent improvements to your property to protect it against a casualty or theft, add the cost of these improvements to your basis in the property. An example would be the cost of a dike to prevent flooding.

Related expenses. The incidental expenses you have due to a casualty or theft, such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not part of your casualty or theft loss.

Repair and replacement costs. The cost of repairing damaged property or of replacing stolen or destroyed property is not part of a casualty or theft loss. Neither is the cost of cleaning up after a casualty. But see *Leased property,* later, and *Indication of decrease in FMV,* later.

Example. You bought a new chair 4 years ago for $300. In April, a fire destroyed the chair. You estimated that it would cost $500 to replace it. If you had sold the chair before the fire, you estimate that you could have received only $100 for it because it was 4 years old. The chair was not insured. Your loss is $100, the FMV of the chair before the fire. It is not $500, the replacement value.

Recovered property. If you get your stolen property back, your loss is measured like a

casualty loss from vandalism. That is, you must consider the actual FMV of the property when you get it back. Your loss is figured using the smaller of:

- The decrease in the FMV of the property from the time it was stolen until the time it is recovered, or
- Your adjusted basis in the property.

Leased property. If you are liable for casualty damage to property you lease, your loss is the amount you must pay to repair the property.

Business or income-producing property. If business or income-producing property is completely destroyed or lost because of a casualty or theft, your loss is:

Your adjusted basis in the property

MINUS

Any salvage value

MINUS

Any insurance or other reimbursement you receive or expect to receive

The decrease in FMV is not considered. See Chapter 26 in Publication 334.

Separate computations. Generally, if a single casualty or theft involves more than one item of property, you must figure the loss on each item separately. Then combine the losses to determine the total loss from that casualty or theft.

Exception for real property. In figuring a casualty loss on nonbusiness real property, the entire property (including any improvements, such as buildings, trees, and shrubs) is treated as one item. Figure the loss using the smaller of:

- The decrease in FMV of the entire property, or
- The adjusted basis of the entire property.

Decrease in fair market value. To figure the decrease in FMV because of a casualty or theft, you must make a determination of the actual price you could have sold your property for immediately before and immediately after the loss. An appraisal is the best way to make this determination.

Items not to be considered. You generally should not consider the following items when attempting to establish the FMV of your property.

Sentimental value. Do not consider sentimental value when determining your loss. If a family portrait, heirloom, or keepsake is damaged, destroyed, or stolen, you must base your loss only on its actual market value.

General decline in market value. A decrease in the value of your property because it is in or near an area that suffered a casualty, or that might again suffer a casualty, is not to be taken into consideration. You have a loss only for actual casualty damage to your property. However, if your home is in a federally declared disaster area, see *Disaster Area Losses* in Publication 547.

Indication of decrease in FMV. You can use the cost of cleaning up or of making repairs after a casualty as a measure of the decrease in FMV if you meet all the following conditions.

1) The repairs are necessary to bring the property back to its condition before the casualty.
2) The amount spent for repairs is not excessive.
3) The repairs take care of the damage only.
4) The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

Restoration of landscaping. The cost of restoring landscaping to its original condition after a casualty may indicate the decrease in FMV. You may be able to measure your loss by what you spend on the following:

1) Removing destroyed or damaged trees and shrubs minus any salvage you receive,
2) Pruning and other measures taken to preserve damaged trees and shrubs, and
3) Replanting necessary to restore the property to its approximate value before the casualty.

Sources of information. It is often difficult to value your property before and after the casualty or theft. The following sources will be helpful in establishing these values.

Photographs. Photographs taken after a casualty will be helpful in establishing the condition and value of the property after it was damaged.

The costs of photographs obtained for this purpose are not a part of the loss. You can claim this cost as a miscellaneous deduction subject to the 2% of adjusted gross income limit on line 22, Schedule A (Form 1040). The cost of the photographs is an expense of determining your tax liability. See Chapter 30.

Cars. Books issued by various automobile organizations may be useful in figuring the value of your car if your car is listed in the books. You can use the books' retail values and modify them by such factors as mileage and the condition of your car to figure its value. The prices are not ''official,'' but they may be useful in determining value and suggesting relative prices for comparison with current sales and offerings in your area. If your car is not listed in the books, you determine its value from other sources. A dealer's offer for your car as a trade-in on a new car is not usually a measure of its true value.

Appraisals. The difference between the FMV of the property immediately before a casualty or theft and immediately afterwards should be determined by a competent appraiser. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This is necessary so that any deduction is limited to the actual loss resulting from damage to the property.

The appraiser should be reliable and experienced. Several factors are important in evaluating the accuracy of an appraisal, including the appraiser's:

- Familiarity with your property before and after the casualty or theft,
- Knowledge of sales of comparable property in the area,
- Knowledge of conditions in the area of the casualty, and
- Method of appraisal.

Appraisal fees. You can deduct your appraisal fees as a miscellaneous deduction subject to the 2% of adjusted gross income limit on line 22, Schedule A (Form 1040). The appraisal fee is an expense of determining your tax liability. It is not a part of the casualty loss. See Chapter 30.

Records. It is important that you have records that will prove your deduction. If you do not have the actual records to support your deduction, you can use other satisfactory evidence that is sufficient to establish your deduction.

Figuring the Loss

Generally, you must figure your loss ***separately for each item*** stolen, damaged, or destroyed. However, a special rule applies for nonbusiness real property.

Real property. Real property is land, the plants and trees that grow on land, and the buildings and other structures that are placed on land. In figuring a loss to real property you own for personal use, all improvements, such as buildings and ornamental trees, are considered together. The loss is the smaller of the decrease in the fair market value of the entire property or its adjusted basis.

Example. You bought your home a few years ago. You paid $50,000 ($10,000 for the land and $40,000 for the house). You also spent $2,000 for landscaping. This year a fire destroyed your home. The fire also damaged the shrubbery and trees in your yard. The fire was your only casualty or theft loss this year. Competent appraisers valued the property as a whole at $75,000 before the fire, but only $15,000 after the fire. (The loss to your household furnishings is not shown in this example but would be figured separately, as explained later.) You figure your casualty loss deduction as follows:

1) Adjusted basis of the entire property (cost of land, building, and landscaping)	$52,000
2) FMV of entire property before fire	$75,000
3) FMV of entire property after fire	15,000
4) Decrease in FMV of entire property	$60,000
5) Amount of loss (smaller of 1 or 4)	**$52,000**

Personal property. Personal property is generally any property that is not real property. If your personal property is stolen or is damaged or destroyed by a casualty, you must figure your loss separately for each item of property. The loss is the smaller of the decrease in the FMV of the property or its adjusted basis.

Example. A fire in your home destroyed an upholstered chair, an oriental rug, and an antique table. You did not have fire insurance to cover your loss. (This was the only casualty or theft you had during the year.) The chair cost you $750, and you established that it had an FMV of $500 just before the fire. The rug cost you $3,000 and had an FMV of $2,500 just before the fire. You bought the table at an auction for $100, before discovering it was an antique. It had been appraised at $900 before the fire. You figure your loss on each of these items as follows:

	Chair	Rug	Table
1) Basis (cost)	$ 750	$3,000	$ 100
2) FMV before fire	$ 500	$2,500	$ 900
3) FMV after fire	–0–	–0–	–0–
4) Decrease in FMV	$ 500	$2,500	$ 900
5) Loss (smaller of 1 or 4)	$ 500	$2,500	$ 100
6) Total loss			**$3,100**

Both real and personal properties. When a casualty involves both real and personal properties, you must figure the loss separately for each type of property, as shown in the previous examples. But you apply a single $100 reduction to the total loss. Then you apply the 10% rule. Both are explained later.

Property used partly for business and partly for personal purposes. When property is used partly for personal (nonbusiness) purposes and partly for business or income-producing purposes, the casualty or theft loss deduction must be figured separately for the nonbusiness portion and for the business portion. You must figure each loss separately because the losses attributed to these two uses are figured in two different ways. The $100 rule and the 10% rule (explained later) apply only to the casualty or theft loss on the nonbusiness portion of the property.

Insurance and Other Reimbursements

If your property is covered by insurance, you should file a timely insurance claim for reimbursement of a loss. Otherwise, you cannot deduct this loss as a casualty or theft loss. The portion of the loss not covered by insurance (for example, a deductible) is not subject to this rule.

Example. You have a car insurance policy with a $500 deductible. Because your insurance did not cover the first $500 of an auto collision, the $500 would be deductible (subject to the $100 and 10% rules discussed later). This is true, even if you do not file an insurance claim, since your insurance policy would never have reimbursed you for it.

Reduction of loss. If you receive insurance or another type of reimbursement, you must subtract the reimbursement when you figure your loss. You do not have a casualty or theft loss to the extent you are reimbursed.

If you expect to be reimbursed, but have not yet received payment, you must still subtract the expected reimbursement. See *When to Deduct a Loss,* later.

Gain from reimbursement. If your reimbursement is more than your basis in the property, you have a gain. This is true even if the decrease in the FMV of the property is more than its basis. If you have a gain, you may have to pay tax on it, or you may be able to postpone reporting the gain.

See Publication 547 for more information on how to treat a gain from the reimbursement for a casualty or theft.

Other reimbursements. Insurance is the most common way to be reimbursed for a casualty or theft loss. But you may be reimbursed in some other way. The following items are considered reimbursements:

- The forgiven part (the part you do not have to pay back) of a federal disaster loan under the Disaster Relief and Emergency Assistance Act,
- The repayment and cost of repairs by the person who leases your property,
- The court awards for damages for a casualty or theft loss (the amount you are able to collect) minus lawyers' fees and other necessary expenses,
- The repairs, restoration, or cleanup provided by relief agencies, and
- The payment you receive from a bonding company for a theft loss.

If you receive money as an employee from your employer's emergency disaster fund, and you must use that money to rehabilitate or replace property on which you are claiming a casualty loss deduction, then you must take that money into consideration in computing the casualty loss deduction to the extent you used such money to replace your destroyed or damaged property.

Example. Your home was extensively damaged by a tornado. The company you work for set up a fund. The fund made payments to employees. You must use any money you receive from the fund to rehabilitate or replace your property. In figuring your casualty loss deduction, you must take these payments into consideration to the extent you used the payments as reimbursement for or replacement of damaged or destroyed property.

Payments not considered reimbursements. If you are a disaster victim who receives excludable cash gifts, and there are no limits on how you can use the money, you do not reduce your casualty loss deduction by the amount of the excludable cash gifts even if you use the money to pay for repairs to property damaged in the disaster.

Example. Your home was damaged by a hurricane. Relatives and neighbors made cash gifts to you which were excludable from your income. You applied part of the cash gifts to the cost of repairing your home. There were no limits or restrictions on how you could use the cash gifts. The money you received as excludable gifts and used to pay for repairs to your home does not reduce the amount that you may deduct as a casualty loss on the damaged home.

Payments for living costs. If an insurance company pays you for any of your living expenses after you lose the use of your home because of a casualty, the insurance payments are not considered a reimbursement. They do not reduce your casualty loss.

You must report as income insurance payments covering your normal living expenses. However, the part of insurance payments that compensates you for a temporary increase in the living expenses you and your family have during this period does not have to be reported as income. The same rule applies to insurance payments for living expenses if you are denied access to your home by government authorities due to a casualty or the threat of a casualty.

The increase in your living expenses is the excess of your actual living expenses over your normal living expenses. Do not include in income the payment you received for your extra expenses for renting suitable housing and for transportation, food, utilities, and miscellaneous services during the period you are unable to use your home because of the casualty.

Example. As a result of a fire, you vacated your apartment for a month and moved to a motel. You normally pay $525 a month rent. None was charged for the month the apartment was vacated. Your motel rent for this month was $1,200. You received $1,100 reimbursement from your insurance company for rental expenses.

The part of the insurance payment that reimburses you for the temporary increase of your actual rent over your normal rent is

$675 ($1,200 – $525). You do not include the $675 in income. But you do include in income the rest of the insurance received, $425 ($1,100 – $675).

Disaster relief. Food, medical supplies, and other forms of assistance you receive do not reduce your casualty loss unless they are replacements for lost or destroyed property. These items are not taxable income to you.

Deduction Limits

After you have figured your casualty or theft loss and subtracted any reimbursements, you must figure how much of the loss you can deduct. If your loss was to property you had for your own or your family's personal use, there are ***two limits*** on the amount you can deduct for your casualty or theft loss:

1) You must reduce each loss by ***$100.***
2) You must further reduce your loss by ***10% of your adjusted gross income*** (line 32, Form 1040).

$100 rule. A single $100 reduction applies to each casualty or theft, no matter how many pieces of property are involved. This rule applies after all reimbursements have been subtracted from your total casualty or theft loss.

Single event. Generally, events closely related in origin cause a single casualty. It is a single casualty when the damage is from two or more closely related causes, such as wind and flood damage caused by the same storm. A single casualty may also damage two or more pieces of property, such as a hailstorm that damages both your home and your car parked in your driveway.

More than one loss. If you have more than one casualty or theft loss during the tax year, you must ***reduce each loss by $100.***

Example. Your family car was damaged in an accident in January. Your loss after the insurance reimbursement was $75. In February, your car was damaged in another accident. This time your loss after the insurance reimbursement was $90. Apply the $100 rule to each separate casualty loss. Since neither accident resulted in a loss of over $100, you are not entitled to any deduction for these accidents.

10% rule. You must reduce the total of all your casualty or theft losses by 10% of your adjusted gross income (line 32, Form 1040). Apply this rule after you reduce each loss by any reimbursements and by $100. If you had more than one casualty or theft loss during the year, reduce each loss by any reimbursements and by $100. Then you ***reduce the total of all your losses by 10%*** of your adjusted gross income. If you have casualty or theft gains, see *Gains and losses,* later in this discussion.

Example 1. In June, you discovered that your house had been burglarized. Your loss after insurance reimbursement was $2,000. Your adjusted gross income is $29,500. You first apply the $100 rule and then the 10% rule. Figure your theft loss as follows:

1. Loss after insurance	$2,000
2. Subtract $100	100
3. Loss after $100 rule	$1,900
4. Subtract 10% of $29,500 AGI	2,950
5. Theft loss deduction	–0–

When you apply the 10% rule, you find you do not have a casualty or theft loss deduction because your loss ($1,900) is less than 10% of your adjusted gross income ($2,950).

Example 2. In March, you had a car accident that totally destroyed your car. You did not have collision insurance on your car, so you did not receive any insurance reimbursement. Your loss on the car was $1,200. In November, you had a fire that damaged your basement and totally destroyed the furniture, washer, dryer, and other items you had stored there. Your loss on the basement items after reimbursement was $1,700. Your adjusted gross income is $25,000. You figure your casualty loss deduction as follows:

	Car	Basement
1. Loss	$1,200	$ 1,700
2. Subtract $100 per incident	100	100
3. Loss after $100 rule	$1,100	$ 1,600
4. Total loss		$ 2,700
5. Subtract 10% of $25,000 AGI		2,500
6. Casualty loss deduction		$ 200

Gains and losses. If you had both gains and losses from casualties or thefts to nonbusiness property, special rules apply. If your total losses are more than your total gains, only the excess losses are subject to the 10% rule.

However, if your total gains are more than your total losses, the difference (gains minus losses) will be treated as capital gain on Schedule D (Form 1040). None of the losses will be subject to the 10% rule.

Table 27–1 gives a brief explanation of how to apply the $100 rule and the 10% rule in various situations. For more detailed explanations and examples, get Publication 547.

When to Deduct a Loss

A casualty usually is apparent when it happens. A theft may not be discovered until later. This affects the year in which you may deduct a casualty or a theft loss. See *Table 27–2.*

Loss on deposits. When you deduct a loss on deposits in an insolvent or bankrupt financial institution depends on the type of loss you choose to take on your return. See *Loss on Deposits,* earlier.

Casualty losses. Generally, you may deduct casualty losses only in the tax year in which the casualty occurred. This is true even if you do not repair or replace the damaged property until a later year.

Disaster area losses. If you have a casualty loss in a federally declared disaster area, you can choose to deduct the loss on your tax return for the year immediately preceding the year in which the disaster occurred. This may enable you to get an immediate refund of taxes you already paid. For more information, see *Disaster Area Losses* in Publication 547.

Theft losses. You may generally deduct a theft loss only in the year you discover your property is missing. You must be able to show there was a theft, but you do not have to know when the theft took place. However, you should show when you discovered that your property was missing.

Reimbursement Claims

If there is a reasonable prospect you will be reimbursed for part or all of your loss, you must subtract the expected reimbursement when you figure your loss. You must reduce your loss even if you do not receive payment until a later tax year. You are believed to have a reasonable prospect of reimbursement if you have filed suit for damages.

If you later receive less reimbursement than you expected, you include that difference as a loss with your other losses (if any) on your return for the year in which you can reasonably expect no more reimbursement.

Example. Your personal car had an FMV of $2,000 when it was destroyed in a collision with another car in 1993. The accident was due to the negligence of the other driver. At the end of the year, there was a reasonable prospect that the owner of the other car would reimburse you in full. Therefore, you do not have a deductible loss in 1993.

In January 1994, the court awards you a judgment of $2,000. However, in July it becomes apparent that you will be unable to collect any amount from the other driver. Since this is your only casualty or theft loss, you can deduct the loss in 1994 that is more than $100 and 10% of your 1994 adjusted gross income.

If you later receive more reimbursement than you expected, you may have to report the difference as income. If you have already taken a deduction for a casualty or theft loss in one year, and then in a later year you receive reimbursement, you must include it in your income for the later year to the extent your deduction reduced your tax for the earlier year.

However, if any part of your original deduction for the loss did not actually lower your tax, you do not include that part of the reimbursement in your income. You do not refigure your tax for the year you claimed the deduction. For more information, see *Recoveries* in Chapter 13.

Table 27-1. **Deduction Limit Rules—**These rules apply to a casualty or theft loss to nonbusiness property.

	$100 Rule	10% Rule
Definition of Rule	You must reduce each casualty or theft loss by $100 when figuring your deduction. Apply this rule after you reduce your loss by any reimbursement.	You must reduce your total casualty or theft loss by 10% of your adjusted gross income from line 32 of Form 1040. Apply this rule after you reduce each loss by any reimbursement and by $100 (the $100 rule).
Single Event	Apply this rule only once, even if many pieces of property are affected.	Apply the rule only once, even if many pieces of property are affected.
More Than One Event	Apply this rule to the loss from each event.	Apply the rule to the total of all your losses from all events.
More Than One Person- With Loss From the Same Event (other than a married couple filing jointly)	Apply the rule separately to each person.	Apply the rule separately to each person.
Married Couple— With Loss From the Same Event		
Filing jointly	Apply this rule as if you were one person.	Apply this rule as if you were one person.
Filing separately	Apply this rule separately to each spouse.	Apply this rule separately to each spouse.
More Than One Owner (other than a married couple filing jointly)	Apply the rule separately to each owner of jointly owned property.	Apply the rule separately to each owner of jointly owned property.

Table 27-2. **When to Deduct a Loss**

Type of Loss	Tax Year Deducted	Can You Choose Years?
Casualty losses	Year loss occurred	No
Loss on deposits		
• Casualty loss	Year a reasonable estimate can be made	No
• Bad debt	Year deposits are totally worthless	No
• Ordinary loss	Year a reasonable estimate can be made	No
Federal disasters	Year the disaster occurred or the year immediately before the disaster	Yes
Thefts	Year of discovery of the theft	No

Publication 525 has a worksheet for you to use when only part of your original deduction reduced your tax in the earlier year.

Note. If the total of all the reimbursements you receive is more than your adjusted basis in the destroyed or stolen property, you will have a ***gain*** on the casualty or theft. Get Publication 547 for more information on how to treat a gain from the reimbursement of a casualty or theft.

If you receive exactly the reimbursement you expected to receive, you may not have any amount to include in your income or any loss to deduct.

Example. In December 1993, you had a collision while driving your personal car. Repairs to the car cost $950. You had $100 deductible collision insurance. Your insurance company agreed to reimburse you for the rest of the damage. As a result of your expected reimbursement from the insurance company, you do not have a casualty loss deduction in 1993.

Due to the $100 rule, you cannot deduct the $100 you paid as the deductible. When you receive the $850 from the insurance company in 1994, you do not have to report it as income.

Recovered property is your property that was stolen and later returned to you. If you recovered property after you have already taken a theft loss deduction, you must refigure your loss using the smaller of the property's adjusted basis (explained under *Amount of Loss,* earlier) or the decrease in FMV from the time it was stolen until the time it was recovered. Use this amount to refigure your total loss for the year in which the loss was deducted.

This is your refigured loss. If this amount is less than the loss you deducted, you generally have to report the difference as income in the recovery year. But report the difference only up to the amount of the loss that reduced your tax.

How to Report Gains or Losses

If you have a deductible casualty or theft loss from nonbusiness property, you can claim this loss only on Schedule A (Form 1040).

Form 4684. Use Section A of Form 4684 to figure and report your gain or loss. Be sure to attach Form 4684 to your return.

Section A—Personal Use Property. This section is for casualties and thefts of property ***not*** used in a trade or business or for income producing purposes. You must list each item or article for which you are reporting a casualty or theft on Form 4684. If more than four items of property were stolen or damaged in a single casualty or theft, you

will need to complete additional Form(s) 4684. Or, you may want to substitute your own statement for these lines. The statement must include the same information asked on lines 1 through 9. If you have to figure your loss on many different personal and household items, you may want to use the worksheets in Publication 584. Copies of these worksheets can be used in place of additional Forms 4684.

More than one casualty or theft. If you had more than one casualty or theft during the year, you must complete lines 1 through 12 on separate Forms 4684 for each casualty or theft. Use only one Form 4684 for lines 13 through 18.

Losses. If you have only losses from nonbusiness property, transfer the amount from line 18 of Section A, Form 4684, to line 19 of Schedule A (Form 1040). Schedule A is used to itemize deductions. If you do not itemize deductions, you cannot deduct your casualty or theft loss.

Gains. If you have only gains from nonbusiness property, this amount will be shown on line 15 of Section A, Form 4684. You may also have to complete Schedule D (Form 1040). For more information, get Publication 547.

Gains and losses. If you have both gains and losses due to casualties in a single year, get Publication 547.

Adjustments to basis. If you have a casualty or theft loss deduction, you must reduce your basis in the property by any deductible loss and any insurance or other reimbursements. The result is your ***adjusted basis*** in the property. Amounts you spend to restore your property after a casualty increase your adjusted basis. See *Adjusted Basis* in Publication 551 for more information.

Net operating loss. If your casualty or theft losses are more than your income, you may have a net operating loss. You can use a net operating loss to lower your taxes in an earlier year, allowing you to get a refund for taxes that you have already paid. Or, you can use it to lower your taxes in a later year. You do not have to be in business to have a net operating loss from a casualty or theft. For more information, get Publication 536, *Net Operating Losses.*

28.

Car Expenses and Other Employee Business Expenses

Important Changes for 1994

Travel expenses paid for others. Beginning in 1994, you cannot deduct travel expenses you pay or incur for a spouse, dependent, or other individual who accompanies you (or your employee) on business travel unless the travel satisfies specific requirements. See *Travel expenses for another individual.*

Club dues. Beginning in 1994, you are not allowed a deduction for dues (including initiation fees) for membership in any club organized for business, pleasure, recreation, or other social purpose.

Business meals and entertainment. Beginning in 1994, the amount you can deduct for business meals and entertainment expenses is reduced from 80% to 50%. See *50% Limit.*

Standard mileage rate. The standard mileage rate for the cost of operating your car in 1994 is 29 cents per mile for all business miles.

Form 2106–EZ. You may be able to use new Form 2106–EZ to claim your employee business expenses. See *Form 2106–EZ* under *Completing Forms 2106 and 2106–EZ.*

Important Reminders

Tax incentives for clean-fuel vehicles. You may be entitled to a tax credit for an electric vehicle or a deduction from gross income for a part of the cost of a clean-fuel vehicle if you place one of these vehicles in service from July 1, 1993, through December 31, 2004. The vehicle must meet certain requirements, and you do not have to use it in your business to qualify for the credit or the deduction. For more information, see Chapter 15 of Publication 535, *Business Expenses.*

Limit on itemized deductions. If you are an employee, you can deduct certain work-related expenses as itemized deductions on Schedule A (Form 1040). The amount you can deduct is limited to the excess over 2% of your adjusted gross income. It may be further limited if your adjusted gross income is more than $111,800 ($55,900 if you are married filing separately). For more information, see Chapters 22 and 30 and the instructions for Form 1040.

Introduction

This chapter discusses rules for deducting business-related expenses connected with:

- Travel away from home,
- Entertainment,
- Business gifts,
- Local business transportation, and
- Business use of a car.

This chapter also discusses:

- What records you must make or keep to prove your expenses,
- How to handle reimbursements of your employee business expenses, and
- How to report your expenses on Forms 2106 and 2106–EZ.

Expenses fully reimbursed. You will not need to read this chapter if ***all*** of the following are true.

1) You fully accounted to your employer for your work-related expenses.
2) You received full reimbursement for your expenses.
3) Your employer required you to return any excess reimbursement and you did so.
4) Box 13 of your Form W–2 shows no amount with a code **L.**

If you meet these four conditions, there is no need to show the expenses or the reimbursements on your return. See *Reimbursements,* later, if you would like more information on reimbursements and accounting to your employer.

If you do not meet all of these conditions, you must complete Form 2106 or 2106–EZ and itemize your deductions on Schedule A (Form 1040) to claim your expenses. See *Completing Forms 2106 and 2106–EZ,* later.

Note: If you meet these conditions and your employer included reimbursements on your Form W–2 in error, ask your employer for a corrected Form W–2.

Useful Items

You may want to see:

Publication

- ❑ **463** Travel, Entertainment, and Gift Expenses
- ❑ **535** Business Expenses
- ❑ **917** Business Use of a Car

Form (and Instructions)

- ❑ **Schedule A (Form 1040)** Itemized Deductions
- ❑ **Schedule C (Form 1040)** Profit or Loss From Business
- ❑ **Schedule C–EZ (Form 1040)** Net Profit From Business
- ❑ **Schedule F (Form 1040)** Profit or Loss From Farming
- ❑ **Form 2106** Employee Business Expenses
- ❑ **Form 2106–EZ** Unreimbursed Employee Business Expenses

Travel Expenses

If you temporarily travel away from your tax home, you can use this section to determine if you have deductible travel expenses. This section includes the definitions of ''tax home'' and ''temporary'' and a discussion of different types of travel expenses. The section then discusses the rules for travel inside and outside the United States and deductible expenses of attending a convention.

Travel expenses defined. For tax purposes, travel expenses are ordinary and necessary expenses that you pay while traveling away from home for your business, profession, or job. An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate to your business. An expense does not have to be indispensable to be considered necessary. However, you cannot deduct expenses to the extent they are lavish or extravagant.

You will find examples of deductible travel expenses later in this section.

Traveling away from home. You are traveling away from home if:

1) Your duties require you to be away from the general area of your tax home (defined later) substantially longer than an ordinary day's work, and
2) You need to get sleep or rest to meet the demands of your work while away from home.

This rest requirement is not satisfied by merely napping in your car. You do not have to be away from your tax home for a whole day or from dusk to dawn as long as your relief from duty is long enough to get necessary sleep or rest.

Example 1. You are a railroad conductor. You leave your home terminal on a regularly scheduled round-trip run between two cities and return home 16 hours later. During the run, you have 6 hours off at your turnaround point where you eat two meals and rent a hotel room to get necessary sleep

before starting the return trip. You are considered to be away from home, and you can deduct travel expenses.

Example 2. You are a truck driver. You leave your terminal and return to it later the same day. You get an hour off at your turnaround point to eat. Because you are not off to get necessary sleep and the brief time off is not an adequate rest period, your trip is not considered as travel away from home. You cannot deduct travel expenses.

Tax Home

To deduct travel expenses, you must first determine the location of your tax home.

Generally, your tax home is your regular place of business or post of duty, regardless of where you maintain your family home. It includes the ***entire city or general area*** in which your business or work is located. If you have more than one regular place of business, your tax home is your main place of business. If you do not have a regular or a main place of business because of the nature of your work, then your tax home may be the place where you regularly live. See *No main place of business or work,* later.

If you do not fit any of these categories, you are considered a transient (an itinerant) and your tax home is wherever you work. As a transient, you cannot claim a travel expense deduction because you are never considered away from home.

Main place of business or work. If you have more than one place of work, you should use the following factors to determine your main place of business or work:

1) The total time you ordinarily spend working in each area,
2) The degree of your business activity in each area, and
3) The relative amount of your income from each area.

Example. You live in Cincinnati where you have a seasonal job for 8 months and earn $15,000. You work the remaining 4 months in Miami, also at a seasonal job, and earn $4,000. Cincinnati is your main place of work because you spend most of your time there and earn most of your income there.

No main place of business or work. You may have a tax home even if you do not have a regular or main place of work. Your tax home may be the home where you regularly live. If you do not have a regular or main place of business or work, use the following three factors to see if you have a tax home.

1) You have part of your business in the area of your main home and use that home for lodging while doing business there.
2) You have living expenses at your main home that you duplicate because your business requires you to be away from that home.
3) You have not left the area in which both your traditional place of lodging and your main home are located; you have a member or members of your family living at your main home; or you often use that home for lodging.

If you meet all three factors, your tax home is the home where you regularly live, and you may be able to deduct travel expenses. If you meet only two of the factors, you may have a tax home depending on all the facts and circumstances. If you meet only one factor, you are a transient; you do not have a tax home and you cannot deduct travel expenses.

Example. You are an outside salesperson with a sales territory covering several states. Your employer's main office is in Denver, and you return there for one month each year for business and nonbusiness reasons. Your business work assignments are temporary, and you have no way of knowing where future assignments will be located.

You have lived in Denver for 14 years, first with your spouse in your own house until your divorce, and then with your married sister in her house. You pay your sister $100 a month for a room in her house where you stay when you are in Denver. You also keep in the room your furniture and any clothing that you do not take on your out-of-town business trips.

You have met all three factors listed earlier, including the traditional lodging aspects of factor (3). Therefore, you have a tax home in Denver for travel expense deduction purposes.

Transient workers. If you move from job to job, maintain no fixed home, and are not associated with any particular business locality, each place you work becomes your main place of business and your tax home. You cannot deduct your expenses for meals and lodging.

Living away from your tax home. If you (and your family) live in an area outside your tax home (main place of work), you cannot deduct travel expenses between your tax home and your family home. You also cannot deduct the cost of meals and lodging while at your tax home. See *Examples 1 and 2,* below.

If you are working temporarily in the same city where you and your family live, you may be considered as traveling away from home. See *Example 3,* below.

Example 1. You live with your family in Chicago, but work in Milwaukee, where you stay in a hotel and eat in restaurants during the week. You return to Chicago every weekend. You cannot deduct any of your expenses for travel, meals, and lodging in Milwaukee. This is because Milwaukee is your tax home and the travel on weekends is not for a business reason.

Example 2. You are a truck driver and you and your family live in Tucson. You are employed by a trucking firm that has its terminal in Phoenix. At the end of your long runs, you return to your home terminal in Phoenix and spend one night there before returning home. You cannot deduct any of your travel costs in Phoenix because Phoenix is your tax home.

Example 3. Your family home is in Pittsburgh, where you work 12 weeks a year. The rest of the year you work for the same employer in Baltimore. In Baltimore, you eat in restaurants and sleep in a rooming house. Your salary is the same whether you are in Pittsburgh or Baltimore.

Because you spend most of your working time and earn most of your salary in Baltimore, that city is your tax home. You cannot deduct any expenses you have for meals and lodging there. However, when you return to work in Pittsburgh, you are away from your tax home even though you stay at your family home. Therefore, you can deduct the cost of your round trip between Baltimore and Pittsburgh. You can also deduct your part of your family's living expenses for meals and lodging while you are living and working in Pittsburgh.

Temporary Assignment or Job

Although you regularly work or carry on your business activities within the city or general area of your tax home, you may have to work or conduct business at another location. It may not be practical to return home from this other location at the end of each day's work.

If your assignment or job away from your main place of work is ***temporary,*** your tax home does not change. You are considered to be away from home for the whole period, and your travel expenses are deductible. Generally, a temporary assignment in a single location is one that is realistically expected to last (and does in fact last) for one year or less.

However, if your assignment or job is ***indefinite,*** that location becomes your new tax home and you cannot deduct your travel expenses while there. Your assignment or job in a single location is considered indefinite if it is realistically expected to last for more than one year, regardless of whether it actually exceeds one year.

If your assignment is indefinite, you must include in your income any amounts you receive from your employer for living expenses, even if they are called travel allowances and you account to your employer for them. You may be able to deduct the cost of relocating to your new tax home as a moving expense. See Chapter 19 for more information.

Determining temporary or indefinite. You must determine whether your assignment is temporary or indefinite when you start work. If you expect employment to last for one year or less, it is temporary in the absence of facts and circumstances that indicate otherwise. Employment that is initially temporary may become indefinite due to changed circumstances. A series of assignments to the same location, all for short periods but that

together cover a long period, may be considered an indefinite assignment.

Going home on days off. If you go back to your tax home from a temporary assignment on your days off, you are not considered away from home while you are in your hometown. You cannot deduct the cost of your meals and lodging there. However, you can deduct your travel expenses, including meals and lodging, while traveling from the area of your temporary place of work to your hometown and back to work. You can claim these expenses up to the amount it would have cost you for meals and lodging had you stayed at your temporary place of work.

If you keep your hotel room during your visit home, you can deduct the cost of your hotel room. In addition, you can deduct your expenses of returning home up to the amount you would have spent for meals had you stayed at your temporary place of work.

Probationary work period. If you take a job that requires you to move, with the understanding that you will keep the job if your work is satisfactory during a probationary period, the job is indefinite. You cannot deduct any expenses for meals and lodging during the probationary period.

Members of the Armed Forces. If you are a member of the U.S. Armed Forces on a permanent duty assignment overseas, you are not traveling away from home. Therefore, you cannot deduct your expenses for meals and lodging. You cannot deduct these expenses even if you are required to maintain a home in the United States for your family members who are not allowed to accompany you overseas. If you are transferred from one permanent duty station to another, you may have deductible moving expenses, which are explained in Chapter 19.

A naval officer assigned to permanent duty aboard a ship that has regular eating and living facilities has a tax home aboard ship for travel expense purposes.

What Are Travel Expenses?

Once you have determined that you are traveling away from your tax home, you can determine what travel expenses are deductible on your tax return.

Records. When you travel away from home on business, you should keep records of all the expenses you incur and any advances you receive from your employer. You can use a log, diary, notebook, or any other written record to keep track of your expenses. The types of expenses you need to record, along with supporting documentation, are described later under *Recordkeeping.*

Deductible travel expenses include those ordinary and necessary expenses you incur while traveling away from home on business. The type of expense you can deduct depends on the facts and your circumstances. *Table 28–1* summarizes the expenses you may be able to deduct.

You can use the discussion that follows as a general guideline. You may have other deductible travel expenses that are not covered here, depending on the facts and your circumstances.

Transportation fares. You can generally deduct travel by airplane, train, or bus between your home and your business destination. Your cost is the amount you paid for your ticket. If you were provided with a ticket or you are riding free as a result of a ''frequent flyer'' or other similar program, you have no deduction.

If you travel by ship, the amount you can deduct may be limited. See *Luxury Water Travel* and *Cruise ships* (under *Conventions)* in Chapter 1 of Publication 463.

Taxi, commuter bus, and limousine fares. You can generally deduct the fares you pay for taxis, airport limousines, buses, or other types of transportation between the airport or station and your hotel. You can also deduct these fares between your hotel and the work location of your customers or clients, your business meeting place, or your temporary work location. You cannot deduct costs of sightseeing, shopping, or similar nonbusiness activities.

Baggage and shipping costs. You can deduct the cost of sending baggage and sample or display material between your regular work location and your temporary work location.

Car expenses. You can deduct the cost of operating and maintaining your car when traveling away from home on business. See *Local Transportation Expenses,* later, for information on how to figure this deduction.

Leasing a car. You can deduct the cost of leasing a car for business purposes while you are traveling away from home. However, if you lease a car for 30 days or more, you may have to include an amount called an ''inclusion amount'' in your income. This inclusion amount is explained in Chapter 3 of Publication 917.

You can also deduct actual operating expenses for a car you lease. Examples are gas, oil, and repairs. However, you cannot claim the standard mileage rate.

Operating expenses. For a car you own, you may have a choice of deducting actual business-related expenses or claiming the standard mileage rate. The 1994 standard mileage rate is 29 cents a mile for all business miles. See *Local Transportation Expenses,* later, for information about using actual expenses or the standard mileage rate.

Lodging. You can deduct the cost of lodging if your business trip is overnight or long enough to require you to stop for sleep or rest to properly perform your duties.

Meals. You can deduct the cost of meals only if your business trip is overnight or long enough to require you to stop for sleep or rest to properly perform your duties. You cannot deduct the cost of meals if it is not necessary for you to rest. If you pay for a business meal when you are not traveling, you can deduct the cost only if you meet the rules for business entertainment. These rules are explained later under *Entertainment Expenses.*

The expense of a meal includes amounts you spend for your food, beverages, taxes, and tips relating to the meal. You can deduct either the actual cost or a standard amount. See *Standard Meal Allowance* later in this section.

50% limit on meals. You can deduct only 50% of the cost of your business-related meals unless you are reimbursed for these expenses. This limit applies whether the unreimbursed meal expense is for business travel or business entertainment. The 50% limit is explained later under *Entertainment Expenses.*

Lavish or extravagant. You cannot deduct expenses for meals to the extent they are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable based on the facts and circumstances. Expenses will not be disallowed merely because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, night clubs, or resorts.

Cleaning and laundry expenses. You can deduct reasonable laundry expenses while traveling away from home on business.

Telephone expenses. You can deduct the cost of business calls while you are traveling away from home. This includes the cost of business communication by fax machine or other devices.

Tips. You can deduct tips you pay for any of the expenses in this section.

Other expenses. You can deduct other similar ordinary and necessary expenses that are related to your business travel. Such expenses might include the costs of operating and maintaining a house trailer, public stenographer's fees, and computer rental fees.

Travel expenses for another individual. If a spouse, dependent, or other individual goes with you (or your employee) on a business trip or to a business convention, you generally cannot deduct his or her travel expenses. You can only deduct the travel expenses you pay or incur for such an accompanying individual if that individual:

1) Is your employee,
2) Has a bona fide business purpose for the travel, ***and***
3) Would otherwise be allowed to deduct the travel expenses.

For a bona fide business purpose to exist, you must prove a real business purpose

Table 28-1. **Deductible Travel Expenses**

Expense	Description
Transportation	The cost of travel by airplane, train, or bus between your home and your business destination.
Taxi, commuter bus, and limousine	Fares for these and other types of transportation between the airport or station and your hotel, or between the hotel and your work location away from home.
Baggage and shipping	The cost of sending baggage and sample or display material between your regular and temporary work locations.
Car	The costs of operating and maintaining your car when traveling away from home on business. You may deduct actual expenses or the standard mileage rate, including business-related tolls and parking. If you lease a car while away from home on business, you can deduct business-related expenses only.
Lodging	The cost of lodging if your business trip is overnight or long enough to require you to get substantial sleep or rest to properly perform your duties.
Meals	The cost of meals only if your business trip is overnight or long enough to require you to stop to get substantial sleep or rest. Includes amounts spent for food, beverages, taxes, and related tips.
Cleaning	Cleaning and laundry expenses while away from home overnight.
Telephone	The cost of business calls while on your business trip, including business communication by fax machine or other communication devices.
Tips	Tips you pay for any expenses in this chart.
Other	Other similar ordinary and necessary expenses related to your business travel such as public stenographer's fees and computer rental fees.

for the individual's presence. Incidental services, such as typing notes or assisting in entertaining customers, are not enough to warrant a deduction.

Example. Jerry drives to Chicago on business and takes his wife, Linda, with him. Linda is not Jerry's employee, Linda's presence serves no business purpose, and Linda does not otherwise qualify to deduct the travel expenses. Jerry pays $115 a day for a double room. A single room costs $90 a day. He can deduct the total cost of driving his car to and from Chicago, but only $90 a day for his hotel room. If he uses public transportation, he can deduct only his fare.

Standard Meal Allowance

You generally can deduct a standard amount for your daily meals and incidental expenses while you are traveling away from home on business. Incidental expenses include costs for laundry, cleaning, and tips for services. In this chapter, the term ''standard meal allowance'' refers to meals and incidental expenses.

This method is an alternative to the actual cost method and allows you to deduct a set amount, depending on where you travel, instead of keeping records of actual meal expenses. If you use the standard meal allowance, you still must keep records to prove the time, place, and business purpose of your travel. See the recordkeeping rules explained later under *Recordkeeping.*

Who can use the standard meal allowance. You can use the standard meal allowance whether you are an employee or self-employed. You cannot use the standard meal allowance, however, if you are related to your employer as defined later.

You can use the standard meal allowance whether or not you are reimbursed for your traveling expenses. However, if you are not reimbursed for meal expenses, you can deduct only 50% of the standard meal allowance. This 50% limit is figured when you complete Form 2106, Form 2106–EZ, or Schedule C. If you file Schedule C–EZ, enter the total amount of your business expenses on line 2. You can only include 50% of the standard meal allowance in that total. If you file Schedule F, enter the total amount of your travel, meals and entertainment expenses on line 34. You can only include 50% of the standard meal allowance in that total.

Related to employer. You are related to your employer if:

1) Your employer is your brother or sister, half-brother or half-sister, spouse, ancestor, or lineal descendent,
2) Your employer is a corporation in which you own, directly or indirectly, more than 10% in value of the outstanding stock, or
3) Certain fiduciary relationships exist between you and your employer involving grantors, trusts, beneficiaries, etc.

You may be considered to indirectly own stock, for purposes of (2) above, if you have an interest in a corporation, partnership, estate, or trust that owns the stock or if a family member or partner owns the stock.

Amount of standard meal allowance. The standard meal allowance is ***$26 a day*** for most areas in the United States. Other locations in the United States are designated as high-cost areas, qualifying for higher standard meal allowances.

Table 2 in Publication 463 shows the locations qualifying for rates of $30, $34, or $38 a day for travel on or after January 1, 1994.

If you travel to more than one location in one day, use the rate in effect for the area where you stop for sleep or rest. If you work in the transportation industry, however, see *Special rate for transportation workers,* later in this section.

Example. You regularly live and work in Chicago. You sometimes travel overnight to Des Moines for business. Your employer expects you to pay your expenses out of your regular salary and does not separately or specifically reimburse your expenses for business trips. You must keep receipts to prove the amount of your lodging expense. You can claim the standard meal allowance for Des Moines, $30, on your Form 2106 or Form 2106–EZ. You are subject to the 50% limit on meal and entertainment expenses. You are also subject to the 2% of adjusted gross income limit that applies to most other miscellaneous itemized deductions.

Standard meal allowance for areas outside the continental United States. The previously mentioned standard meal allowance rates do not apply to travel in Alaska, Hawaii, or any other nonforeign locations outside the continental United States. They also do not apply to foreign locations. The federal per diem rates for these locations are published monthly in the *Maximum Travel Per Diem Allowances for Foreign Areas.*

Your employer may have these rates available, or you can purchase the publication from the:

Superintendent of Documents
U.S. Government Printing Office
P.O. Box 371954
Pittsburgh, PA 15250–7954

You can also order it by calling the Government Printing Office at (202)512–1800 (not a

toll-free number). To find out the rate for a specific foreign location, you can call the Department of State at (703)875–7900 (not a toll-free number).

Special rate for transportation workers. You may be able to use a special standard meal allowance if you work in the transportation industry. You are in the transportation industry if your work:

1) Directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and
2) Regularly requires you to travel away from home and, during any single trip, usually involves travel to areas eligible for different standard meal allowance rates.

If this applies to you, you can claim a ***$32 a day*** standard meal allowance ($36 for travel outside the continental United States).

Using the special rate for transportation workers eliminates the need for you to determine the standard meal allowance for every area where you stop for sleep or rest. If you choose to use the special rate for any trip, however, you must continue to use the special rate (and not use the regular standard meal allowance rates) for all trips you take that year.

Travel for less than 24 hours. If you are not traveling for the entire 24-hour day, you must prorate the standard meal allowance. You can do so by dividing the day into 6-hour quarters. The 6-hour quarters are:

1) Midnight to 6 a.m.,
2) 6 a.m. to noon,
3) Noon to 6 p.m., and
4) 6 p.m. to midnight.

You can claim one-fourth of the full day standard meal allowance for each 6-hour quarter of the day during any part of which you are traveling away from home.

Example 1. You live and work in Los Angeles. Your employer sends you to San Francisco on a temporary assignment. You leave home at 8 a.m. on March 23. Your assignment is completed on March 26. You arrive home at 4 p.m. on that day. You are considered to be traveling for 3½ days (a ¾ day on March 23 + 2 full days + a ¾ day on March 26). Your standard meal allowance is $133 (3½ × $38) while on this assignment.

Example 2. Maria is employed in Milwaukee as a convention planner. In April she went on a one-week business trip. She left her home in Milwaukee at 7 a.m. on April 5 and flew to Washington, DC, where she spent two nights. She then went to Albany, NY, arriving there at 4 p.m. on April 7. After three nights in Albany, she went to New York City to attend a planning seminar at her employer's request. She arrived at 1 p.m. on April 10. On April 12, she flew back to Milwaukee, arriving at her home at 5:45 p.m.

Maria decides to use the standard meal allowance and arrives at her expense as follows:

City	Number of Days	Allowance Amount	Total
Washington, DC	1¾	$38	$ 66.50
Albany, NY	3	$30	90.00
New York City	2¾	$38	104.50
			$261.00

Maria's total standard meal allowance for the trip is $261.00 ($66.50 + $90.00 + $104.50). If her employer does not reimburse her for her meals, Maria will be able to deduct 50% of her unreimbursed meals as an itemized deduction. She will figure this limit on Form 2106 or Form 2106–EZ.

Investment and education expenses. You can also use the standard meal allowance to prove meal expenses you incurred in connection with investment and other income-producing property and/or qualifying educational expenses while traveling away from home.

Standard meal allowance not allowed. You cannot use the standard meal allowance to prove the amount of your meals if you are traveling for medical or charitable purposes.

Travel in the United States

The following discussion applies to travel in the United States. For this purpose, the United States includes the 50 states and the District of Columbia. The treatment of your travel expenses depends on how much of your trip was business related and on how much of your trip occurred within the United States.

Trip Primarily for Business

You can deduct all your travel expenses if your trip was entirely business related. If your trip was primarily for business and, while at your business destination, you extended your stay for a vacation, made a nonbusiness side trip, or had other nonbusiness activities, you can deduct your business-related travel expenses. These expenses include the travel costs of getting to and from your business destination, and you can deduct any business-related expenses at your business destination.

Example. You work in Atlanta and take a business trip to New Orleans. On your way home, you stop in Mobile to visit your parents. You spend $630 for the 9 days you are away from home for travel, meals, lodging, and other travel expenses. If you had not stopped in Mobile, you would have been gone only 6 days, and your total cost would have been $580. You can deduct $580 for your trip, including the round-trip transportation to and from New Orleans. The cost of your meals is subject to the 50% limit on meals discussed earlier.

Trip Primarily for Personal Reasons

If your trip was primarily for personal reasons, such as a vacation, the entire cost of the trip is a nondeductible personal expense. However, you can deduct any expenses you have while at your destination that are directly related to your business.

A trip to a resort or on a cruise ship may be a vacation even if the promoter advertises that it is primarily for business. The scheduling of incidental business activities during a trip, such as viewing videotapes or attending lectures dealing with general subjects, will not change what is really a vacation into a business trip.

Part of Trip Outside the United States

If part of your trip is outside the United States, use the rules described later under *Travel Outside the United States* for that part of the trip. For the part of your trip that is inside the United States, use the rules in this section. Travel outside the United States does not include travel from one point in the United States to another point in the United States. The following discussion can help you determine whether your trip was entirely within the United States.

Public transportation. If you travel by public transportation, any place in the United States where that vehicle makes a scheduled stop is a point in the United States. Once the vehicle leaves the last scheduled stop in the United States on its way to a point outside the United States, you apply the rules under *Travel Outside the United States.*

Example 1. You fly from New York to Puerto Rico with a scheduled stop in Miami. You return to New York nonstop. The flight from New York to Miami is in the United States, so only the flight from Miami to Puerto Rico is outside the United States. All of the return trip is outside the United States, as there are no scheduled stops between Puerto Rico and New York.

Example 2. You travel by train from New York to Montreal. The travel from New York to the last scheduled stop in the United States is travel in the United States.

Private car. Travel by private car in the United States is travel between points in the United States, even when you are on your way to a destination outside the United States.

Example. You travel by car from Denver to Mexico City and return. Your travel from Denver to the border and from the border back to Denver is travel in the United States, and the rules in this section apply. The rules under *Travel Outside the United States* apply to your trip from the border to Mexico City and back to the border.

Private plane. If you travel by private plane, any trip, or part of a trip, for which both your

takeoff and landing are in the United States is travel in the United States. This is true even if part of your flight is over a foreign country.

Example. You fly nonstop from Seattle to Juneau. Although the flight passes over Canada, the trip is considered to be travel in the United States.

Travel Outside the United States

If any part of your business travel is outside the United States, some of your deductions for the cost of getting to and from your destination may be limited. For this purpose, the United States includes the 50 states and the District of Columbia.

How much of your travel expenses is deductible depends in part upon how much of your trip outside the United States was business related.

See Chapter 1 of Publication 463 for information on luxury water travel.

Travel Entirely for Business

If you travel outside the United States and you spend the entire time on business activities, all your expenses of getting to and from your business destination are deductible.

In addition, even if you do not spend your entire time on business activities, your trip is considered entirely for business, and you can deduct all of your business-related travel expenses if you meet at least one of the following four conditions.

1) You did not have substantial control over arranging the trip. You are not considered to have substantial control merely because you control the timing of your trip.

   You are considered not to have substantial control over your trip if you:

   a) Are an employee who was reimbursed or paid a travel expense allowance,

   b) Are not related to your employer, and

   c) Are not a managing executive.

''Related to your employer'' was defined earlier in this chapter under *Standard Meal Allowance.* A ''managing executive'' is an employee who has the authority and responsibility, without being subject to the veto of another, to decide on the need for the business travel.

A self-employed person is generally regarded as having substantial control over arranging business trips.

2) You were outside the United States a week or less, combining business and nonbusiness activities. One week means seven consecutive days. In counting the days, do not count the day you leave the United States, but count the day you return to the United States.

   Example. You traveled to Paris primarily for business. You left Denver on Tuesday and flew to New York. On Wednesday, you flew from New York to Paris, arriving the next morning. On Thursday and Friday, you had business discussions, and from Saturday until Tuesday, you were sightseeing. You flew back to New York, arriving Wednesday afternoon. On Thursday, you flew back to Denver. Although you were away from your home in Denver for more than a week, you were not outside the United States for more than a week. This is because the day of departure does not count as a day outside the United States. You can deduct your cost of the round-trip flight between Denver and Paris. You can also deduct the cost of your stay in Paris for Thursday and Friday while you conducted business. However, you cannot deduct the cost of your stay in Paris from Saturday through Tuesday because those days were spent on nonbusiness activities.

3) You spent less than 25% of the total time you were outside the United States on nonbusiness activities, even if the trip outside the United States was for more than a week. For this purpose, count both the day your trip began and the day it ended.

   Example. You flew from Seattle to Tokyo, where you spent 14 days on business and 5 days on personal matters. You then flew back to Seattle. You spent one day flying in each direction. Because only 5/21 (less than 25%) of your total time abroad was for nonbusiness activities, you can deduct as travel expenses what it would have cost you to make the trip if you had not engaged in any nonbusiness activity. The amount you can deduct is the cost of the round-trip plane fare and 16 days of meals (subject to the 50% limit), lodging, and other related expenses.

4) You can establish that a personal vacation was not a major consideration, even if you have substantial control over arranging the trip.

If you do not meet any of these conditions, you may still be able to deduct some of your expenses. See *Travel Primarily for Business,* next.

Travel Primarily for Business

If you traveled outside the United States primarily for business purposes, but spent 25% or more of your time on nonbusiness activities, your travel expense deductions are limited unless you meet one of the four conditions listed earlier under *Travel Entirely for Business.* If your deductions are limited, you must allocate your travel expenses of getting to and from your destination between your business and nonbusiness activities to determine your deductible amount.

Travel allocation rules. If your trip was not entirely for business, you must allocate your travel expenses on a day-to-day basis between days you conducted business and days you did not conduct business.

To figure the deductible amount of your round-trip travel expenses between the United States and your business destination, multiply the total cost by the following fraction. The numerator (top number) is the total number of business days outside the United States. The denominator (bottom number) is the total number of all days outside the United States. The day of your departure from the United States and the day you return to the United States are both counted as days outside the United States.

Counting business days. Your business days include transportation days, days your presence was required, days you spent on business, and certain weekends and holidays.

Transportation day. Count as a business day any day you spend traveling to or from a business destination. However, if because of a nonbusiness activity you do not travel by a direct route, your business days are the days it would have taken you to travel a reasonably direct route to your business destination. Extra days for side trips or nonbusiness activities cannot be counted as business days.

Presence required. Count as a business day any day that your presence is required at a particular place for a specific business purpose, even if you spend most of the day on nonbusiness activities.

Day spent on business. If your principal activity during working hours is in pursuit of your trade or business, the day is counted as a business day. Also, count as a business day any day you are prevented from working because of circumstances beyond your control.

Certain weekends and holidays. Weekends, holidays, and other necessary standby days are counted as business days if they fall between business days. But if they follow your business meetings or activity and you remain at your business destination for nonbusiness or personal reasons, they are not business days.

Example 1. Your tax home is in New York City. You travel to Quebec where you have a business appointment on Friday. You have another appointment on the following Monday. Because you had a business activity on Friday and had another business activity on Monday, the days in between are counted as business days. This is true even though you use that time for sightseeing, personal visiting, or other nonbusiness activities.

Example 2. If, in *Example 1,* you had no other business in Quebec after Friday, but stayed until Monday before starting home, Saturday and Sunday would be nonbusiness days.

Nonbusiness activity on the route to or from your business destination. If you had a vacation or other nonbusiness activity between the United States and your business destination, or between your business destination and the United States, you must

allocate your travel expenses between business and nonbusiness days. You can do so as follows:

1) Divide the number of business days by the total number of travel days.
2) Multiply the result in (1) by the cost of round-trip travel between the United States and your nonbusiness destination.
3) Add to the result in (2) the round-trip cost of travel between the United States and your business destination minus the round-trip cost of travel between the United States and your nonbusiness destination. This is the deductible part of your cost of getting to and from your business destination.
4) Add to the result in (3) your business travel expenses while at your business destination. These are your total allowable travel expenses.

Example. You live in New York and flew to Brussels on Thursday, May 19, to attend a conference with a customer that began at noon Friday, May 20. The conference ended at noon Monday, May 23. That evening you flew to Dublin where you visited with friends until the afternoon of June 5, when you flew home to New York. The primary purpose for the trip was to attend the conference.

If you had not stopped in Dublin, you would have arrived home the evening of May 23. You were outside the United States more than a week, and you are unable to show that you had no substantial control over arranging the trip, or that a personal vacation was not a major consideration in making the trip. May 19 through May 23 (5 days) are business days and May 24 through June 5 (13 days) are nonbusiness days. You cannot deduct your expenses while in Dublin. You also cannot deduct 13/18 of the cost of round-trip airfare and any other expenses from New York to Dublin.

You can deduct the cost of your meals (subject to the 50% limit), lodging, and other business-related travel expenses while in Brussels. You figure the deductible part of your travel between the United States and Brussels as follows:

1) 5/18 of the round-trip airfare and other expenses between New York and Dublin, **plus**
2) The cost of the round-trip fare and any other expenses between New York and Brussels minus the cost of the round-trip fare and any other expenses between New York and Dublin.

Assume the round-trip plane fare and other expenses between New York and Brussels are $800 and the expenses between New York and Dublin are $600. Your deductible plane fare and other expenses are $366.67 [(5/18 × $600) + ($800 – $600)].

Nonbusiness activity at or beyond business destination. If you had a vacation or other nonbusiness activity at or beyond your business destination, you must allocate your travel expenses between your business and nonbusiness days. None of your travel expenses for nonbusiness activities at or beyond your business destination are deductible. You must also allocate your round-trip transportation and other costs between the United States and your business destination as follows.

Multiply the cost of your round-trip travel between the United States and your business destination by a fraction. The numerator (top number) is the number of business days. The denominator (bottom number) is the total number of travel days. Add to this result your other business-related travel expenses at your business destination. The sum is your total deductible travel expenses.

Example. Assume that the dates are the same as in the prior example but that instead of going to Dublin for your vacation, you fly to Venice, Italy, for a vacation. You cannot deduct any part of the cost of your trip from Brussels to Venice and return to Brussels. In addition, you cannot deduct 13/18 of the airfare and other expenses from New York to Brussels and back to New York. You may deduct 5/18 of the round-trip plane fare and other expenses from New York to Brussels, plus your meals, lodging, and any other business expenses you had in Brussels. If the round-trip plane fare and other expenses are $800 from New York to Brussels, you can deduct travel costs of $222.22 (5/18 × $800).

Other methods. You can use another method of counting business days if you establish that it more clearly reflects the time spent on nonbusiness activities outside the United States.

Travel Primarily for Vacation

If your travel was primarily for vacation, or for **investment** purposes, and you spent some time attending brief professional seminars or a continuing education program, the entire cost of the trip is a nondeductible personal expense. You may, however, deduct your registration fees and any other expenses incurred that were directly related to your business.

Example. You are a doctor practicing medicine and are a member of a professional association. The association sponsored a 2-week trip to two foreign countries with three professional seminars in each country. Each seminar was 2 hours long and was held in a different city. You also made an optional side trip to a well-known tourist attraction in each of the countries visited. At the end of the trip you received a Certificate of Continuing Education in Medicine.

You paid the cost of airfare, hotel accommodations, meals, a special escort, transportation to and from hotels, and tips. No part of the cost was specifically stated for the seminars, which were arranged for you by the sponsoring professional association.

Your participation in the professional seminars did not change what was essentially a vacation into a business trip. Your travel expenses were not related primarily to your business. You had no other expenses that were directly for your business. Therefore, you cannot deduct the cost of your trip as an ordinary and necessary business expense.

Conventions

You can deduct your travel expenses when you attend a convention if you can show that your attendance benefits your trade or business. You cannot deduct the travel expenses for your family. If the convention is for **investment,** political, social, or other purposes unrelated to your trade or business, you cannot deduct the expenses. Nonbusiness expenses, such as social or sightseeing expenses, are personal expenses and are not deductible.

Your appointment or election as a delegate does not, in itself, entitle you to or deprive you of a deduction. Your attendance must be connected to your own trade or business.

Convention agenda. The agenda of the convention does not have to deal specifically with your official duties or the responsibilities of your position or business. It is enough if the agenda is so related to your active trade or business and your responsibilities that attendance for a business purpose is justified.

Foreign conventions. See Chapter 1 of Publication 463 for information on conventions held outside the North American area.

Entertainment Expenses

You may be able to deduct business-related entertainment expenses you have for entertaining a client, customer, or employee.

To be deductible, the expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be indispensable to be considered necessary.

In addition, the entertainment expense must meet one of two tests:

1) Directly-related test, or
2) Associated test.

You must also meet the requirements discussed later in this chapter under *Recordkeeping.*

Even if you meet all the requirements for claiming a deduction for entertainment expenses, the amount you can deduct may be limited. Generally, you can deduct only 50% of your unreimbursed entertainment expenses. This limit is discussed later under *50% Limit.*

Club dues and membership fees. Beginning in 1994, you are not allowed a deduction

for dues (including initiation fees) for membership in any club organized for business, pleasure, recreation, or other social purpose.

Entertainment. Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. Examples include entertaining guests at night clubs; at social, athletic, and sporting clubs; at theaters; at sporting events; on yachts; or on hunting, fishing, vacation, and similar trips. You cannot deduct expenses for entertainment to the extent they are lavish or extravagant. If you buy a ticket to an entertainment event for a client, you generally cannot deduct more than the face value of the ticket.

A meal as a form of entertainment. Entertainment includes the cost of a meal you provide to a customer, or client, whether the meal is a part of other entertainment or by itself. A meal sold in the normal course of your business is not entertainment. Generally, to deduct an entertainment-related meal, you or your employee must be present when the food or beverages are provided.

A meal expense includes the cost of food, beverages, taxes, and tips for the meal.

No double deduction allowed for meals. You cannot claim the cost of your meal as an entertainment expense if you are also claiming the cost of your meal as a travel expense.

Taking turns paying for meals or entertainment. Expenses are ***not*** deductible when a group of business acquaintances take turns picking up each other's meal or entertainment checks without regard to whether any business purposes are served.

Trade association meetings. You can deduct expenses for entertainment that are directly related to and necessary for attending business meetings or conventions of certain exempt organizations. These organizations include business leagues, chambers of commerce, real estate boards, trade associations, and professional associations. The expenses of your attendance must be related to your active trade or business. These expenses are subject to the 50% limit on entertainment expenses.

Additional information. For more information on entertainment expenses, including discussions of the directly-related and associated tests, see Chapter 2 of Publication 463.

50% Limit

In general, you can deduct only 50% of your business-related meal and entertainment expenses. This limit applies to employees or their employers, and to self-employed persons (including independent contractors) or their clients, depending on whether the expenses are reimbursed.

The 50% limit applies to meals or entertainment expenses incurred while:

1) Traveling away from home (whether eating alone or with others) on business,
2) Entertaining business customers at your place of business, a restaurant, or other location, or
3) Attending a business convention or reception, business meeting, or business luncheon at a club.

Taxes and tips relating to a business meal or entertainment activity are included in the amount that is subject to the 50% limit. Expenses such as cover charges for admission to a night club, rent paid for a room in which you hold a dinner or cocktail party, or the amount paid for parking at a sports arena are also subject to the 50% limit. However, the cost of transportation to and from a business meal or a business-related entertainment activity is not subject to the 50% limit.

If you pay or incur an expense for goods and services consisting of meals, entertainment, and other services (such as lodging or transportation), you must allocate that expense between the cost of meals and entertainment and the cost of the other services. You must have a reasonable basis for making this allocation. For example, you must allocate your expenses if a hotel includes one or more meals in its room charge, or if you are provided with one per diem amount to cover both your lodging and meal expenses.

Application of 50% limit. The 50% limit on meal and entertainment expenses applies if the expense is otherwise deductible and is not covered by the exception discussed later in this section.

The 50% limit also applies to activities that are not a trade or business. It applies to meal and entertainment expenses incurred for the production of income, including rental or royalty income. It also applies to deductible educational expenses.

When to apply the 50% limit. You apply the 50% limit after determining the amount that would otherwise qualify for a deduction. You first determine the amount of meal and entertainment expenses that would be deductible under the rules discussed in this chapter.

You then apply the 50% limit. If you are an employee, use Form 2106 or Form 2106–EZ to figure the limit. If you are self-employed, figure the limit on Schedule C. If you file Schedule C–EZ, enter the total amount of your business expenses on line 2. You can only include 50% of your meal and entertainment expenses in that total. If you file Schedule F, enter 50% of your meal and entertainment expenses on line 34.

Finally, to determine the actual amount you can deduct if you are an employee, you must apply the 2% of adjusted gross income limit on Schedule A (Form 1040).

Example 1. You spend $100 for a business-related meal. If $40 of that amount is not allowable because it is considered lavish and extravagant, the remaining $60 is subject to the 50% limit. Your deduction cannot be more than $30 (.50 × $60).

Example 2. You purchase two tickets to a concert and give them to a client. You purchased the tickets through a ticket agent. You paid $150 for the two tickets, which had a face value of $60 each ($120 total). Your deduction cannot be more than $60 (.50 × $120).

Exception to the 50% Limit

The 50% limit on meal and entertainment expenses applies if the expense is otherwise deductible based on the tests and rules explained in this chapter.

You can use *Figure 28–A* to help you determine if the 50% limit applies to you. Your meal or entertainment expense is ***not*** subject to the 50% limit if the expense meets the following exception.

Employee's reimbursed expenses. As an employee, you are not subject to the 50% limit if your employer reimburses you under an accountable plan and does not treat your reimbursement as wages. Accountable plans are discussed later under *Reimbursements.*

Business Gift Expenses

If you give business gifts in the course of your trade or business, you can deduct the cost subject to the limits and rules in this section.

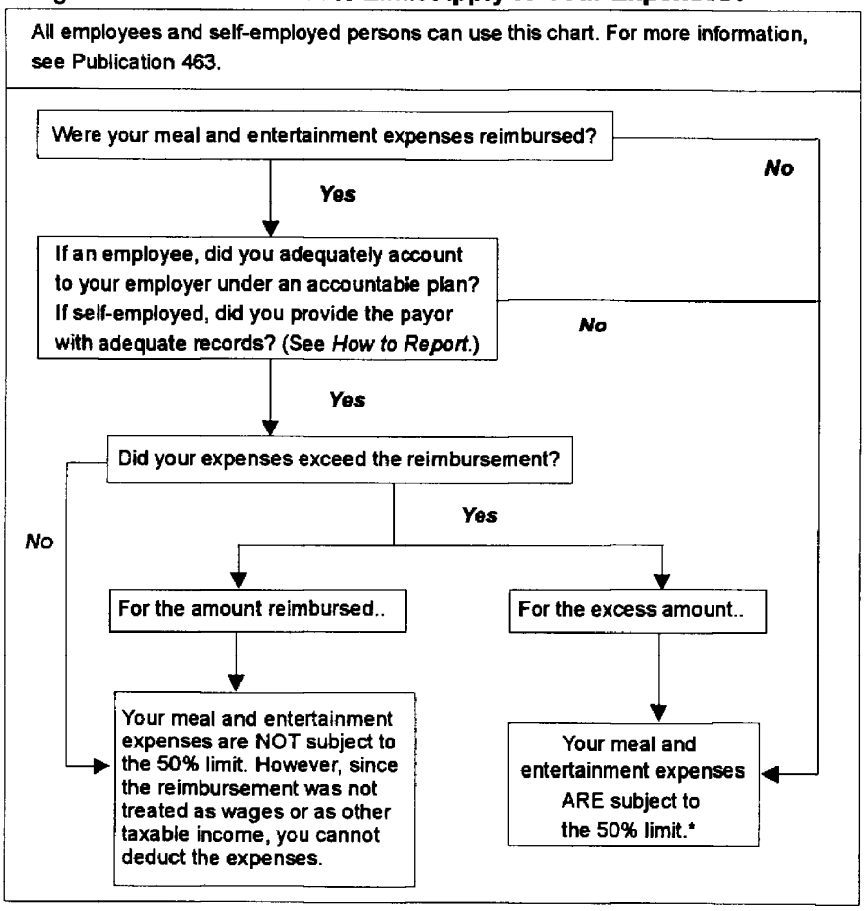
Limit on business gifts. You can deduct no more than $25 for business gifts you give directly or indirectly to any one person during your tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift.

A gift to the spouse of a business customer or client is an indirect gift to the customer or client. However, if you have an independent bona fide business connection with the spouse, the gift generally will not be considered an indirect gift to the other spouse. It will, however, be considered an indirect gift to the other spouse if it is intended for that spouse's eventual use or benefit. These rules also apply to gifts to any other family member.

If you and your spouse both give gifts, both of you are treated as one taxpayer. It does not matter whether you have separate businesses, are separately employed, or whether each of you has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer.

Incidental costs. Incidental costs, such as engraving on jewelry, or packaging, insuring, and mailing, are generally not included in determining the cost of a gift for purposes of the $25 limit.

Figure 28-A. Does the 50% Limit Apply to Your Expenses?



* There are exceptions to this rule. For example, you are not subject to the 50% limit on meals and entertainment if:

A) You incur the expenses as a means of advertising to, or promoting goodwill in, the general community,
B) You pay the expenses as part of a package deal that includes a ticket to a charitable sports event, or
C) Your business involves the sale of meals and/or entertainment to the public.

A related cost is considered incidental only if it does not add substantial value to the gift. For example, the cost of gift wrapping is considered an incidental cost. However, the purchase of an ornamental basket for packaging fruit is not considered an incidental cost of packaging if the basket has a substantial value compared to the value of the fruit.

Exceptions. The following items are not subject to the $25 limit for business gifts.

1) An item that costs $4 or less and:

   a) Has your name clearly and permanently imprinted on the gift, and

   b) Is one of a number of identical items you widely distribute.

Examples include pens, desk sets, and plastic bags and cases.

2) Signs, display racks, or other promotional material to be used on the business premises of the recipient.

Gift or entertainment. Any item that might be considered either a gift or an entertainment expense generally will be considered an entertainment expense. However, if you give a customer packaged food or beverages that you intend the customer to use at a later date, treat it as a gift expense.

If you give tickets to a theater performance or sporting event to a business customer and you do not go with the customer to the performance or event, you can choose to treat the tickets as either a gift or entertainment expense, whichever is to your advantage.

You can change your treatment of the tickets at a later date, but not after the time allowed for the assessment of income tax. In most instances, this assessment period ends 3 years after the due date of your income tax return. But if you go with the customer to the event, you must treat the cost of the tickets as an entertainment expense. You cannot choose, in this case, to treat the tickets as a gift expense.

Local Transportation Expenses

This section discusses expenses you can deduct for local business transportation. It also discusses deductions you can take for business use of your car, whether you use it for business-related local transportation or for traveling away from home overnight on business.

Local transportation expenses include the ordinary and necessary expenses of getting from one workplace to another in the course of your business or profession when you are traveling within your tax home area. Tax home is defined earlier.

The following discussion applies to you if you have a regular or main job away from your residence. If your principal place of business is in your home, see *Office in the home,* later.

Local transportation expenses also include the cost of getting from your home to a temporary workplace when you have one or more regular places of work. These temporary workplaces can be either within the area of your tax home or outside that area.

Local business transportation does ***not*** include expenses you have while traveling away from home overnight. Transportation expenses you can deduct while traveling away from home overnight and the definition of tax home are discussed earlier under *Travel Expenses.*

Local business transportation expenses include the cost of transportation by air, rail, bus, taxi, etc., and the cost of driving and maintaining your car.

You can deduct your expenses for local business transportation, including the business use of your car, if the expenses are ordinary and necessary. An ordinary expense is one that is common and accepted in your field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be indispensable to be considered necessary.

Commuting expenses. You cannot deduct the costs of taking a bus, trolley, subway, taxi, or driving a car between ***your home*** and your main or regular place of work. These costs are personal commuting expenses. You cannot deduct commuting expenses no matter how far your home is from your regular place of work. You cannot deduct commuting expenses even if you work during the commuting trip.

Example. You had a telephone installed in your car. You sometimes use that telephone to make business calls while commuting to and from work. Sometimes business associates ride with you to and from work, and you have a business discussion in the car. These activities do not change the trip's expenses from commuting to business. You cannot deduct your commuting expenses.

Car pools. You cannot deduct the cost of using your car in a nonprofit car pool. Do not

include payments you receive from the passengers in your income. These payments are considered reimbursements of your expenses. However, if you operate a car pool for a profit, you must include these payments from passengers in your income, and you can deduct your car expenses (using the rules in this chapter).

Hauling tools or instruments. If you haul tools or instruments in your car while commuting to and from work, this does not make your commuting costs deductible. However, you can deduct additional costs, such as renting a trailer that you tow with your vehicle, for carrying equipment to and from your job.

Parking fees. Fees you pay to park your car at your place of business are nondeductible commuting expenses. You can, however, deduct business-related parking fees when visiting a customer or client.

Advertising display on car. The use of your car to display material that advertises your business does not change the use of your car from personal use to business use. If you use this car for commuting or other personal uses, you cannot deduct your expenses for such uses. Commuting or personal expenses are not deductible.

Union members' trips from a union hall. If you get your work assignments at a union hall and then go to your place of work, these costs are nondeductible commuting expenses.

Office in the home. If you have an office in your home that qualifies as a ***principal place of business,*** you can deduct your daily transportation costs between your home and another work location in the same trade or business. (See Chapter 30 for information on determining if your home office qualifies as a principal place of business.)

If your home office does not qualify as a principal place of business, follow the general rules explained in this chapter.

Examples of deductible local transportation. The following examples illustrate when you can deduct local transportation expenses based on the location of your work and your home.

Example 1. Your office is in the same city as your home. You cannot deduct the cost of transportation between your home and your office. This is a personal commuting expense. You can deduct the cost of round-trip transportation between your office and a client's or customer's place of business.

Example 2. You regularly work in an office in the city where you live. Your employer requires that you attend a one-week training session at a different office in the same city. You travel directly from your home to the training location and return each day. You can deduct the cost of your daily round-trip transportation between your home and the training location.

Example 3. Your principal place of business is in your home. (The rules for "principal place of business" are discussed in Chapter 30.) You can deduct the round-trip business-related local transportation expenses between your qualifying home office and your client's or customer's place of business. You must, however, distinguish between business and personal transportation.

Example 4. You have no regular office, and you do not have an office in your home. In this case, the location of your first business contact is considered your office. Transportation expenses between your home and this first contact are nondeductible commuting expenses. In addition, transportation expenses between your last business contact and your home are also nondeductible commuting expenses. Although you cannot deduct the costs of these first and last trips, you can deduct the costs of going from one client or customer to another.

Illustration of local transportation. *Figure 28–B* illustrates the rules for when you can deduct local transportation expenses when you have a regular or main job away from your residence. You may want to refer to it when deciding whether you can deduct your local business transportation expenses.

Temporary work location. If you have one or more regular places of business and commute to a temporary work location, you can deduct the expenses of the daily round-trip transportation between your residence and the temporary location. The temporary work must be irregular or short term (generally a matter of days or weeks).

If the temporary work location is beyond the general area of your regular place of work, and you stay overnight, you are traveling away from home and may have deductible travel expenses as discussed earlier in this chapter.

If you do not have a regular place of work, but you ordinarily work at different locations in the metropolitan area where you live, you can deduct daily transportation costs between your home and a temporary work site ***outside*** your metropolitan area. Generally, a metropolitan area includes the area within the city limits and the suburbs that are considered part of that metropolitan area. You cannot deduct daily transportation costs between your home and temporary work sites ***within*** your metropolitan area. These are nondeductible commuting costs.

Two places of work. If you work at two places in a day, whether or not for the same employer, you can deduct the expense of getting from one workplace to the other. However, if for some personal reason you do not go directly from one location to the other, you can deduct only the amount it would have cost you to go directly from the first location to the second. Transportation expenses you have in going between home and a part-time job on a day off from your main job are commuting expenses. You cannot deduct them.

Armed Forces reservists. A meeting of an Armed Forces reserve unit is considered a second place of business if the meeting is held on the same day as your regular job. You can deduct the expense of getting to or from one workplace to the other as just discussed under *Two places of work.* You usually cannot deduct the expense if the meeting is held on a nonworkday for your regular job. In this case, your transportation is generally considered a nondeductible commuting cost.

For reserve meetings held on nonworkdays, you can deduct your daily round-trip transportation expenses only if the location of the meeting is temporary and you have one or more regular places of work.

If you ordinarily work in a particular metropolitan area but not at any specific location and the reserve meeting is held at a temporary location outside that metropolitan area, you can deduct your daily transportation expenses.

If you travel away from home overnight to attend a guard or reserve meeting, you can deduct your travel expenses. These include the costs of your meals, lodging, and your round-trip transportation between your home and the meeting site. For more information, see *Travel Expenses,* earlier.

Car Expenses

If you use your car for business purposes, you may be able to deduct car expenses. You generally can use one of two methods to figure your expenses: actual expenses or the standard mileage rate.

You may be entitled to a tax credit for an electric vehicle or a deduction from gross income for a part of the cost of a clean-fuel vehicle if you place one of these vehicles in service from July 1, 1993, through December 31, 2004. The vehicle must meet certain requirements, and you do not have to use it in your business to qualify for the credit or the deduction. For more information, see Chapter 15 of Publication 535.

Car expense records. Whether you use actual expenses or the standard mileage rate, you must keep records to show when you started using your car for business and the cost or other basis of the car. Your records must also show the business miles and the total miles you drove your car during the year.

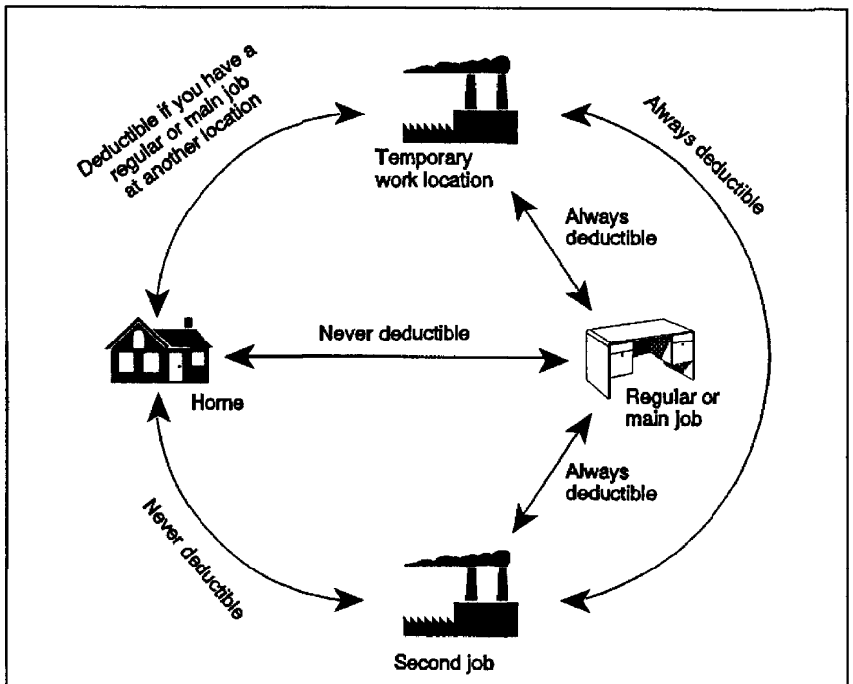
Actual expenses. If you deduct actual expenses, you must keep records of the costs of operating the car, such as car insurance, interest, taxes, licenses, maintenance, repairs, depreciation, gas, and oil. If you lease a car, you must also keep records of this cost.

Actual Expenses

If you choose to deduct actual expenses, you can deduct the cost of the following items:

Depreciation	Lease fees	Rental fees
Garage rent	Licenses	Repairs
Gas	Oil	Tires
Insurance	Parking fees	Tolls

Figure 28-B. When Are Local Transportation Expenses Deductible? (Do not use this chart if your home is your principal place of business. See *Office in the home.*)



Home: The place where you reside. Transportation expenses between your home and your main or regular place of work are personal commuting expenses.

Regular or main job: Your principal place of business. If you have more than one job, you must determine which one is your regular or main job. Consider the time you spend at each, the activity you have at each, and the income you earn at each.

Temporary work location: A place where your work assignment is irregular or short-term, generally a matter of days or weeks. Unless you have a regular place of business, you can only deduct your transportation expenses to a temporary location outside your metropolitan area.

Second job: If you regularly work at two or more places in one day, whether or not for the same employer, you can deduct your transportation expenses of getting from one workplace to another. You cannot deduct your transportation costs between your home and a second job on a day off from your main job.

Business and personal use. If you use your car for both business and personal purposes, you must divide your expenses between business and personal use.

Example. You are a contractor and drive your car 20,000 miles during the year: 12,000 miles for business use and 8,000 miles for personal use. You can claim only 60% (12,000 ÷ 20,000) of the cost of operating your car as a business expense.

Interest on car loans. If you are an employee, you cannot deduct any interest paid on a car loan. This interest is treated as personal interest and is not deductible. However, if you are self-employed and use your car in that business, see Chapter 8 of Publication 535.

Personal property taxes on your car. If you are an employee, you can deduct personal property taxes paid on your car if you itemize deductions. Enter the amount paid on line 7 of Schedule A (Form 1040). (See Chapter 24 for more information on taxes.)

You cannot deduct luxury or sales taxes, even if you use your car 100% for business. Luxury and sales taxes are part of your car's basis and may be recovered through depreciation.

If you are not an employee, see Chapter 9 of Publication 535 for information on taxes.

Fines and collateral. Fines and collateral for traffic violations are not deductible.

Leasing a car. If you lease a car that you use in your business, you can deduct the part of each lease payment that is for the use of the car in your business. You cannot deduct any part of a lease payment that is for commuting to your regular job or for any other personal use of the car.

You must spread any advance payments over the entire lease period. You cannot deduct any payments you make to buy a car even if the payments are called lease payments.

If you lease a car that you use in your business for 30 days or more, you may have to include in income an amount called an "inclusion amount." For more information, see Chapter 3 of Publication 917.

Depreciation and section 179 deductions. If you use your car for business purposes as an employee or as a sole proprietor, you may be able to recover its cost by claiming a depreciation or section 179 deduction. The amount you may claim depends on the year you placed the car in service and the amount of your business use.

For more information, see the instructions for Form 2106 (if you are an employee) or Form 4562 (if you are self-employed). Also see Chapter 2 of Publication 917 for a detailed discussion of these deductions.

Standard Mileage Rate

Instead of figuring actual expenses, you may be able to use the standard mileage rate to figure the deductible cost of operating your car, van, pickup, or panel truck for business purposes. You can use the standard mileage rate only for a car that you own. For 1994, the standard mileage rate is ***29 cents*** a mile for all business miles (43.5 cents a mile for U.S. Postal Service employees with rural routes). These rates are adjusted periodically for inflation.

If you choose to take the standard mileage rate, you ***cannot*** deduct actual operating expenses. These include depreciation, maintenance and repairs, gasoline (including gasoline taxes), oil, insurance, and vehicle registration fees.

You generally can use the standard mileage rate regardless of whether you are reimbursed and whether any reimbursement is more or less than the amount figured using the standard mileage rate. See *Reimbursements* later in this chapter.

Choosing the standard mileage rate. If you want to use the standard mileage rate for a car, you must choose to use it in the first year you place the car in service in business. Then in later years, you can choose to use the standard mileage rate or actual expenses.

If you choose to use the standard mileage rate, you are considered to have made an election not to use the depreciation methods under the modified accelerated cost recovery system (MACRS). This is because the standard mileage rate allows for depreciation. You also cannot claim the section 179 deduction. If you change to the actual expenses method in a later year, but before your car is considered fully depreciated, you have to estimate the useful life of the car and use straight line depreciation. For information on how to figure that depreciation, see the exception in *Methods of depreciation*

under *Depreciation Deduction* in Publication 917.

Standard mileage rate not allowed. You cannot use the standard mileage rate if you:

1) Do not own the car,
2) Use the car for hire (such as a taxi),
3) Operate two or more cars at the same time (as in fleet operations), or
4) Claimed a deduction for the car in an earlier year using:
   a) ACRS or MACRS depreciation, or
   b) A section 179 deduction.

Two or more cars. If you own two or more cars that are used for business at the same time, you cannot take the standard mileage rate for the business use of any car. However, you may be able to deduct a part of the actual expenses for operating each of the cars. See *Actual Car Expenses* in Chapter 2 of Publication 917 for information on how to figure your deduction.

You are ***not*** using two or more cars for business at the same time if you alternate using (use at different times) the cars for business.

The following examples illustrate the rules for when you can and cannot use the standard mileage rate for two or more cars.

Example 1. Marcia, a salesperson, owns a car and a van that she alternates using for calling on her customers. She can take the standard mileage rate for the business mileage of the car and the van.

Example 2. Tony uses his own pickup truck in his landscaping business. During 1994, he traded in his old truck for a newer one. Tony can take the standard mileage rate for the business mileage of both the old and the new truck.

Example 3. Chris owns a repair shop and an insurance business. He uses his pickup truck for the repair shop and his car for the insurance business. No one else uses either the pickup truck or the car for business purposes. Chris can take the standard mileage rate for the business use of the truck and the car.

Example 4. Maureen owns a car and a van that are both used in her housecleaning business. Her employees use the car and she uses the van to travel to the various customers. Maureen cannot take the standard mileage rate for the car or the van. This is because both vehicles are used in Maureen's business at the same time. She must use actual expenses for both vehicles.

Parking fees and tolls. In addition to using the standard mileage rate, you can deduct any business-related parking fees and tolls. (Parking fees that you pay to park your car at your place of work are nondeductible commuting expenses.)

Basis of car. If you used the standard mileage rate for the business use of your car, depreciation was included in that rate. The rate of depreciation that was allowed in the standard mileage rate is shown in the chart that follows. This depreciation reduces the basis of your car (but not below zero) in figuring its adjusted basis when you dispose of it.

Note. These rates do not apply for any year in which the actual cost method was used.

Year	Rate per Mile
1994	12 cents
1992 – 1993	11½ cents
1989 – 1991	11 cents
1988	10½ cents
1987	10 cents
1986	9 cents
1983 – 1985	8 cents
1982	7½ cents
1980 – 1981	7 cents

For tax years before 1990, the rates applied to the first 15,000 miles. For tax years after 1989, the depreciation rate applies to all business miles.

Example. In 1989, you bought a car for exclusive use in your business. The car cost $14,000. From 1989 through 1994, you used the standard mileage rate to figure your car expense deduction. You drove your car at least 15,000 business miles in 1989. You drove your car 20,000 miles in 1990, 18,750 miles in 1991, 17,200 miles in 1992, 18,100 miles in 1993, and 16,300 miles in 1994. The depreciation allowed is figured as follows:

Year	Miles × Rate	Amount
1989	15,000 × .11	$1,650
1990	20,000 × .11	2,200
1991	18,750 × .11	2,063
1992	17,200 × .115	1,978
1993	18,100 × .115	2,082
1994	16,300 × .12	1,956
Total		$11,929

At the end of 1994, your adjusted basis in the car is $2,071 ($14,000 – $11,929).

For more information on basis, see Chapter 14.

Recordkeeping

This section discusses the written records you need to keep if you plan to deduct an expense discussed in this chapter. By keeping timely and accurate records, you will have support to show the IRS if your tax return is ever examined. Or, your employer may require proof of expenses for which you are reimbursed under an accountable plan, as discussed later under *Adequate Accounting.*

Proof required. You must be able to prove (substantiate) your deductions for travel, entertainment, business gift, and local transportation expenses. You should keep adequate records or have sufficient evidence that will support your own statement. Estimates or approximations do not qualify as proof of an expense.

Timely recordkeeping. You do not need to write down the elements of every expense at the time of the expense. However, a record of the elements of an expense or of a business use made at or near the time of the expense or use, supported by sufficient documentary evidence, has more value than a statement prepared later when generally there is a lack of accurate recall. A log maintained on a weekly basis, which accounts for use during the week, is considered a record made at or near the time of the expense or use.

Duplicate information. You do not have to record information in your account book or other record that duplicates information shown on a receipt as long as your records and receipts complement each other in an orderly manner. You do not have to record amounts your employer pays directly for any ticket or other travel item. However, if you charge these items to your employer, through a credit card or otherwise, you must make a record of the amounts you spend.

Expense accounts. An expense account statement you give your employer, client, or customer is considered to have been made at or near the time of the expense or use. The statement must be copied from your account book, diary, statement of expense, or similar record.

Chart that shows proof required. *Table 28–2* summarizes the factors to use in proving the elements of your expenses for travel, entertainment, gifts, and local business transportation. These factors are discussed in more detail in Chapter 5 of Publication 463.

To deduct these expenses, you must be able to prove the elements listed in column 1 of the chart. You prove these elements by having the information and receipts (where required) for the expenses listed in columns 2, 3, 4, or 5, whichever apply.

Adequate records. You should keep the proof you need for these items in an account book, diary, statement of expense, or similar record, and keep adequate documentary evidence (such as receipts, canceled checks, or bills), that together will support each element of an expense. Documentary evidence is explained in more detail later in this discussion. Written evidence has considerably more value than oral evidence alone.

Separating expenses. Each separate payment usually is considered a separate expense. If you entertain a customer or client at dinner and then go to the theater, the dinner expense and the cost of the theater tickets are two separate expenses. You must record them separately in your records.

Totaling items. You may make one daily entry for reasonable categories of expenses such as taxi fares, telephone calls, gas and oil, or other incidental travel costs. Meals should be in a separate category. You

should include tips with the costs of the services you received.

Expenses of a similar nature occurring during the course of a single event are considered a single expense. For example, if during entertainment at a cocktail lounge, you pay separately for each serving of refreshments, the total expense for the refreshments is treated as a single expense.

Documentary evidence. You generally must have documentary evidence, such as receipts, canceled checks, or bills, to support your expenses. However, this evidence is not required if:

1) You have meals or lodging expenses while traveling away from home for which you account to your employer under an accountable plan and you use a per diem allowance method that includes meals and/or lodging,
2) You are reimbursed under a mileage allowance,
3) Your expense, other than lodging, is less than $25, ***or***
4) You have a transportation expense for which a receipt is not readily available.

Accountable plans and per diem and mileage allowances are discussed later under *Reimbursements.*

Adequate evidence. Documentary evidence ordinarily will be considered adequate if it shows the amount, date, place, and essential character of the expense.

For example, a hotel receipt is enough to support expenses for business travel if it has:

1) The name and location of the hotel,
2) The dates you stayed there, and
3) Separate amounts for charges such as lodging, meals, and telephone calls.

A restaurant receipt is enough to prove an expense for a business meal if it has:

1) The name and location of the restaurant,
2) The number of people served, and
3) The date and amount of the expense.

If a charge is made for items other than food and beverages, the receipt must show that this is the case.

Canceled check. A canceled check, together with a bill from the payee, ordinarily establishes the cost. However, a canceled check by itself does not prove a business expense without other evidence to show that it was for a business purpose.

Business purpose. A written statement of the business purpose of an expense is generally needed. However, the degree of proof varies according to the circumstances in each case. If the business purpose of an expense is clear from the surrounding circumstances, a written explanation is not needed.

Example. A sales representative who calls on customers on an established sales route does not have to submit a written explanation of the business purpose for traveling that route.

Confidential information. Confidential information relating to an element of a deductible expense, such as the place, business purpose, or business relationship, need not be put in your account book, diary, or other record. However, the information has to be recorded elsewhere at or near the time of the expense and be available to fully prove that element of the expense.

Inadequate records. If you do not have adequate records to prove an element of an expense, then you must prove the element by:

1) Your own statement, whether written or oral, that contains specific information about the element, and
2) Other supporting evidence that is sufficient to establish the element.

Additional information for the IRS. The IRS may require additional information to clarify or to establish the accuracy or reliability of information contained in your records, statements, testimony, or documentary evidence before a deduction is allowed.

How long to keep records and receipts. You must keep proof to support your claim to a deduction as long as your income tax return can be examined. Generally, it will be necessary for you to keep your records for 3 years from the date you file the income tax return on which the deduction is claimed. A return filed early is considered as filed on the due date.

Employees who give their records and documentation to their employers and are reimbursed for their expenses generally do not have to keep duplicate copies of this information. However, you may have to prove your expenses if:

1) You claim deductions for expenses that are more than reimbursements,
2) Your expenses are reimbursed under a nonaccountable plan,
3) Your employer does not use adequate accounting procedures to verify expense accounts, or
4) You are related to your employer, as defined earlier under *Standard Meal Allowance.*

See the next section, *How to Report,* for a discussion of reimbursements, adequate accounting, and nonaccountable plans.

Additional information. See Chapter 5 of Publication 463 for more information on recordkeeping, including a discussion on how to prove each type of expense discussed in this chapter.

How to Report

This section explains how to report on your tax return the expenses that are discussed in this chapter. It discusses reimbursements, including treatment of accountable and nonaccountable plans, adequate accounting, and per diem allowances. This section ends by showing you how to complete Form 2106.

Self-employed. If you are self-employed, you must report your income and expenses on Schedule C or C–EZ (Form 1040) if you are a sole proprietor, or on Schedule F (Form 1040) if you are a farmer. You do not use Form 2106 or Form 2106–EZ. See Publication 535 or Publication 225, *Farmer's Tax Guide,* and your form instructions for information on how to complete your tax return.

Both self-employed and an employee. If you are both self-employed and an employee, you must keep separate records for each business activity. Report your business expenses for self-employment on Schedule C, Schedule C–EZ, or on Schedule F, as discussed earlier. Report your business expenses for your work as an employee on Form 2106 or Form 2106–EZ, as discussed next.

Employees. If you are an employee, you generally must complete Form 2106 to deduct your travel, transportation, and entertainment expenses. However, you can use Form 2106–EZ instead of Form 2106 if you meet both of the following conditions.

1) You were not reimbursed for your expenses or, if you were reimbursed, the reimbursements were included in your income (box 1 of your Form W–2).
2) If you claim car expenses, you use the standard mileage rate.

For more information on how to report your expenses on Forms 2106 and 2106–EZ, see *Completing Forms 2106 and 2106–EZ,* later.

Gifts. If you did not receive any reimbursements (or the reimbursements were all included in box 1 of your Form W–2) and the only business expense you are claiming is for business gifts, do not complete Form 2106 or 2106–EZ. Instead, claim the amount of your deductible business gifts directly on Schedule A. Otherwise, you must complete Form 2106 or 2106–EZ.

Statutory employees. If you received a Form W–2 and the ''Statutory employee'' box in box 15 was checked, you report your income and expenses related to that income on Schedule C or C–EZ (Form 1040). Do not complete Form 2106 or Form 2106–EZ. See your Form 1040 instructions for more information.

Statutory employees include full-time life insurance salespersons, certain agent or commission drivers, traveling salespersons, and certain homeworkers.

Table 28-2. **Elements To Prove Certain Business Expenses**

Element to be proved (1)	Expense			
	Travel (2)	**Entertainment (3)**	**Gift (4)**	**Transportation (car) (5)**
Amount	Amount of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories, such as taxis, daily meals for traveler, etc.	Amount of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.	Cost of gift.	1) Amount of each separate expense including cost of the car, 2) Mileage for each business use of the car, and 3) Total miles for the tax year.
Time	Date you left and returned for each trip, and number of days for business.	Date of entertainment. For meals or entertainment directly before or after a business discussion, the date and duration of the business discussion.	Date of gift.	Date of the expense or use.
Place	Name of city or other designation.	Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. Place where business discussion was held if entertainment is directly before or after a business discussion.	Not applicable.	Name of city or other designation if applicable.
Description	Not applicable.	Not applicable.	Description of gift.	Not applicable.
Business Purpose	Business reason for travel or the business benefit gained or expected to be gained.	Business reason or the business benefit gained or expected to be gained. Nature of business discussion or activity.	Business reason for giving the gift or the business benefit gained or expected to be gained.	Business reason for the expense or use of the car.
Business Relationship	Not applicable.	Occupations or other information—such as names or other designations—about persons entertained that shows their business relationship to you. If all people entertained did not take part in business discussion, identify those who did. You must also prove that you or your employee was present if entertainment was a business meal.	Occupation or other information—such as name or other designation—about recipient that shows his or her business relationship to you.	Not applicable.

Unclaimed reimbursement. If you are entitled to a reimbursement from your employer but you do not claim it, you cannot claim a deduction for the expenses to which that reimbursement applies.

Reimbursement for personal expenses. If your employer reimburses you for nondeductible personal expenses, such as for vacation trips, you must report the reimbursement as wage income on your tax return. You cannot deduct personal expenses.

Reimbursements

This section explains what to do when you receive an advance or are reimbursed for any of the employee business expenses discussed in this chapter.

If you received an advance, allowance, or reimbursement for your expenses, how you report this amount and your expenses depends on whether the reimbursement was paid to you under an accountable plan or a nonaccountable plan.

This section explains the two types of plans, how per diem allowances simplify proving the amount of your expenses, and the tax treatment of your reimbursements and expenses.

Reimbursement, allowance, or advance. A reimbursement or other expense allowance arrangement is a system or plan that an employer uses to pay, substantiate, and recover the expenses, advances, reimbursements, and amounts charged to the employer for employee business expenses. It can also be a system used to keep track of amounts you receive from your employer's agent or a third party. Arrangements include per diem and mileage allowances. If a single payment includes both wages and an expense reimbursement, the amount of the reimbursement must be specifically identified.

Your employer has different options for reimbursing you for business-related travel expenses:

1) Reimbursing you for your actual expenses, as discussed throughout this chapter,
2) Reimbursing you for business use of your car:
   a) Based on your actual operating expenses, or
   b) Using a car or mileage allowance as discussed in Chapter 5 of Publication 917,
3) Using the meals only allowance (discussed later) to reimburse your meals and incidental expenses and reimbursing you for your actual lodging expenses,
4) Using the regular federal per diem rate (discussed later),

5) Using the high-low method (discussed later), or
6) Reimbursing you under any other method that is acceptable to the IRS.

Your employer should tell you what method of reimbursement is used and what records you must submit.

No reimbursement. If you are paid a salary or commission with the understanding that you will pay your own expenses, you are not reimbursed or given an allowance for your expenses. In this situation, you have no reimbursement or allowance arrangement, and you deduct your expenses using either Form 2106 or Form 2106–EZ and Schedule A (Form 1040), or only Schedule A (Form 1040) if you are only claiming business gift expenses. You do not have to read this section on reimbursements. Instead, see *Completing Forms 2106 and 2106–EZ,* later, for information on completing your tax return.

Accountable Plans

To be an accountable plan, your employer's reimbursement or allowance arrangement must include all three of the following rules:

1) Your expenses must have a business connection — that is, you must have paid or incurred deductible expenses while performing services as an employee of your employer,
2) You must adequately account to your employer for these expenses within a reasonable period of time, and
3) You must return any excess reimbursement or allowance within a reasonable period of time.

''Adequate accounting'' and ''returning excess reimbursements'' are discussed later.

An ***excess reimbursement or allowance*** is any amount you are paid that is more than the business-related expenses that you adequately accounted for to your employer. See *Returning Excess Reimbursements,* later, for information on how to handle these excess amounts.

Reasonable period of time. The definition of ''reasonable period of time'' depends on the facts of your situation. The IRS will consider it reasonable for you to:

1) Receive an advance within 30 days of the time you have an expense,
2) Adequately account for your expenses within 60 days after they were paid or incurred, and
3) Return any excess reimbursement within 120 days after the expense was paid or incurred.

If you are given a periodic statement (at least quarterly) that asks you to either return or adequately account for outstanding reimbursements and you comply within 120 days of the statement, the IRS will consider the amount adequately accounted for or returned within a reasonable period of time.

Employee meets accountable plan rules. If you meet the three rules for accountable plans, your employer should not include any reimbursements in your income in box 1 of your Form W–2. If your expenses equal your reimbursement, you do not complete Form 2106. You have no deduction since your expenses and reimbursement are equal.

Note: If your employer included reimbursements in box 1 of your Form W–2 and you meet all three rules for accountable plans, ask your employer for a corrected Form W–2.

Employee does not meet accountable plan rules. You may be reimbursed under your employer's accountable plan but only part of your expenses may meet all three rules.

If your expenses are reimbursed under an otherwise accountable plan but you do not return, within a reasonable period of time, any reimbursement of expenses for which you did not adequately account, then only the amount for which you did adequately account is considered as paid under an accountable plan. The remaining expenses are treated as having been reimbursed under a nonaccountable plan (discussed later).

If you received an allowance or advance that was higher than the federal rate, see *Returning Excess Reimbursements,* later.

Reimbursement of nondeductible expenses. You may be reimbursed under your employer's accountable plan for expenses related to that employer's business, some of which are deductible as employee business expenses and some of which are not deductible. The reimbursements you receive for the nondeductible expenses are treated as paid under a nonaccountable plan.

Example. Your employer's plan may reimburse you for travel expenses you incurred while away from home on business, and for meal expenses you paid when you work late at the office, even though you are not away from home. The part of the arrangement that reimburses you for the nondeductible meals while you work late at the office is treated as a second arrangement. The payments under this second arrangement are treated as paid under a nonaccountable plan.

Per diem allowances. If you are reimbursed by a per diem allowance (daily amount) that you received under an accountable plan, two facts affect your reporting:

1) The federal rate for the area where you traveled, and
2) Whether the allowance or your actual expenses were more than the federal rate.

For this purpose, the ***federal rate*** can be figured by using any one of three methods:

1) The regular federal per diem rate (discussed later in this chapter),
2) The high-low method (discussed later in this chapter), or
3) The standard meal allowance (discussed earlier under *What Are Travel Expenses?*).

The following discussions explain where to report your expenses depending upon how the amount of your per diem allowance compares to the federal rate.

Per diem allowance LESS than or EQUAL to the federal rate. If your per diem allowance is less than or equal to the federal rate, the allowance will not be included in boxes 1, 3, and 5 of your Form W–2. You do not need to report the related expenses or the per diem allowance on your return if your expenses are equal to or less than the allowance.

However, if your actual expenses (or your expenses using the standard meal allowance) are more than your per diem allowance, you can complete Form 2106 and deduct the excess amount on Schedule A (Form 1040). If you are using actual expenses, you must be able to prove to the IRS the total amount of your expenses and reimbursements for the entire year. If you are using the standard meal allowance, you do not have to prove that amount.

Example 1. In April Jeremy takes a 2-day business trip to Boston. The federal rate in Boston is $139 per day. As required by his employer's accountable plan, he accounts for the time (dates), place, and business purpose of the trip. His employer reimburses him $139 a day ($278 total) for living expenses. Jeremy's living expenses in Boston are not more than $139 a day.

Jeremy's employer does not include any of the reimbursement on his Form W–2. Jeremy does not deduct the expenses on his return.

Example 2. The facts in Matt's case are the same as those in *Example 1* above. However, Matt's employer uses the high-low method (discussed later) to reimburse employees. Since Boston is a high-cost area, Matt is given an advance of $152 a day ($304 total) for his lodging, meals, and incidental expenses. Matt's actual expenses totaled $390.

Matt is reimbursed under an accountable plan. However, since his $390 of expenses exceed his $304 advance, Matt itemizes his deductions on Schedule A (Form 1040) in order to claim the excess expenses. Matt completes Form 2106 (showing ***all*** of his expenses and reimbursements). He must also allocate his reimbursement between his meals and other expenses as discussed later under *Completing Forms 2106 and 2106–EZ.*

Per diem allowance MORE than the federal rate. If your per diem allowance is more than the federal rate, your employer is required to include the allowance amount up to the federal rate in box 13 (code **L**) of your

Form W–2. This amount is not taxable. However, the per diem allowance in excess of the federal rate will be included in box 1 (and in boxes 3 and 5 if applicable) of your Form W–2. You must report this part of your reimbursement as if it were wage income.

If your actual expenses are less than or equal to the federal rate, you do not complete Form 2106 or claim any of your expenses on your return.

However, if your actual expenses are more than the federal rate, you can complete Form 2106 and deduct those expenses that are more than the federal rate on Schedule A (Form 1040). You must report on Form 2106 your reimbursements up to the federal rate (as shown in box 13 of your Form W–2) and all your expenses. You should be able to prove these amounts to the IRS.

Example 1. Laura lives and works in Austin. Her employer sent her to Dallas for 2 days on business. Laura's employer paid the hotel directly for her lodging and reimbursed Laura $40 a day ($80 total) for meals and incidental expenses. Laura's actual meal expenses did not exceed the federal rate for Dallas, which is $34 per day.

Her employer included the $12 excess over the federal rate [($40 − $34) × 2] in boxes 1, 3, and 5 of Laura's Form W–2. Her employer shows $68 ($34 a day × 2) in box 13 of her Form W–2. This amount is not included in Laura's income. Laura does not have to complete Form 2106; however, she must include the $12 excess in her gross income as wages (by reporting the total amount shown in box 1 of her Form W–2).

Example 2. Joe also lives in Austin and works for the same employer as Laura. In May the employer sent Joe to Washington, DC, and paid the hotel directly for his hotel bill. The employer reimbursed Joe $45 a day for his meals and incidental expenses. The federal rate for Washington, DC, is $38 a day.

Joe can prove that his actual meal expenses totaled $120. His employer's accountable plan will not pay more than $45 a day for travel to Washington, DC, so Joe does not give his employer the records that prove that he actually spent $120. However, he does account for the time, place, and business purpose of the trip. This is Joe's only business trip in 1994.

Joe was reimbursed $90 ($45 × 2 days), which is $14 more than the federal rate of $76 ($38 × 2 days). The employer includes the $14 as income on Joe's Form W–2 in boxes 1, 3, and 5. The employer also enters $76 in box 13 of Joe's Form W–2, along with a code **L**.

Joe completes Form 2106 to figure his deductible expenses. He enters the total of his actual expenses for the year ($120) on Form 2106. He also enters the reimbursements that were not included in his income ($76). His total deductible expense, before the 50% limit, is $44. After he figures the 50% limit on his unreimbursed meals and entertainment, he will enter the balance, $22, on line 20 of Schedule A (Form 1040).

Table 28-3. **Reporting Travel, Entertainment, and Gift Expenses and Reimbursements**

Type of Reimbursement (or Other Expense Allowance) Arrangement	Employer Reports on Form W–2	Employee Shows on Form 2106[1]
Accountable		
Actual expense reimbursement Adequate accounting and excess returned	Not reported	Not shown if expenses do not exceed reimbursement
Actual expense reimbursement Adequate accounting and return of excess both required but excess not returned	Excess reported as wages in box 1.[2] Amount adequately accounted for is reported only in box 13—it is *not* reported in box 1.	All expenses (and reimbursements reported on Form W–2, box 13), *only* if some or all of the excess expenses are claimed.[3] Otherwise, form is not filed.
Per diem or mileage allowance (up to federal rate) Adequate accounting and excess returned	Not reported	All expenses and reimbursements *only* if excess expenses are claimed.[3] Otherwise, form is not filed.
Per diem or mileage allowance (exceeds federal rate) Adequate accounting up to the federal rate only and excess not returned	Excess reported as wages in box 1.[2] Amount up to the federal rate is reported only in box 13—it is *not* reported in box 1.	All expenses (and reimbursements equal to the federal rate) *only* if expenses in excess of the federal rate are claimed.[3] Otherwise, form is not filed.
Nonaccountable		
Either adequate accounting or return of excess, or both, not required by plan	Entire amount is reported as wages in box 1.[2]	All expenses[3]
No reimbursement	Normal reporting of wages, etc.	All expenses[3]

[1] You may be able to use Form 2106-EZ. See *Completing Forms 2106 and 2106-EZ*.

[2] Excess is also reported in boxes 3 and 5, if applicable.

[3] Any allowable business expense is carried to line 20 of Schedule A (Form 1040) and deducted as a miscellaneous itemized deduction.

Car or mileage allowances. How you report a car or mileage allowance that you received under an accountable plan depends on whether the reimbursement or your actual expenses were more than the standard mileage rate of 29 cents a mile for 1994. The standard mileage rate is considered to be the federal rate. If your allowance was equal to or less than 29 cents a mile, see *Per diem allowance LESS than or EQUAL to the federal rate,* earlier. If your allowance was more than 29 cents a mile, see *Per diem allowance MORE than the federal rate,* earlier.

Example 1. Nicole drives 10,000 miles a year for business. Under her employer's accountable plan, she accounts for the time (dates), place, and business purpose of each trip. Her employer pays her a mileage allowance of 29 cents a mile. Nicole's expenses of operating her car do not exceed 29 cents a mile.

Nicole's employer does not include any of the reimbursement on her Form W–2. Nicole does not deduct the expenses on her return because her expenses are not more than the allowance she received.

Example 2. The facts are the same as in *Example 1,* except Nicole gets reimbursed 35 cents a mile, which is 6 cents a mile more than the standard mileage rate. Her employer must include the reimbursement amount up to the standard mileage rate, $2,900 (10,000 miles × 29 cents), in box 13 (code **L**) of her Form W–2. That amount is not taxable.

Nicole's employer must also include $600 (10,000 miles × 6 cents) in box 1 (and boxes 3 and 5, if applicable) of her Form W–2. This is the reimbursement in excess of the standard mileage rate. Nicole must include the $600 in her wage income. Because her reimbursement is equal to or more than her expenses, Nicole does not complete Form 2106.

Employer's plan. The employer makes the decision whether to reimburse employees under an accountable plan or a nonaccountable plan. If you are an employee who receives payments under a nonaccountable plan, you cannot convert these amounts to payments under an accountable plan by voluntarily accounting to your employer for the expenses and voluntarily returning excess reimbursements to the employer.

Adequate Accounting

One of the three rules (listed earlier) for a reimbursement or other expense allowance arrangement to qualify as an accountable plan was that you adequately account to your employer for your expenses. You adequately account by giving your employer documentary evidence of your mileage, travel, and other employee business expenses, along with a statement of expense, an account book, a diary, or a similar record in which you entered each expense at or near the time you had it. Documentary evidence includes receipts, canceled checks, and bills. See *Recordkeeping,* earlier, for a discussion of the aspects or elements of each expense that you must prove.

You must account for ***all*** amounts received from your employer during the year as advances, reimbursements, or allowances for business use of your car, travel, entertainment, gifts, or any other expenses. This includes amounts that were charged to your employer by credit card or other method. You must give your employer the same type of records and supporting information that you would have to give to the IRS if the IRS questioned a deduction on your return. You must pay back the amount of any reimbursement or other expense allowance for which you do not adequately account or that exceeds the amount for which you accounted.

Per diem allowance or reimbursement. You may be able to prove the amount of your travel expenses by using a per diem allowance amount. If your employer reimburses you for your lodging, meals, and incidental expenses at a fixed amount per day of business travel, that amount is called a per diem allowance.

The term ''incidental expenses'' includes, but is not limited to, laundry expenses, cleaning and pressing expenses, and fees and tips for persons who provide services, such as food servers and luggage handlers. Incidental expenses do not include taxicab fares or the costs of telegrams or telephone calls.

A per diem allowance satisfies the adequate accounting requirements for the amount in question if:

1) Your employer reasonably limits payments of the travel expenses to those that are ordinary and necessary in the conduct of the trade or business,
2) The allowance is similar in form to and not more than the federal per diem (that is, your allowance varies based on where and how long you were traveling),
3) You are not related to your employer (as defined earlier under *Standard Meal Allowance),* and
4) The time, place, and business purpose of the travel are proved, as explained earlier under *Recordkeeping.*

If the IRS finds that an employer's travel allowance practices are not based on reasonably accurate estimates of travel costs, including recognition of cost differences in different areas, you will not be considered to have accounted to your employer. In this case, you may be required to prove your expenses to the IRS.

Allowance for meals. These rules also apply if you are reimbursed only for your meal expenses or get a separate per diem allowance for meals and incidental expenses. Your reimbursement or allowance must not be more than the standard meal allowance. A per diem allowance is paid separately for meals and incidental expenses if your employer furnishes lodging in kind, pays you a meal allowance plus the actual cost of your lodging, or pays the hotel, motel, etc. directly for your lodging. A per diem allowance is also paid separately for meals and incidental expenses if your employer does not have a reasonable belief that you incurred lodging expenses, such as when you stay with friends or relatives or sleep in the cab of your truck.

Proving your expenses with a per diem allowance. If your employer pays for your expenses using a per diem allowance, including a meals only allowance, you can generally use the allowance as proof for the amount of your expenses. However, the amount of expense that can be proven this way cannot be more than the regular federal per diem rate or the high-low method, both discussed later.

The per diem allowance can only be used as proof of the cost of meals and/or lodging under the adequate accounting requirements. You must still provide other proof of the time, place, and business purpose for each expense.

Regular federal per diem rate. The regular federal per diem rate is the highest amount that the federal government will pay to its employees for lodging, meals, and incidental expenses (or meals and incidental expenses only) while they are traveling away from home in a particular area. The rates are different for different locations. You must use the rate in effect for the area where you stop for sleep or rest. Your employer should have these rates available. (Employers can get Publication 1542, *Per Diem Rates,* which gives the rates in the continental United States for the current year.)

The federal rates for meals and incidental expenses are the same as those rates discussed earlier under *Standard Meal Allowance.*

High-low method. This is a simplified method of computing the federal per diem rate for travel within the continental United States. It eliminates the need to keep a current list of the per diem rate in effect for each city in the continental United States.

Under the high-low method, the per diem amount for travel on or after January 1, 1994, is $152 for certain locations. All other areas have a per diem amount of $95. The areas eligible for the $152 per diem amount under the high-low method for all of the year or the portion of the year specified in parentheses under the key city name are listed in *Table 6* in Publication 463.

Allocation of per diem on partial days of travel. The federal per diem rate or the federal meals and incidental expenses is for a full 24-hour day of travel. If you travel for part of a day, the full day rate must be allocated. You can use either of the following methods to figure the federal per diem rate for that day.

1) Count one-fourth of the federal rate for each 6-hour quarter of the day during any portion of which you are traveling away from home for business. The 6-hour quarters are midnight to 6 a.m.; 6 a.m. to noon; noon to 6 p.m.; and 6 p.m. to midnight.
2) Prorate the federal rate using any method that is consistently applied and is in accordance with reasonable business practice. For example, an employer can treat 2 full days of per diem paid for travel away from home from 9 a.m. of one day to 5 p.m. of the next day as being no more than the federal rate. This is true even though a federal employee would be limited to a reimbursement for only 1½ days.

These rules apply whether your employer uses the regular federal per diem rate or the high-low method.

Car or mileage allowance. A car or mileage allowance satisfies the adequate accounting requirements for the amount if:

1) Your employer reasonably limits payments of the car expenses to those that are ordinary and necessary in the conduct of the trade or business,
2) The allowance is paid at the standard mileage rate, at another rate per mile, or other acceptable method, and
3) You prove the time (dates), place, and business purpose of using your car to your employer within a reasonable period of time.

If your employer pays for your expenses using a car or mileage allowance, you can generally use the allowance as proof for the amount of your expenses. However, the amount of expense that can be proven this way cannot be more than the standard mileage rate or the amount of the fixed and variable rate allowance that your employer does ***not*** include in boxes 1, 3, and 5 of your Form W–2.

Only the amount can be proven under the adequate accounting requirements. You must still prove the time (dates), place, and business purpose for each expense.

Returning Excess Reimbursements

Under an accountable plan, you must be required to return any excess reimbursement for your business expenses to the person paying the reimbursement or allowance. ***Excess reimbursement*** means any amount for which you did not adequately account within a reasonable period of time. For example, if you received a travel advance and you did not spend all the money on business-related expenses, or if you do not have proof of all your expenses, you have an excess reimbursement.

''Adequate accounting'' and ''reasonable period of time'' were discussed earlier.

Travel advance. If your employer provides you with an expense allowance before you actually have the expense, and the allowance is reasonably calculated not to exceed your expected expenses, you have received a travel advance. Under an accountable plan, you must be required to adequately account to your employer for this advance and be required to return any excess within a reasonable period of time. See *Reasonable period of time,* earlier. If you do not adequately account for or do not return any excess advance within a reasonable period of time, the amount you do not account for or return will be treated as having been paid under a nonaccountable plan (discussed later).

Unproven amounts. If you do not prove that you actually traveled on each day for which you received a per diem or mileage allowance (proving the elements described earlier under *Recordkeeping*), you must return this unproven amount of the travel advance within a reasonable period of time. If you fail to do this, your employer will include as income in boxes 1, 3, and 5 of your Form W–2 the unproven amount of per diem allowance as excess reimbursement. This unproven amount is considered paid under a nonaccountable plan (discussed later).

Per diem MORE than federal rate. If your employer's accountable plan pays you a per diem or similar allowance that is higher than the federal rate for the area you traveled to, you do not have to return the difference between the two rates for the period you can prove business-related travel expenses. However, the difference will be reported as wages on your Form W–2. This excess amount is considered paid under a nonaccountable plan (discussed later).

Example. Your employer sends you on a 5-day business trip to Miami and gives you a $200 ($40 × 5 days) advance to cover your meals and incidental expenses. The federal per diem for meals and incidental expenses in Miami is $34. Your trip lasts only 3 days. Under your employer's accountable plan, you must return the $80 ($40 × 2 days) advance for the 2 days you did not travel. You do not have to return the $18 difference [($40 – $34) × 3 days]. However, the $18 will be reported on your Form W–2 as wages.

Nonaccountable Plans

A ***nonaccountable plan*** is a reimbursement or expense allowance arrangement that does not meet the three rules listed earlier under *Accountable Plans.*

In addition, the following payments made under an accountable plan will be treated as being paid under a nonaccountable plan:

1) Excess reimbursements you fail to return to your employer, and
2) Reimbursements of nondeductible expenses related to your employer's business. See *Reimbursement of nondeductible expenses* earlier under *Accountable Plans.*

If you are not sure if the reimbursement or expense allowance arrangement is an accountable or nonaccountable plan, see your employer.

Your employer will combine the amount of any reimbursement or other expense allowance paid to you under a nonaccountable plan with your wages, salary, or other compensation. Your employer will report the total in box 1 (and boxes 3 and 5 if they apply) of your Form W–2.

You must complete Form 2106 or 2106–EZ and itemize your deductions on Schedule A (Form 1040) to deduct your expenses for travel, transportation, meals, or entertainment. Your meal and entertainment expenses will be subject to the 50% limit discussed earlier under *Entertainment Expenses.* Also, your total expenses will be subject to the 2% of adjusted gross income limit that applies to most miscellaneous itemized deductions. This 2% limit is figured on line 25 of Schedule A (Form 1040).

Example. Kim's employer gives her $500 a month, $6,000 total this year, for her business expenses. Kim does not have to provide any proof of her expenses to her employer, and Kim can keep any funds that she does not spend.

Kim is being reimbursed under a nonaccountable plan. Her employer will include the $6,000 on Kim's Form W–2 as if it were wages. If Kim wants to deduct her business expenses, she must complete Form 2106 or Form 2106–EZ and itemize her deductions on Schedule A (Form 1040). The 50% limit applies to her meal and entertainment expenses, and the 2% of adjusted gross income limit applies to her total employee business expenses.

Part of reimbursement paid under accountable plan. If your expenses are reimbursed under an otherwise accountable plan but you do not return, within a reasonable period of time, any reimbursement for which you do not adequately account, only the amount for which you do not adequately account is considered as paid under a nonaccountable plan. The remainder is treated as having been paid under an accountable plan (as discussed earlier).

Completing Forms 2106 and 2106–EZ

This section briefly describes how employees complete Forms 2106 and 2106–EZ. *Table 28–3* explains what the employer reports on Form W–2 and what the employee reports on Form 2106. The *Instructions for Form 2106* have more information on completing the form.

Form 2106–EZ. You may be able to use new Form 2106–EZ to claim your employee business expenses. You qualify to use this form if you meet both of the following conditions.

1) You were not reimbursed for your expenses or, if you were reimbursed, the reimbursement was included in your income (box 1 of your Form W–2).
2) If you claimed car expenses, you use the standard mileage rate.

Car expenses. If you used a car or other vehicle to perform your job as an employee, you may be able to deduct certain vehicle expenses. Vehicle expenses are generally figured in Part II of Form 2106, and then claimed on line 1, Column A, of Part I of Form 2106. Vehicle expenses using the standard mileage rate can also be figured on Form 2106–EZ by completing Part III and line 1 of Part II.

Local transportation expenses. Show your local business transportation expenses that did not involve overnight travel on line 2, Column A, of Form 2106 or on line 2, Part II of Form 2106–EZ. Also include on this line business expenses you have for parking fees and tolls. Do not include expenses of operating your car or expenses of commuting between your home and work.

Employee business expenses other than meals and entertainment. Show your other employee business expenses on lines 3 and 4, Column A, of Form 2106 or Form 2106–EZ. Do not include expenses for meals and entertainment on those lines. Line 4 is for expenses such as business gifts, educational expenses (tuition and books), office-in-the-home expenses, and trade and professional publications.

Note: If these are the only expenses you are claiming and you received no reimbursements (or the reimbursements were all included in box 1 of your Form W–2), do not complete Form 2106 or 2106–EZ. Instead, claim these amounts directly on Schedule A. List the type and amount of each expense on the dotted lines next to line 20 and include the total on line 20.

Meal and entertainment expenses. Show the full amount of your expenses for business-related meals and entertainment on line 5, Column B, of Form 2106. Include

meals you paid for while away from your tax home overnight and other business meals and entertainment. Enter 50% of the line 8 meal and entertainment expenses on line 9 in Column B, of Form 2106.

If you file Form 2106–EZ, enter the full amount of your meals and entertainment on the line to the left of line 5 and multiply the total by 50%. Enter the result on line 5.

Reimbursements. Enter on line 7 of Form 2106 the amounts your employer (or third party) reimbursed you for employee business expenses that were ***not*** included in box 1 of your Form W–2. (You cannot use Form 2106–EZ.) This includes any reimbursement reported under code **L** in box 13 of Form W–2.

Allocating your reimbursement. If you were reimbursed under an accountable plan and want to deduct excess expenses that were not reimbursed, you may have to allocate your reimbursement. If your employer paid you a single amount that covers meals or entertainment, as well as other business expenses, you must allocate the reimbursement so that you know how much to enter in Column A and Column B of line 7 of Form 2106.

Use the following worksheet to allocate your reimbursement.

1. Enter the total amount of the reimbursements your employer gave you that **were not** reported to you in box 1 of your Form W–2 ..... _____
2. Enter the total amount of your expenses for the periods covered by this reimbursement ..... _____
3. Of the amount on line 2, enter the part of your total expense for meals and entertainment ..... _____
4. Divide line 3 by line 2. Enter the result as a decimal (to at least two places) _____
5. Multiply line 1 by line 4. Enter the result here and in Column B, line 7 _____
6. Subtract line 5 from line 1. Enter the result here and in Column A, line 7 _____

Example. Assume your employer paid you an expense allowance of $5,000 during 1994 under an accountable plan. It is not clear how much of the allowance is for the cost of deductible meals. You actually spent $6,500 during the year ($2,000 for meals and $4,500 for automobile expenses). First, divide your meal expenses by your total expenses ($2,000 ÷ $6,500). The result is .31. Multiply your reimbursement by this decimal ($5,000 × .31). The result is $1,550 (the amount of reimbursement attributable to your meals). Enter this amount on line 7, Column B, of Form 2106. Enter the remainder of the reimbursement, $3,450 ($5,000 – $1,550), on line 7, Column A of Form 2106.

Schedule A (Form 1040). After you have completed your Form 2106 or 2106–EZ, follow the directions on that form to deduct your expenses on the appropriate line of your tax return. For most taxpayers this is on line 20 of Schedule A (Form 1040). However, if you are a performing artist or a disabled employee with impairment-related work expenses, see *Special Rules,* later.

Limits on employee business expenses. Your employee business expenses may be subject to any of the three limits described below. These limits are figured in the following order on the form specified.

1. Limit on meals and entertainment. Certain meal and entertainment expenses are subject to a 50% limit. Employees figure this limit on line 9 of Form 2106 or line 5 of Form 2106–EZ. See *50% Limit* under *Entertainment Expenses,* earlier.

2. Limit on employee business expenses. Employees deduct employee business expenses (as figured on Form 2106 or 2106–EZ) on line 20 of Schedule A (Form 1040). Most miscellaneous itemized deductions, including employee business expenses, are subject to a 2% of adjusted gross income limit. This limit is figured on line 25 of Schedule A.

3. Limit on total itemized deductions. If your adjusted gross income (line 32 of Form 1040) is more than $111,800 ($55,900 if you are married filing separately), the amount of your overall itemized deductions, including employee business expenses, may be limited. See Chapter 22 for more information on this limit.

Special Rules

This section discusses special rules that apply only to performing artists and disabled employees with impairment-related work expenses.

Expenses of certain performing artists. If you are a performing artist, you may qualify to deduct your employee business expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. To qualify, you must meet ***all*** of the following requirements.

1) During the tax year, you perform services in the performing arts for at least two employers.
2) You receive at least $200 each from any two of these employers.
3) Your related performing-arts business expenses are more than 10% of your gross income from the performance of such services.
4) Your adjusted gross income is not more than $16,000 before deducting these business expenses.

Special rules for married persons. If you are married, you must file a joint return unless you lived apart from your spouse at all times during the tax year.

If you file a joint return, you must figure requirements (1), (2), and (3) separately for both you and your spouse. However, requirement (4) applies to your and your spouse's combined adjusted gross income.

Where to report. If you meet all of the above requirements, you should first complete Form 2106 or 2106–EZ. Then you include your performing-arts-related expenses from line 10 of Form 2106 or line 6 of Form 2106–EZ in the total on line 30 of Form 1040. Write ''QPA'' and the amount of your performing-arts-related expenses on the dotted line next to line 30 of Form 1040.

If you do not meet all of the above requirements, you do not qualify to deduct your expenses as an adjustment to gross income. Instead, you must complete Form 2106 or 2106–EZ and deduct your employee business expenses on line 20 of Schedule A (Form 1040).

Expenses of disabled employees. If you are an employee with a physical or mental disability, your impairment-related work expenses are not subject to the 2% of adjusted gross income limit that applies to most other employee business expenses. After you complete Form 2106 or 2106–EZ, enter your impairment-related work expenses from line 10 of Form 2106 or line 6 of Form 2106–EZ on line 28 of Schedule A (Form 1040). Enter your employee business expenses that are ***unrelated*** to your disability from line 10 of Form 2106 or line 6 of Form 2106–EZ on line 20 of Schedule A.

Impairment-related work expenses are your allowable expenses for attendant care at your workplace and other expenses you have in connection with your workplace that are necessary for you to be able to work. For more information, see Chapters 23 and 30.

Illustrated Example

Bill Wilson is an employee of Fashion Clothing Co. in Manhattan, NY. In a typical week, Bill leaves his home on Long Island on Monday morning and drives to Albany to exhibit the Fashion line for 3 days to prospective customers. Then he drives to Troy to show X Department Store, an old customer, Fashion's new line of merchandise. While in Troy, he talks with Tom Brown, purchasing agent for X Department Store, to discuss the new line. He later takes John Smith of Y Co., Troy, out to dinner to discuss Y Co.'s buying Fashion's new line of clothing.

Bill uses the standard mileage rate for car expense purposes. He records his total mileage, business mileage, parking fees, and tolls for the year. Bill timely records his expenses and other pertinent information in a travel expense log (not shown). He obtains receipts for his expenses for lodging and for any other expenses of $25 or more.

During the year, Bill drove a total of 25,000 miles of which 20,000 miles were for business. Following the instructions for Part II of Form 2106, he answers all the questions and figures his vehicle expense to be $5,800 (20,000 business miles × 29 cents standard mileage rate).

His total employee business expenses are shown in the following table.

Type of Expense	Amount
Parking fees and tolls	$ 400
Vehicle expenses	5,800
Meals	2,632
Lodging, laundry, cleaning	10,000
Entertainment	1,870
Gifts, education, etc.	400
Total	**$21,102**

Bill received a reimbursement of $300 per month to help offset his car expenses. The reimbursement was figured at 25 cents per mile for up to 1,200 miles. Bill accounted to his employer for at least 1,200 business miles each month, and he received $3,600 in reimbursements for 1994. Because the reimbursement was less than the standard mileage rate, Bill's employer did not include the $3,600 in box 1 of Bill's Form W–2.

Bill files Form 2106 with his tax return. His filled-in form is shown at the end of this chapter.

Form **2106**

Department of the Treasury
Internal Revenue Service (1)

Employee Business Expenses

▶ See separate instructions.

▶ Attach to Form 1040.

OMB No. 1545-0139

1994

Attachment Sequence No. **54**

Your name	Social security number	Occupation in which expenses were incurred
Bill Wilson	555 00 5555	Sales

Part I **Employee Business Expenses and Reimbursements**

STEP 1 Enter Your Expenses		Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29	1	5,800	
2 Parking fees, tolls, and transportation, including train, bus, etc., that **did not** involve overnight travel	2	400	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. **Do not** include meals and entertainment	3	10,000	
4 Business expenses not included on lines 1 through 3. **Do not** include meals and entertainment	4	400	
5 Meals and entertainment expenses (see instructions)	5		4,502
6 **Total expenses.** In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6	16,600	4,502

Note: *If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.*

STEP 2 Enter Amounts Your Employer Gave You for Expenses Listed in STEP 1

7 Enter amounts your employer gave you that were **not** reported to you in box 1 of Form W-2. Include any amount reported under code "L" in box 13 of your Form W-2 (see instructions)	7	3,600	-0-

STEP 3 Figure Expenses To Deduct on Schedule A (Form 1040)

8 Subtract line 7 from line 6	8	13,000	4,502
Note: *If **both columns** of line 8 are zero, **stop here.** If Column A is less than zero, report the amount as income on Form 1040, line 7.*			
9 In Column A, enter the amount from line 8 (if zero or less, enter -0-). In Column B, multiply the amount on line 8 by 50% (.50)	9	13,000	2,251
10 Add the amounts on line 9 of both columns and enter the total here. **Also, enter the total on Schedule A (Form 1040), line 20.** (Qualified performing artists and individuals with disabilities, see the instructions for special rules on where to enter the total.) ▶	10		15,251

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11700N Form **2106** (1994)

Part II Vehicle Expenses (See instructions to find out which sections to complete.)

Section A.—General Information		(a) Vehicle 1	(b) Vehicle 2
11 Enter the date vehicle was placed in service	11	1 / 2 / 92	/ /
12 Total miles vehicle was driven during 1994	12	25,000 miles	miles
13 Business miles included on line 12	13	20,000 miles	miles
14 Percent of business use. Divide line 13 by line 12	14	80 %	%
15 Average daily round trip commuting distance	15	10 miles	miles
16 Commuting miles included on line 12	16	2,600 miles	miles
17 Other personal miles. Add lines 13 and 16 and subtract the total from line 12	17	2,400 miles	miles

18 Do you (or your spouse) have another vehicle available for personal purposes? ☑ Yes ☐ No

19 If your employer provided you with a vehicle, is personal use during off duty hours permitted? ☐ Yes ☐ No ☑ Not applicable

20 Do you have evidence to support your deduction? ☑ Yes ☐ No

21 If "Yes," is the evidence written? ☑ Yes ☐ No

Section B.—Standard Mileage Rate (Use this section only if you own the vehicle.)

22 Multiply line 13 by 29¢ (.29). Enter the result here and on line 1. (Rural mail carriers, see instructions.) 22 5,800

Section C.—Actual Expenses		(a) Vehicle 1	(b) Vehicle 2
23 Gasoline, oil, repairs, vehicle insurance, etc.	23		
24a Vehicle rentals	24a		
b Inclusion amount (see instructions)	24b		
c Subtract line 24b from line 24a	24c		
25 Value of employer-provided vehicle (applies only if 100% of annual lease value was included on Form W-2—see instructions)	25		
26 Add lines 23, 24c, and 25	26		
27 Multiply line 26 by the percentage on line 14	27		
28 Depreciation. Enter amount from line 38 below	28		
29 Add lines 27 and 28. Enter total here and on line 1	29		

Section D.—Depreciation of Vehicles (Use this section only if you own the vehicle.)

		(a) Vehicle 1	(b) Vehicle 2
30 Enter cost or other basis (see instructions)	30		
31 Enter amount of section 179 deduction (see instructions)	31		
32 Multiply line 30 by line 14 (see instructions if you elected the section 179 deduction)	32		
33 Enter depreciation method and percentage (see instructions)	33		
34 Multiply line 32 by the percentage on line 33 (see instructions)	34		
35 Add lines 31 and 34	35		
36 Enter the limitation amount from the table in the line 36 instructions	36		
37 Multiply line 36 by the percentage on line 14	37		
38 Enter the **smaller** of line 35 or line 37. Also, enter this amount on line 28 above	38		

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29.

Employee's Educational Expenses

Important Reminders

Employer-provided educational assistance. The exclusion from income of up to $5,250 of employer-provided educational assistance under a qualified plan had expired for amounts paid after June 30, 1992. The exclusion has been reinstated and applies to payments made through December 31, l994.

For tax years beginning after December 31, 1988, amounts paid or incurred by your employer for your education or training that do not qualify as educational assistance may still be excludable from your income. You may exclude these amounts if (and only if) the expense would have been a deductible employee business expense had you paid it.

These changes may entitle you to a refund of income, social security, and Medicare taxes. For more information, see the discussion beginning with *Refund procedure for employees* under *Expenses Relating to Tax-Exempt Income,* later.

Limit on itemized deductions. If your adjusted gross income is more than $111,800 ($55,900 if you are married filing separately), the overall amount of your itemized deductions may be limited. See Chapter 22 if you need more information about this limit.

Introduction

This chapter discusses how employees deduct their costs of work-related education. To figure the deduction, you must know:

- Whether the courses qualify,
- What expenses are deductible, and
- How to report the expenses.

First, you must determine whether the courses you are taking are qualifying courses. Not all courses are qualifying education. Courses must meet certain requirements before the related expenses can be deducted. This is explained under *Qualifying Education.*

If your courses qualify, you can then determine which expenses qualify to be deducted. Only certain expenses of education are deductible. This is explained under *What Educational Expenses Are Deductible.*

If you know which expenses qualify, you can then determine how to report those educational expenses. You may not be able to fully deduct all of your expenses. This is explained under *How to Report Educational Expenses.*

Useful Items

You may want to see:

Publication

❑ **508** Educational Expenses

Form (and Instructions)

❑ **2106** Employee Business Expenses

Qualifying Education

Education must meet certain requirements before the expenses of that education can be deducted. If these requirements are met, the education is qualifying education. You may be able to deduct the costs of qualifying education even though the education may lead to a degree.

Requirements. The education must:

1) Be required by your employer or the law to keep your present salary, status, or job (and serve a business purpose of your employer), or
2) Maintain or improve skills needed in your present work.

Exception. Even if your education meets one of the requirements above, it is not qualifying education if it:

1) Is needed to meet the minimum educational requirements of your present trade or business, or
2) Is part of a program of study that can qualify you for a new trade or business, even if you have no plans to enter that trade or business.

See *Nonqualifying Education,* later.

Present work. Your education must relate to your present work. Education that will relate to work you may enter in the future is not qualifying education. Education that prepares you for a future occupation includes any education that keeps you up-to-date for a return to work or that qualifies you to reenter a job you had in the past.

Temporary absence. If you stop work for a year or less and then go back to the same kind of work, your absence is ordinarily considered temporary. Education during a vacation, temporary leave, or other temporary absence from your job is considered related to your present job. However, after your temporary absence you must return to the same kind of work.

Example. You quit your biology research job to become a full-time biology graduate student for one year. If you return to work in biology research after completing the courses, the education is related to your present work. You may even choose to take a similar job with another employer.

Education Required by Employer or by Law

Once you have met the minimum educational requirements for your job, your employer or a law may require you to get more education. This additional education must be required for you to keep your present salary, status, or job. It must serve a business purpose of your employer and not be part of a program that will qualify you for a new trade or business.

When you take more education than your employer or the law requires, the additional education is qualifying only if it maintains or improves skills required in your present work. See *Education to Maintain or Improve Skills,* later.

Example. You are a teacher who has satisfied the minimum requirements for teaching. Your employer requires you to take an additional college course each year to keep your teaching job. You take a course and pay for it yourself. This is qualifying education even if you eventually receive a master's degree and an increase in salary because of this extra education.

Education to Maintain or Improve Skills

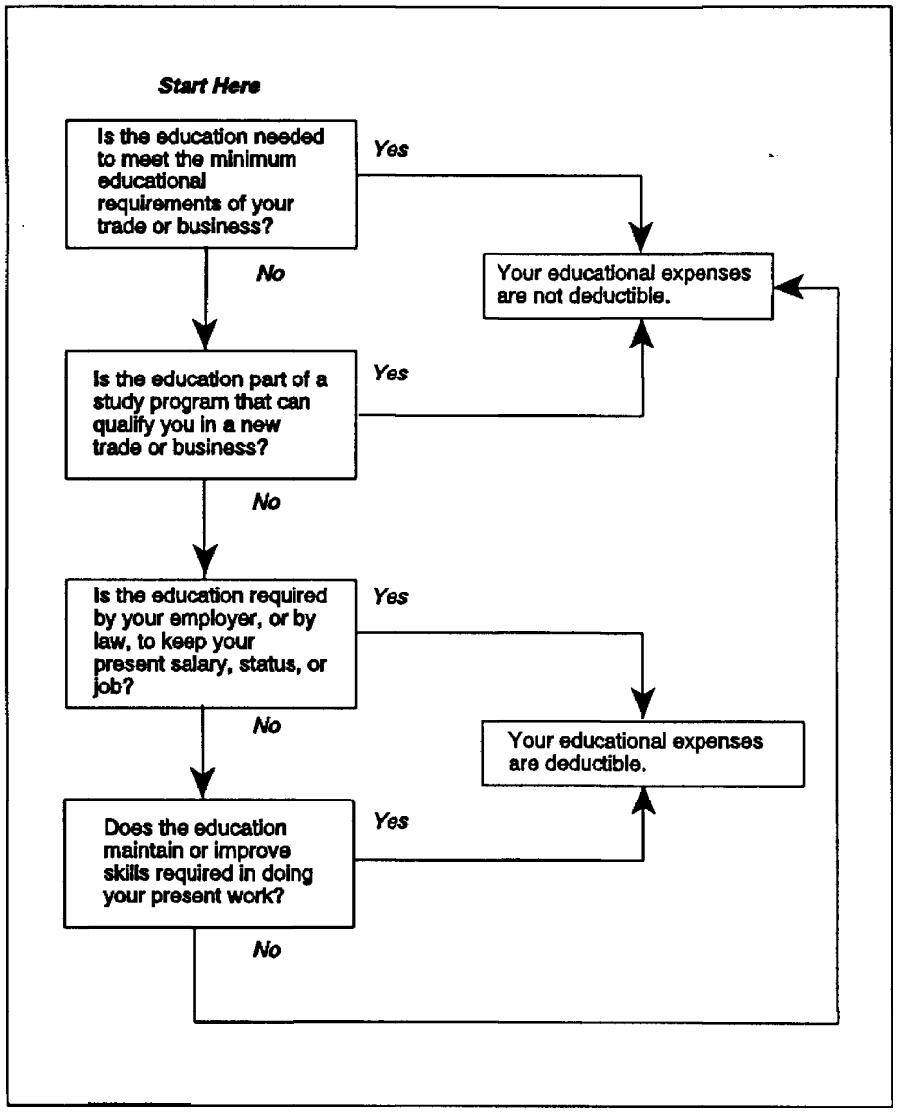
If your education is not required by your employer or a law, it must maintain or improve skills needed in your job to be qualifying education. This includes refresher courses, courses on current developments, and academic or vocational courses. However, courses you take that are needed to meet the minimum educational requirements for your job or to qualify you for a new trade or business are not qualifying education. See *Education to Qualify for a New Trade or Business,* later.

Example. You repair televisions, radios, and stereo sets for XYZ Store. To keep up with the latest changes, you take special courses in radio and stereo service. These courses maintain and improve skills required in your work.

Nonqualifying Education

If you need education to meet the minimum requirements for a trade or business or if the education is part of a program of study that will qualify you for a new trade or business, it is nonqualifying education. You cannot deduct the costs of nonqualifying education. Education that is nonqualifying is explained below.

Figure 29-A. Are Your Educational Expenses Deductible?



Education to Meet Minimum Requirements

Education needed to meet the minimum educational requirements for your present trade or business is nonqualifying education. The minimum education necessary is determined by:

1) Laws and regulations,
2) Standards of your profession or business, and
3) Your employer's requirements.

You have not necessarily met the minimum educational requirements of your trade or business simply because you are already doing the work.

Once you have met the minimum educational requirements that were in effect when you were hired, you do not have to satisfy this rule again. This means that if the minimum requirements change, any education you need to meet the new requirements is qualifying education.

Example 1. You are a full-time engineering student. You work part time as an engineer for a firm that will employ you full time as an engineer after you finish college. Although your college engineering courses improve your skills in your present job, you have not met the minimum job requirements for a full-time engineer. The education is nonqualifying education.

Example 2. You are an accountant and you have met the minimum educational requirements of your employer. Your employer later changes the minimum educational requirements and requires you to take college courses to keep your job. These additional courses are not minimum requirements because you already have satisfied the initial minimum requirements. The education is qualifying education.

However, a new accountant coming into the firm would have to satisfy these new minimum requirements. The education the new accountant would need to meet the new minimum requirements would be nonqualifying education.

Example 3. You have your own accounting business. To improve your skills, you take several courses in tax accounting. You already have met the minimum educational requirements to be an accountant. These courses improve skills required in your business and are not part of a program of study that will qualify you for a new trade or business. These courses are qualifying education.

Requirements for Teachers

This discussion applies to teachers and others employed by educational organizations. The minimum educational requirement for teachers is usually set by the state or school district. It is based upon a minimum number of college hours or a college degree usually required of a person hired for that position.

If no requirements exist, you will have met the minimum educational requirement when you become a faculty member. You generally will be considered a faculty member when one of the following occurs:

1) You have tenure,
2) Your years of service count toward obtaining tenure,
3) You have a vote in faculty decisions, or
4) Your school makes contributions for you to a retirement plan other than social security or a similar program.

Example 1. Your state law requires beginning secondary school teachers to have a bachelor's degree, including ten professional education courses. In addition, to keep the job, a teacher must complete a fifth year of training within 10 years from the date of hire. However, if qualified teachers cannot be found, a school may hire persons with only 3 years of college on the condition that they get the bachelor's degree and the required professional education courses within 3 years.

Under these facts, the bachelor's degree, whether it includes the ten professional education courses or not, is considered the minimum educational requirement for qualification as a teacher in your state.

If you have all of the required education except the fifth year, you have met the minimum educational requirements. However, if the fifth year will qualify you for a new trade or business, it is nonqualifying education. See *Education to Qualify for a New Trade or Business,* later.

Example 2. Assume the same facts as in Example 1. If you have a bachelor's degree and only six professional education courses, the additional four education courses would be qualifying education. Because a bachelor's degree is the minimum requirement for qualification as a teacher, you have already

met the minimum requirements, even though you do not have all of the required courses.

Example 3. Assume the same facts as in Example 1. If you are hired with only 3 years of college, the courses you take that lead to a bachelor's degree (including those in education) are nonqualifying education. They are required to meet the minimum education for employment as a teacher.

Example 4. You have a bachelor's degree and you work as a temporary instructor at a university. At the same time, you take graduate courses toward an advanced degree. The rules of the university state that you may become a faculty member only if you get a graduate degree. Also, you may keep your job as an instructor only as long as you show satisfactory progress toward getting this degree. You have not met the minimum educational requirements to qualify you as a faculty member. The graduate courses are nonqualifying education.

Certification in a new state. Once you have met the minimum educational requirements for your state, you are considered to have met the minimum educational requirements in a new state, even if you must take additional education to be certified in the new state. Any additional education you need is qualifying education.

Example. You hold a permanent teaching certificate in State A and are employed as a teacher in that state for several years. You move to State B and are promptly hired as a school teacher. You are required, however, to complete certain prescribed courses to get a permanent teaching certificate in State B. These additional courses are qualifying education because the teaching position in State B involves the same general kind of work for which you were qualified in State A. You have already met the minimum requirements for teaching and have not entered a new trade or business.

Education to Qualify for a New Trade or Business

Education that is part of a program of study that can qualify you for a new trade or business is nonqualifying education. This is true even if you are not seeking a new job.

If you are an employee, a change of duties is not a new trade or business if the new duties involve the same general work you did in your old job.

Example 1. You are an accountant. Your employer requires you to get a law degree at your own expense. You register at a law school for the regular curriculum that leads to a law degree. Even if you do not intend to become a lawyer, the education is nonqualifying because the law degree will qualify you for a new trade or business.

Example 2. You are a general practitioner of medicine. You take a 2-week course to review new developments in several specialized fields of medicine. The course does not qualify you for a new profession. It is qualifying education because it maintains or improves skills required in your present profession.

Example 3. While working in the private practice of psychiatry, you enter a program to study and train at an accredited psychoanalytic institute. The program will lead to qualifying you to practice psychoanalysis. The psychoanalytic training does not qualify you for a new profession. It is qualifying education because it maintains or improves skills required in your present profession.

Bar or CPA Review Course

Review courses to prepare for the bar examination or the certified public accountant (CPA) examination are nonqualifying education. These are personal expenses that qualify you for a new profession.

Qualifications for Teachers

All teaching and related duties are considered the same general kind of work. It is not considered a change to a new business, if you change duties in any of the following ways:

1) Elementary school teacher to secondary school teacher.
2) Teacher of one subject, such as biology, to teacher of another subject, such as art.
3) Classroom teacher to guidance counselor.
4) Classroom teacher to school administrator.

What Educational Expenses Are Deductible

If your education meets the requirements described earlier under *Qualifying Education,* you can deduct your educational expenses if you itemize your deductions or if you are self-employed.

Deductible expenses. The following educational expenses can be deducted:

1) Tuition, books, supplies, lab fees, and similar items.
2) Certain transportation and travel costs.
3) Other educational expenses, such as costs of research and typing when writing a paper as part of an educational program.

Nondeductible expenses. Educational expenses do not include personal or capital expenses. For example, you cannot deduct the dollar value of vacation time or annual leave you take to attend classes. This amount is a personal expense.

Unclaimed reimbursement. If you do not claim reimbursement that you are entitled to receive from your employer, you cannot otherwise deduct the expenses to which that reimbursement applies. For example, your employer agrees to pay your educational expenses if you file a voucher showing your expenses. You do not file a voucher, and you do not get reimbursed. Because you did not file a voucher, you cannot deduct the expenses on your tax return.

Transportation Expenses

If your education qualifies, you can deduct local transportation costs of going directly from work to school. If you are regularly employed and go to school on a strictly ***temporary basis,*** you can also deduct the costs of returning from school to home. A temporary basis is irregular or short-term attendance, generally a matter of days or weeks.

If you go directly from home to school on a temporary basis, you can deduct the round-trip costs of transportation in going from your home to school to home. This is true regardless of the location of the school, the distance traveled, or whether you attend school on non-work days.

Transportation expenses include the actual costs of bus, subway, cab, or other fares, as well as the costs of using your own car. Transportation expenses do not include amounts spent for travel, meals, or lodging while you are away from home overnight.

Using Your Car

If you use your car for transportation to school, you can deduct your actual expenses or use the standard mileage rate to figure the amount you can deduct. The standard mileage rate for 1994 is 29 cents per mile. If you use either method, you may also deduct parking fees and tolls. See *Car Expenses* in Chapter 28 for information on deducting your actual expenses of using a car.

Example 1. You regularly work in Camden, New Jersey, and also attend school every night for 3 weeks to take a course that improves your job skills. Since you are attending school on a temporary basis, you can deduct your daily round-trip transportation expenses in going between home and school. This is true regardless of the distance traveled.

Example 2. Assume the same facts as in Example 1 except that on certain nights you go directly from work to school and then home. You can deduct your transportation expenses from your regular work site to school and then home.

Example 3. Assume the same facts as in Example 1 except that you attend the school for 6 consecutive Saturdays, non-work days. Since you are attending school on a temporary basis, you can deduct your round-trip transportation expenses in going between home and school.

Example 4. Assume the same facts as in Example 1 except that you attend classes twice a week for one year. Since your attendance in school is not considered temporary, you cannot deduct your transportation expenses in going between home and school. However, if you go directly from work to

school, you can deduct the one-way transportation expenses of going from work to school.

Travel Expenses

You can deduct expenses for travel, meals (subject to the 50% limit), and lodging if you travel overnight to obtain qualified education and the main purpose of the trip is to attend a work-related course or seminar. However, you cannot deduct expenses for personal activities, such as sightseeing, visiting, or entertaining.

If your travel away from home is mainly personal, you cannot deduct all of your expenses for travel, meals, and lodging. However, during the time you attend the qualified educational activities, you can deduct your expenses for meals (subject to the 50% limit) and lodging.

Whether a trip's purpose is mainly personal or educational depends upon the facts and circumstances. An important factor is the comparison of the amount of time spent on personal activities with the amount of time spent on educational activities. If you spend more time on personal activities, the trip is considered mainly educational only if you can show a substantial nonpersonal reason for traveling to a particular location.

Example 1. John works in Newark, New Jersey. He traveled to Chicago to take a deductible one-week course at the request of his employer. While there, he took a sightseeing trip, entertained some personal friends, and took a side trip to Pleasantville for a day. Since the trip was mainly for business, he can deduct his round-trip airfare to Chicago, but he cannot deduct his transportation expenses of going to Pleasantville. Only the meals and lodging connected with his educational activities can be claimed as educational expenses.

Example 2. Dave works in Nashville and recently traveled to California to take a deductible 2-week seminar. While there, he spent an additional 8 weeks on personal activities. The facts, including the extra 8-week stay, indicate that his main purpose was to take a vacation. He cannot deduct his round-trip airfare or his meals and lodging for the 8 weeks. He can deduct only his expenses for meals and lodging for the 2 weeks he attended the seminar.

Cruises and conventions. Certain cruises and conventions offer seminars or courses as part of their itinerary. Even if these are work-related, your deduction for travel may be limited. This applies to:

1) Travel by ocean liner, cruise ship, or other form of luxury water transportation, and
2) Conventions outside the North American area.

The limits are the same that apply to cruises and conventions for other business purposes. These are discussed under *Luxury Water Travel* and *Conventions* in Publication 463.

Meal Expenses

If your educational expenses qualify for deduction, you can deduct the cost of meals that qualify as travel expenses.

50% limit. You can deduct only 50% of your business-related meals that were not reimbursed by your employer and that qualify for deduction. This includes meals while traveling away from home to obtain your education. Employees must use Form 2106 to apply the 50% limit.

Note. If your educational expenses include expenses for travel, see *Travel Expenses* in Chapter 28.

Travel as Education

You cannot deduct the cost of travel that in itself is a form of education even though the travel may be directly related to your duties in your work or business.

Example. You are a French language teacher. While on sabbatical leave granted for travel, you traveled through France to improve your knowledge of the French language. You chose your itinerary and most of your activities to improve your French language skills. You cannot deduct your travel expenses as educational expenses, even though you spent most of your time visiting French schools and families, attending movies or plays, and learning French in similar activities.

Expenses Relating to Tax-Exempt Income

Some educational assistance you receive may be tax-exempt income. This is income you receive that you are not required to report on your tax return. The rules for determining whether any item is taxable or nontaxable are not discussed here. See Chapter 13 for information on the rules on tax-exempt income.

Since you do not pay tax on this income, you may not be able to deduct the related expenses. Examples of tax-exempt income include scholarships, veterans' educational assistance, and employer-provided education. If you received assistance from any of these sources, see *Expenses Relating to Tax-Exempt Income* in Publication 508.

Refund procedure for employees. Because the annual exclusion of income of up to $5,250 of employer-provided educational assistance (see *Important Reminders)* was extended retroactively from July 1, 1992, through December 31, 1994, you may be entitled to certain refunds. These refunds would be for federal income, social security, and Medicare taxes paid on excludable educational assistance benefits provided in the second half of 1992 and social security and Medicare taxes paid on excludable benefits provided in 1993.

Those not entitled to refunds. If your employer continued to exclude these benefits from your income after June 30, 1992, you have not overpaid taxes on educational benefits and are not entitled to a refund.

Employee income tax refunds. If you are entitled to an income tax refund for 1992 because you did not exclude your employer-provided educational assistance from your gross income, you can claim a refund by filing a Form 1040X, *Amended U.S. Individual Income Tax Return.* To do this, you need a Form W–2c, *Statement of Corrected Income and Tax Amounts,* from your employer showing the corrected wages.

The IRS has developed special procedures to make it easier for affected employees to get income tax refunds faster. Under these special procedures, you need only include your name, address, social security number, and ''1992 tax year'' on the Form 1040X, sign the form, and attach your Form W–2c. To speed up the processing of these amended returns, you should write ''IRC 127'' in the top margin of your Form 1040X.

However, if you deducted qualified educational expenses because you included employer-provided educational assistance in your gross income, follow the procedures under *Other refunds due to retroactive legislation,* later. Remember, if you exclude employer-provided educational assistance from your gross income, you cannot deduct educational expenses that are equal to or less than the amount you exclude.

Earned income credit. If your Form W–2c shows corrected wages of less than $22,370 for 1992, and you qualify for the earned income credit but did not claim it, you should file a 1992 Schedule EIC with Form 1040X. If you received the earned income credit in 1992, you do not need to complete another Schedule EIC. The IRS will automatically recalculate the earned income credit and make the appropriate adjustments.

Employee social security and Medicare tax refunds. If you are entitled to a refund because of the change in taxation of educational assistance benefits, you may also request reimbursement of social security and Medicare taxes from your employer for 1992 and 1993. In the unusual case in which you are not able to get a refund of 1992 and 1993 social security and Medicare taxes from your employer, you can file a Form 843, *Claim for Refund and Request for Abatement* with the IRS. If you claim a refund on Form 843, you should write ''IRC 127'' in the top margin to speed up processing of your claim.

Other refunds due to retroactive legislation. If employer-provided educational assistance was included in your income for tax years beginning after 1988, and this assistance did not qualify for the employer-provided educational assistance exclusion, but it could have been excludable as a working condition fringe benefit, you may be entitled to an income tax refund for any open year

(generally, 1991 or later year for which the statute of limitations has not expired).

If you are affected by this provision, you can file an amended income tax return (Form 1040X) for the open year or years. To do this, you need a corrected Form W–2 from your employer (Form W–2c) showing your corrected wages for each year. Complete the Form 1040X and attach the Form W–2c to it.

You may also be entitled to the earned income credit and refunds of social security and Medicare taxes for those years. See *Earned income credit,* and *Employee social security and Medicare tax refunds,* earlier, for the procedures for claiming the credit and the refund of the taxes (except do not write ''IRC 127'' at the top of any claim [Form 1040X or Form 843] you file).

How to Report Educational Expenses

Self-employed persons and employees report their educational expenses differently.

This section explains how to deduct your expenses of qualified education. If you are an employee, you must take into account any reimbursement you receive. How you treat the reimbursement depends on the type of reimbursement arrangement and the amount of the reimbursement. For information on how to report your reimbursement, see Chapter 28.

Self-Employed Persons

Self-employed persons must report their educational expenses on the appropriate form used to report their business income and expenses.

For example, if you are a sole proprietor or an independent contractor, use Schedule C, Schedule C–EZ, or Schedule F. If you use Schedule C, list and total your educational expenses for tuition, books, laboratory fees, and similar items in Part V and enter them on line 27. List your transportation and travel expenses for education on lines 10 and 24 of Schedule C. See the instructions for the form that you file for more information.

Employees

To deduct expenses of work-related education, you must take into account all of the following:

1) Your expenses must be for qualified education.

2) You must file Form 1040.

3) You generally must itemize your deductions on Schedule A (Form 1040). Your educational expenses are deducted on line 20 as a miscellaneous deduction. You can deduct only your expenses over 2% of adjusted gross income from line 32 of Form 1040.

4) You may need to complete Form 2106 or 2106–EZ if your expenses for education include meal and transportation expenses or if you receive reimbursement from your employer.

Note. If your adjusted gross income is more than $111,800 ($55,900 if you are married filing separately), your deduction for itemized deductions may be limited. See Chapter 21.

If you are a ***qualified performing artist,*** you may deduct work-related educational expenses even if you do not itemize your deductions. See *Performing Artists* in Publication 529, *Miscellaneous Deductions,* for more information.

Form 2106 or Form 2106–EZ. Whether you must report your educational expenses on Form 2106 or Form 2106–EZ depends primarily on the type of expense, the type of reimbursement or allowance arrangement, and the amount of reimbursement. Reimbursement arrangements are explained in Chapter 28.

Employee business expenses, including educational expenses, are reported on Form 2106 or Form 2106–EZ. Use either form to figure your allowable travel, transportation, meal, and other work-related expenses of education. To deduct these expenses, complete Part I of Form 2106 (Part II of Form 2106–EZ) and enter the result on Schedule A (Form 1040) as a miscellaneous itemized deduction. (Use Part II of Form 2106 [or Part III of Form 2106–EZ] only if you have personal vehicle expenses.) Part I of Form 2106 has three steps:

- Step 1 shows your total business expenses. Lines 1 through 3 are for travel and transportation expenses that are related to your qualifying education. Line 4 is for educational expenses such as tuition and books. Line 5 is for meals while traveling away from home to obtain education.

- Step 2 shows amounts your employer gave you (your reimbursement) for the expenses listed in Step 1. These are amounts your employer did not include as wages in box 1 of your Form W–2.

- Step 3 figures the expenses to deduct on Schedule A (Form 1040). If your employer did not reimburse you, or reimbursed you under a nonaccountable plan, for work-related meals, your deduction is limited to 50% of your expenses. This allowable amount is figured on lines 8 through 10. The allowable meal expenses are added to your other unreimbursed expenses and the total is entered on line 20 of Schedule A (Form 1040).

Exception. You do not have to complete Form 2106 if either of the following applies:

1) Your reimbursements not included in box 1 of Form W–2 are at least as much as your deductible expenses. (Do not deduct the expenses or report the reimbursement as income.)

2) You are not deducting any expenses for travel, transportation, meals, or entertainment, and you were not reimbursed for any expenses. (Unreimbursed expenses for tuition, books, and lab fees can be listed directly on line 20 of Schedule A of Form 1040.)

Even if you were not reimbursed, you must file Form 2106 or Form 2106–EZ if you are a ***qualified performing artist*** or an ***individual with a disability claiming impairment-related work expenses.*** See Publication 529.

Part I of Form 2106–EZ contains general information about who can use this form. You do not have to complete Form 2106–EZ if you are not deducting any expenses for travel, transportation, meals, or entertainment, and you were not reimbursed for any expenses. (Unreimbursed expenses for tuition, books, and lab fees only can be listed directly on line 20 of Schedule A of Form 1040.)

Schedule A (Form 1040). Unreimbursed educational expenses, or expenses that are more than the amount reimbursed by your employer, are entered on line 20 of Schedule A (Form 1040). Generally, you must first use Form 2106 (or Form 2106–EZ) to compute the amount to enter on line 20. To claim these educational expenses, you must be able to itemize your deductions on Schedule A (Form 1040). (If you're not sure whether you can itemize, see Chapter 22.)

You can deduct only the amount of job expenses and most other miscellaneous deductions that is more than 2% of your adjusted gross income. This 2% limit is applied after all other deduction limits have been applied (such as the 50% limit on meal expenses, discussed earlier).

Recordkeeping

You must keep records as proof of any deduction claimed on your tax return. Generally, you should keep your records for 3 years from the date of filing the return and claiming the deduction. For specific information about keeping records of business expenses, see *Examples of records to keep* in Publication 508.

30.

Miscellaneous Deductions

Important Change for 1994

Form 2106–EZ. You may be able to report your unreimbursed employee business expenses on new Form 2106–EZ instead of Form 2106. For more information, see Chapter 28.

Important Reminder

Limit on itemized deductions. For 1994, if your adjusted gross income is more than $111,800 ($55,900 if you are married filing separately), the overall amount of your itemized deductions may be limited. See Chapter 22 if you need more information about this limit.

Introduction

This chapter explains what expenses you can claim as miscellaneous itemized deductions on **Schedule A** (Form 1040). You must reduce the total of most miscellaneous itemized deductions by 2% of your adjusted gross income. This chapter identifies:

- Deductions subject to the 2% limit,
- Deductions not subject to the 2% limit, and
- Expenses you cannot deduct.

It also describes how to report your deductions.

Expenses in each category are presented in a list followed by information about items that need more explanation.

Recordkeeping. You must keep records to verify your deductions. You should keep receipts, cancelled checks, financial account statements, and other documentary evidence. For more information on recordkeeping, get Publication 552, *Recordkeeping for Individuals.*

Useful Items

You may want to see:

Publication

- ❑ **463** Travel, Entertainment, and Gift Expenses
- ❑ **525** Taxable and Nontaxable Income
- ❑ **529** Miscellaneous Deductions
- ❑ **534** Depreciation
- ❑ **535** Business Expenses
- ❑ **587** Business Use of Your Home
- ❑ **917** Business Use of a Car
- ❑ **946** How To Begin Depreciating Your Property

Form (and Instructions)

- ❑ **2106** Employee Business Expenses
- ❑ **2106–EZ** Unreimbursed Employee Business Expenses

Deductions Subject to the 2% Limit

You can deduct the following expenses only as miscellaneous itemized deductions on Schedule A (Form 1040). You can claim them only to the extent that the total you claim is more than 2% of your adjusted gross income. This means you figure your deduction by subtracting 2% of your adjusted gross income from the total amount of these expenses. You can find your adjusted gross income on line 32, Form 1040.

Generally, you apply the 2% limit after you apply any other deduction limit (such as the 50% limit on business-related meals and entertainment).

Deductions subject to the 2% limit are discussed in the two general categories that are shown on Schedule A (Form 1040): unreimbursed employee expenses and other expenses. But see Chapter 28 if you have unreimbursed employee business expenses for travel, transportation, entertainment, or gifts.

Exception for performing artists. If you are a qualifying performing artist, you may be able to deduct your employee business expenses as an adjustment to gross income rather than as a miscellaneous itemized deduction. See *Special Rules* in Chapter 28 if you need more information about this exception. This exception only applies to performing artists with adjusted gross incomes of not more than $16,000 before deducting these expenses.

Exception for impairment-related work expenses. If you have a physical or mental disability certain expenses you incur that allow you to work may not be subject to the 2% limit. See *Impairment-Related Work Expenses,* under *Deductions Not Subject to the 2% Limit,* later.

Unreimbursed Employee Expenses

To be deductible, an unreimbursed employee expense must be:

1) Paid or incurred during the taxable year,
2) For carrying on your trade or business of being an employee, and
3) An ordinary and necessary expense.

An expense is ***ordinary*** if it is common and accepted in that type of trade or business. An expense is ***necessary*** if it is appropriate and helpful to your trade or business.

The following common expenses that meet these requirements are deductible.

- Business bad debt of employee
- Dues to professional societies
- Education that is employment related (see Chapter 29)
- Laboratory breakage fees
- Malpractice insurance premiums
- Medical examinations required by employer
- Occupational taxes you paid
- Passport for business trip
- Subscriptions to professional journals and trade magazines related to your work
- Travel, transportation, entertainment, and gift expenses that are unreimbursed and related to your work (see Chapter 28)

Business Liability Insurance

You can deduct insurance premiums you paid for protection against personal liability for wrongful acts on the job.

Damages for Breach of Employment Contract

If you break an employment contract, you can deduct damages you pay your former employer if the damages are attributable to the pay you received from that employer.

Depreciation on Home Computers or Cellular Telephones

If you purchased a home computer or cellular telephone, you can claim a depreciation deduction if you use these items in your work as an employee and you meet the following tests. Your use of these items must be:

1) For the convenience of your employer, and
2) Required as a condition of your employment.

If you use your computer to produce income other than from a business, such as from investments, see *Depreciation on Home Computer,* under *Other Expenses,* later.

For more information about the rules and exceptions to the rules affecting the allowable deductions for a home computer or cellular telephone, see *Depreciation on Home Computers or Cellular Telephones* in Publication 529.

Reporting and recordkeeping. To claim the depreciation deduction for your home computer or cellular telephone, you must complete Part V of **Form 4562,** *Depreciation and Amortization,* and attach the form to your tax return. Also, you must maintain records to prove your percentage of business use.

For more information about depreciation (including the section 179 deduction) and recordkeeping requirements, get Publication 946, *How To Begin Depreciating Your Property*.

Dues to Chamber of Commerce

You can deduct dues paid to a chamber of commerce or similar organization if membership helps you carry out the duties of your job. However, you may not be able to deduct that part of your dues that is allocable to certain lobbying and political activities. See *Dues* under *Lobbying Expenses,* later.

Home Office

If you use a part of your home regularly and exclusively for business purposes, you may be able to deduct a part of the operating and depreciation expenses on your home. You cannot deduct any part of your personal expenses that are for family household purposes.

For more information on this deduction, see Publication 587, *Business Use of Your Home.*

Requirements for claiming the deduction. You may deduct certain expenses for operating a part of your home only if that part of your home is used ***regularly*** and ***exclusively*** as:

1) Your principal place of business for any trade or business in which you engage, or
2) A place to meet or deal with your patients, clients, or customers in the normal course of your trade or business.

You may also deduct certain expenses of operating a separate structure not attached to your home, if you use it regularly and exclusively for your trade or business.

In addition, if the regular and exclusive business use is for your work as an employee, the use must be ***for the convenience of your employer*** and not just appropriate and helpful in your job.

If you claim a home office deduction based on meeting with patients, clients, or customers, you must physically meet with them on your premises, and your meetings with them must be substantial and integral to the conduct of your business. Occasional meetings and telephone calls are insufficient.

You cannot deduct any operating or depreciation expenses for the use of your home if the use is not in a trade or business. For example, you cannot deduct these expenses if you use a part of your home, even though regularly and exclusively, to read financial periodicals and reports, clip bond coupons, and perform similar investment activities on your own behalf, because these activities are not a trade or business.

The use of a part of your home for both personal and business purposes does not meet the exclusive use test, and you cannot deduct expenses for business use. If, for example, you use the den of your home to write legal briefs, prepare tax returns, or perform similar activities, as well as for personal purposes, you cannot deduct any expenses for the business use of that part of your home.

How to figure the deduction. To figure the percentage of your home used for business, you may compare the square feet of space used for business to the total square feet in your home. Or, if the rooms in your home are approximately the same size, you may compare the number of rooms used for business to the total number of rooms in your home. You may also use any other reasonable method. Generally, you figure the business part of your expenses by applying the percentage to the total of each expense.

Limit on the deduction. The deduction for the business use of your home is limited to the gross income from that business use minus the sum of:

1) The business percentage of the otherwise deductible mortgage interest, real estate taxes, and casualty and theft losses, and
2) The expenses for your business that are not attributable to the use of your home (for example, salaries or supplies).

Repairs. You can deduct the cost of painting and repairing rooms that are used only for business purposes, subject to the limit. You cannot deduct the costs of painting and repairing rooms used for other purposes.

You can deduct part of the cost of painting the outside of your home or repairing the roof based on the percentage of your home used for business. However, you cannot deduct expenses for lawn care and landscaping.

Depreciation. You can deduct depreciation on the part of your home used for business subject to the *limit on the deduction* discussed above.

Home leased to employer. If you lease any part of your home to your employer, you cannot claim a home office deduction for that part for any period you use that part of your home to perform services for your employer.

How to report. If you are an employee, you generally report your expenses for the business use of your home (insurance, maintenance, utilities, depreciation) on **Form 2106** or **Form 2106–EZ.** You then carry over your total expenses to line 20 of Schedule A (Form 1040). If you are not required to file Form 2106 or Form 2106–EZ, enter the amount directly on line 20 of Schedule A.

Include the home office expenses for mortgage interest, real estate taxes, and casualty and theft losses on the appropriate lines of Schedule A, along with your deductible nonbusiness expenses in those categories.

Records. You should keep records that will give the information needed to figure the deduction according to these rules. Also keep canceled checks or account statements, and receipts of the expenses paid, to prove the deductions you claim.

For more information on using your home in your work and how to compute your allowable deduction, get Publication 587.

Job Search Expenses

You may be able to deduct certain expenses you have in looking for a new job in your present occupation, even if you do not get a new job. You cannot deduct these expenses if you are looking for a job in a new occupation, even if you get the job.

If you are unemployed, the kind of work you did for your past employer is your occupation. If there is a substantial break between the time of your past job and your looking for a new one, you cannot deduct your expenses.

You cannot deduct your expenses if you are seeking employment for the first time, even if you get the job.

Employment and outplacement agency fees. You can deduct employment and outplacement agency fees you pay in looking for a new job in your present occupation.

If, in a later year, your employer pays you back for employment agency fees, you must include the amount you receive in your gross income to the extent of your tax benefit in the earlier year (which is explained under *Recoveries* in Chapter 13). If your employer pays the fees directly to the employment agency and you were not responsible for them, you do not include them in your gross income.

Râesumâe. You can deduct amounts you spend for typing, printing, and mailing copies of a râesumâe to prospective employers if you spent the amounts in looking for a new job in your present occupation.

Travel and transportation expenses. If you travel to an area and, while there, you look for a new job in your present occupation, you may be able to deduct travel expenses to and from the area. To be deductible, the trip must be primarily to look for a new job. The amount of time you spend on personal activity compared to the amount of time you spend in looking for work is important in determining whether the trip is primarily personal and not deductible.

Even if the travel expenses to and from an area are not deductible, you can deduct the expenses of looking for a new job in your present occupation, while in the area.

If you use the standard mileage rate to figure your car expenses, use 29 cents per mile. See Chapter 28 for more information. If your job search expenses include travel and transportation expenses, you must file Form 2106 or Form 2106–EZ, as discussed later under *How to Report.*

Repayment of Income Aid Payment

If you repay a lump-sum income aid payment that you received and included in income in an earlier year, you can deduct the repayment. An ''income aid payment'' is one that is received under an employer's plan to aid employees who lose their jobs due to lack of work.

Research Expenses of a College Professor

If you are a college professor, you can deduct research expenses, including travel expenses, for teaching, lecturing, or writing and publishing on subjects that relate directly to the field of your teaching duties. The research must be undertaken as a means of carrying out the duties expected of a professor and without expectation of profit apart from salary. However, no deduction is allowed for travel as a form of education.

Tools Used in Your Work

Generally, amounts you spend for tools used in your work are deductible expenses if the tools wear out and are thrown away within one year from the date of purchase. The cost of tools expected to last more than a year can be depreciated. For more information about depreciation, get Publication 946.

Union Dues and Expenses

You can deduct dues and initiation fees you pay for union membership.

You can also deduct assessments for benefit payments to unemployed union members. However, you cannot deduct the part of the assessments or contributions that provides funds for the payment of sick, accident, or death benefits. Also, you cannot deduct contributions to a pension fund even if the union requires you to make such contributions.

You may not be able to deduct amounts you pay to the union that are allocable to certain lobbying and political activities. See *Dues* under *Lobbying Expenses,* later.

Work Clothes and Uniforms

You can deduct the cost and upkeep of work clothes only if you must wear them as a condition of your employment and they are not suitable for everyday wear. To qualify for the deduction, both conditions must be met. It is not enough that you wear distinctive clothing; the clothing must be specifically required by your employer. Nor is it enough that you do not in fact wear your work clothes away from work; the clothing must not be suitable for taking the place of your regular clothing.

Examples of workers who may be required to wear uniforms which qualify are: delivery workers, firefighters, health care workers, law enforcement officers, letter carriers, professional athletes, and transportation workers (air, rail, bus, etc.).

Musicians and entertainers can deduct the cost of theatrical clothing and accessories if they are not suitable for everyday wear.

However, work clothing consisting of white cap, white shirt or white jacket, white bib overalls, and standard work shoes, which a painter is required by his union to wear on the job, is not distinctive in character or in the nature of a uniform. Similarly, the costs of buying and maintaining blue work clothes worn by a welder at the request of a foreman are not deductible.

Protective clothing. You can deduct the cost of protective clothing required in your work, such as safety shoes or boots, safety glasses, hard hats, and work gloves.

Examples of workers who may be required to wear safety items are: carpenters, cement workers, chemical workers, electricians, fishing boat crew members, machinists, oil field workers, pipe fitters, steamfitters, and truck drivers.

Military uniforms. You generally cannot deduct the cost of your uniforms if you are on full-time active duty in the armed forces. However, if you are an armed forces reservist, you can deduct the unreimbursed cost of your uniform if military regulations restrict you from wearing it except while on duty as a reservist. In figuring the deduction, you must reduce the cost by any nontaxable allowance you receive for these expenses.

If local military rules do not allow you to wear fatigue uniforms when you are off duty, you can deduct the amount by which the cost of buying and keeping up these uniforms is more than the uniform allowance you receive.

If you are a student at an armed forces academy, you cannot deduct the cost of your uniforms if they replace regular clothing. However, you can deduct the cost of insignia, shoulder boards, and related items.

You can deduct the cost of your uniforms if you are a civilian faculty or staff member of a military school.

Other Expenses

You can deduct certain other expenses as miscellaneous itemized deductions subject to the 2% of adjusted gross income limit. These are expenses you pay:

1) To produce or collect income,
2) To manage, conserve, or maintain property held for producing income, or
3) To determine, contest, pay, or claim a refund of any tax.

The expenses for (1) and (2) above must be directly related to the income or income-producing property, and the income must be taxable to you.

These other expenses include:

- Appraisal fees for a casualty loss or charitable contribution
- Clerical help and office rent in caring for investments
- Depreciation on home computers to the extent used for investments
- Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust
- Fees to collect interest and dividends
- Hobby expenses, but generally not more than hobby income
- Indirect miscellaneous deductions of pass-through entities
- Investment fees and expenses
- Legal fees related to producing or collecting taxable income, doing or keeping your job, or getting tax advice
- Loss on deposits in an insolvent or bankrupt financial institution
- Repayments of income
- Repayments of social security benefits
- Safe deposit box rental
- Service charges on dividend reinvestment plans
- Tax advice and preparation fees, including fees for electronic filing
- Trustee's fees for your IRA, if separately billed and paid

If the expenses you pay produce income that is only partially taxable, see *Tax-Exempt Income Expenses,* later, under *Nondeductible Expenses.*

Appraisal Fees

You can deduct appraisal fees if you pay them to figure a casualty loss or the fair market value of donated property.

Clerical Help and Office Rent

You can deduct office expenses, such as rent and clerical help, that you have in connection with your investments and collecting the taxable income on them.

Depreciation on Home Computer

You can deduct depreciation on your home computer to the extent you use it to produce income (for example, managing your investments that produce taxable income). If you work as an employee and use the computer in that work, see *Depreciation on Home Computers or Cellular Telephones* under *Unreimbursed Employee Expenses,* earlier. For more information on depreciation, see Publication 946.

Excess Deductions of an Estate

If the deductions in the estate's last tax year (other than deductions for personal exemptions and charitable contributions) are more than gross income for that year, the beneficiaries succeeding to the estate's property can claim such excess as a miscellaneous deduction. The beneficiaries can claim the deduction only for the tax year in which or with which the estate terminates, whether the year of termination is a normal year or a short tax year. For more information, see

Publication 559, *Survivors, Executors, and Administrators.*

Fees to Collect Interest and Dividends

You can deduct fees you pay to a broker, bank, trustee, or similar agent to collect your taxable bond interest or dividends on shares of stock. But you cannot deduct a fee you pay to a broker to buy investment property, such as stocks or bonds. You must add the fee to the cost of the property.

You cannot deduct the fee you pay to a broker to sell securities unless you are a dealer in securities. You must offset the fee against the selling price.

Hobby Expenses

You can generally deduct hobby expenses, but only up to the amount of hobby income. A hobby is not a business, because it is not carried on to make a profit. See *Activity not for profit* in Chapter 13 under *Miscellaneous Taxable Income.*

Indirect Deductions of Pass-Through Entities

Pass-through entities include partnerships, S corporations, and mutual funds. Deductions of pass-through entities are passed through to the partners or shareholders. If the deductions are miscellaneous itemized deductions, they are generally subject to the 2% limit.

Information returns. You should receive information returns from these entities. Partnerships and S corporations issue **Schedule K–1**, which lists the items and amounts you must report, and identifies the tax return schedules and lines to use.

Example. You are a member of an investment club that is formed solely to invest in securities. The club is treated as a partnership. The partnership's income is solely from taxable dividends, interest, and gains from sales of securities. In this case, you can deduct your share of the partnership's operating expenses as miscellaneous itemized deductions subject to the 2% limit. However, if the investment club partnership has investments that also produce nontaxable income, you cannot deduct your share of the partnership's expenses that produce the nontaxable income. You should receive a copy of Schedule K–1 (Form 1065), *Partner's Share of Income, Credits, Deductions, Etc.*

Allocated expenses of mutual funds. The allocable investment expenses of nonpublicly offered mutual funds are subject to the 2% limit. Those of publicly offered mutual funds are not subject to the 2% limit.

Nonpublicly offered mutual funds. These funds will send you a Form 1099–DIV, *Dividends and Distributions,* or substitute form, showing your share of gross income and investment expenses. You can claim the expenses only as a miscellaneous itemized deduction subject to the 2% limit.

Publicly offered mutual funds. These funds will send you a Form 1099–DIV, or substitute form, showing the net amount of dividend income (gross dividends minus investment expenses). This net figure is the amount you report on your return. A ''publicly offered'' mutual fund is one that is:

1) Continuously offered pursuant to a public offering,
2) Regularly traded on an established securities market, or
3) Held by or for at least 500 persons at all times during the tax year.

Contact your mutual fund if you are not sure if your fund is publicly offered.

Investment Fees and Expenses

You can deduct investment fees, custodial fees, trust administration fees, and other expenses you paid for managing your investments that produce taxable income.

Legal Expenses

You can usually deduct legal expenses that you incur in attempting to produce or collect taxable income or that you pay in connection with the determination, collection, or refund of any tax.

You can also deduct legal expenses that are:

1) Related to either doing or keeping your job, such as those you paid to defend yourself against criminal charges arising out of your trade or business.
2) For tax advice related to a divorce if the bill specifies how much is for tax advice and it is determined in a reasonable way.
3) To collect taxable alimony.

Expenses allocated to resolving tax issues relating to profit or loss from business (Schedule C or C–EZ), rentals or royalties (Schedule E), or farm income and expenses (Schedule F), are deductible on the appropriate schedule. The expenses allocated to resolving nonbusiness tax issues are deductible on Schedule A. See *Tax Preparation Fees,* later.

Loss on Deposits in an Insolvent or Bankrupt Financial Institution

For information on whether, and if so how, you may deduct a loss on your deposit in a qualified financial institution, see *Loss on deposits in an insolvent or bankrupt financial institution* in Chapter 15.

Repayments of Income

If you had to repay an amount that you included in income in an earlier year, you may be able to deduct the amount you repaid. If the amount you had to repay was ordinary income of $3,000 or less, the deduction is subject to the 2% limit. If it is more than $3,000, see *Repayments Under Claim of Right* under *Deductions Not Subject to the 2% Limit,* later.

Repayments of Social Security Benefits

For information on how to deduct your repayments of certain social security benefits, see *Repayments More Than Gross Benefits* in Chapter 12.

Safe Deposit Box Rent

You can deduct safe deposit box rent if you use the box to store taxable income-producing stocks, bonds, or investment-related papers and documents. You cannot deduct the rent if you use the box only for jewelry or other personal items or for tax-exempt securities.

Service Charges on Dividend Reinvestment Plans

You can deduct service charges you pay as a subscriber in a dividend reinvestment plan. These service charges include payments for:

1) Holding shares acquired through a plan,
2) Collecting and reinvesting cash dividends, and
3) Keeping individual records and providing detailed statements of accounts.

Tax Preparation Fees

You can usually deduct tax preparation fees in the year you pay them. Thus, on your 1994 return, you can deduct fees paid in 1994 for preparing your 1993 return.

These fees include the cost of tax preparation software programs and tax publications. It also includes any fee you paid for electronic filing of your return.

Expenses allocated to preparing tax schedules relating to profit or loss from business (Schedule C or C–EZ), rentals or royalties (Schedule E), or farm income and expenses (Schedule F), are deductible on the appropriate schedule. The expenses allocated to preparing the remainder of the return are deductible on Schedule A.

Trustee's Administrative Fees for IRA

You can deduct an IRA trustee's administrative fees that are billed separately and that you paid in connection with your individual retirement arrangement (IRA), if they are ordinary and necessary. These fees do not include capital expenditures such as brokers' commissions that you must add to the cost of securities you buy through brokers. These fees also do not include disguised IRA contributions. These trustee's fees are not subject to the annual dollar limit on contributions you can make to an IRA. Deduct them as a miscellaneous deduction, not with your IRA deduction. For more information about IRAs, see Chapter 18.

Deductions Not Subject to the 2% Limit

The following expenses are deductible as miscellaneous itemized deductions. However, they are not subject to the 2% limit. Report these expenses on line 28, Schedule A (Form 1040).

List of Deductions

- Amortizable premium on taxable bonds
- Federal estate tax on income in respect of a decedent
- Gambling losses to the extent of gambling winnings
- Impairment-related work expenses of persons with disabilities
- Repayments under a claim of right
- Unrecovered investment in a pension

Amortizable Premium on Taxable Bonds

Bond premium is the amount you pay for bonds that is greater than the face value of the bonds. You can choose to amortize the premium on taxable bonds.

For a bond purchased before October 23, 1986, the amortization of the premium is a miscellaneous itemized deduction not subject to the 2% limit.

For a bond acquired after October 22, 1986, and before January 1, 1988, the amortization of the premium is investment interest expense subject to the investment interest limit, unless you choose to treat it as an offset to interest income on the bond.

For a bond acquired after December 31, 1987, the amortization of the premium is an offset to interest income on the bond rather than a separate interest deduction item.

For more information, see *Bond Premium Amortization* in Publication 550, *Investment Income and Expenses.*

Federal Estate Tax on Income in Respect of a Decedent

You can deduct the federal estate tax attributable to income in respect of a decedent that you as a beneficiary include in your gross income. Income in respect of the decedent is gross income that the decedent would have received had death not occurred and that was not properly includible in the decedent's final income tax return. See Chapter 4 for more information.

Gambling Losses to the Extent of Gambling Winnings

You must report the full amount of your gambling winnings on line 21, Form 1040. You deduct your gambling losses on line 28, Schedule A (Form 1040). You cannot deduct gambling losses that are more than your winnings.

Note. You cannot offset your losses against your winnings. You must report the full amount of your winnings and claim your losses as an itemized deduction. Therefore, your records should show your winnings separate from your losses.

You must keep an accurate diary or similar record of your losses and winnings, and you must be able to prove the amounts of your winnings and losses by receipts, tickets, or statements. For more information about gambling winnings and losses, and information on recordkeeping to substantiate gambling losses, see Publication 529.

Impairment-Related Work Expenses

If you have a physical or mental disability that limits your being employed, or substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, and working, your impairment-related work expenses are deductible.

Impairment-related work expenses are allowable business expenses for attendant care services at your place of work and other expenses in connection with your place of work that are necessary for you to be able to work.

If you are an employee, you enter impairment-related work expenses on Form 2106 or Form 2106–EZ. From the amount on line 10 of Form 2106, or line 6 of Form 2106–EZ, you enter the amount that is related to your impairment on line 28, Schedule A (Form 1040), and the amount that is unrelated to your impairment on line 20, Schedule A (Form 1040).

Repayments Under Claim of Right

If you had to repay more than $3,000 that you included in your income in an earlier year because at the time you thought you had an unrestricted right to it, you may be able to deduct the amount you repaid, or take a credit against your tax. See *Repayments* in Chapter 13 for more information.

Unrecovered Investment in Pension

If a retiree had contributed to the cost of a pension or annuity, a part of each payment received can be excluded from income as a tax-free return of the retiree's investment. If the retiree dies before the entire investment is returned, any unrecovered investment is allowed as a deduction on the retiree's final return. See Chapter 11 for more information about the tax treatment of pensions and annuities.

Nondeductible Expenses

You cannot deduct the following expenses.

List of Expenses

- Adoption expenses
- Burial or funeral expenses, including the cost of a cemetery lot
- Campaign expenses
- Capital expenses
- Check-writing fees
- Club dues
- Commuting expenses
- Fees and licenses, such as car licenses, marriage licenses, and dog tags
- Fines and penalties, such as parking tickets
- Health spa expenses
- Hobby losses
- Home repairs, insurance, and rent
- Illegal bribes and kickbacks—See *Bribes and kickbacks* in Chapter 16 of Publication 535
- Investment-related seminars
- Life insurance premiums
- Lobbying expenses
- Losses from the sale of your home, furniture, personal car, etc.
- Lost or misplaced cash or property—but see *Mislaid or lost property* under *Theft* in Chapter 27
- Lunches with co-workers
- Meals while working late
- Personal disability insurance premiums
- Personal legal expenses
- Personal, living, or family expenses
- Political contributions
- Professional accreditation fees
- Professional reputation, expenses to improve
- Relief fund contributions
- Residential telephone line
- Stockholders' meeting, expenses of attending
- Tax-exempt income expenses
- Travel expenses for another individual
- Voluntary unemployment benefit fund contributions
- Wristwatches

Adoption Expenses

You cannot deduct the expenses you paid to adopt a child.

Campaign Expenses

Campaign expenses of a candidate for any office, even if the candidate is running for re-election to the office, are not deductible. These include qualification and registration fees for primary elections.

Legal fees. You cannot deduct legal fees paid to defend charges that arise from participation in a political campaign.

Check-Writing Fees

If you have a personal checking account, you cannot deduct fees charged by the bank for the privilege of writing checks, even if the account pays interest.

Club Dues

You cannot deduct the cost of membership in any club organized for business, pleasure, recreation, or other social purpose.

Commuting Expenses

You cannot deduct commuting expenses (the cost of transportation between your home and your main or regular place of work). If you haul tools, instruments, etc., in your car to and from work, you can deduct only additional costs, such as renting a trailer you towed with your vehicle.

Fines or Penalties

You cannot deduct fines or penalties you pay to a governmental unit for violating a law. This includes an amount paid in settlement of your actual or potential liability for a fine or penalty (civil or criminal). Fines or penalties include parking tickets, tax penalties, and penalties deducted from teachers' paychecks after an illegal strike.

Health Spa Expenses

You cannot deduct health spa expenses, even if there is a job requirement to stay in excellent physical condition, such as might be required of a law enforcement officer.

Homeowners' Insurance Premiums

You cannot deduct insurance premiums that you pay or that are placed in escrow for your home, such as fire and liability or mortgage insurance.

Investment-Related Seminars

You cannot deduct any expenses for attending a convention, seminar, or similar meeting for investment purposes.

Life Insurance Premiums

You cannot deduct premiums you pay on your life insurance. Premiums you pay on life insurance policies assigned to your ex-spouse may be deductible as alimony. See Chapter 20 for information on alimony.

Lobbying Expenses

You cannot deduct amounts paid or incurred for lobbying expenses. These include expenses to:

- Influence legislation,
- Participate, or intervene, in any political campaign for, or against, any candidate for public office,
- Attempt to influence the general public, or segments of the public, about elections, legislative matters, or referendums, or
- Communicate directly with covered executive branch officials in any attempt to influence the official actions or positions of such officials.

Include, as part of these expenses, any amount paid or incurred for research, preparation, planning, or coordination of that activity.

Covered executive branch official. A covered executive branch official includes:

The President,

The Vice President,

Any officer or employee of the White House Office of the Executive Office of the President, and the two most senior level officers of each of the other agencies in the Executive Office, and

Any individual serving in a position in Level I of the Executive Schedule under Section 5312 of Title 5, United States Code, any other individual designated by the President as having Cabinet-level status, and any immediate deputy of such individual.

Dues. You cannot deduct that portion of your dues or other amounts you pay to a tax-exempt organization that notifies you that such amounts are allocable to nondeductible lobbying expenses.

Exceptions. The following expenses are exceptions to the disallowance rule.

1) Expenses for attempting to influence the legislation of any local council or similar governing body (local legislation). An Indian tribal government shall be treated as a local council or similar governing body.
2) Any in-house expenses for influencing legislation or communicating directly with a covered executive branch official if such expenses for the tax year do not exceed $2,000 (excluding overhead expenses).
3) Expenses incurred by taxpayers engaged in the trade or business of lobbying (professional lobbyists) on behalf of another person. (The disallowance rule applies to payments by the other person to the lobbyist for lobbying activities.)

Lunches with Co-Workers

You cannot deduct the expenses of lunches with co-workers, except while traveling away from home on business. See Chapter 28 for information on these deductible expenses.

Meals While Working Late

You cannot deduct the cost of meals while working late. However, you may be able to claim a deduction if it is a deductible entertainment expense or you are traveling away from home. See Chapter 28 for information on these deductible expenses.

Personal Legal Expenses

You cannot deduct personal legal expenses such as those for the following:

1) Custody of children,
2) Breach of promise (to marry) suit,
3) Civil or criminal charges resulting from a personal relationship,
4) Damages for personal injury,
5) Preparation of a title (or to defend or perfect title),
6) Preparation of a will, and
7) Property claims or property settlement in a divorce.

You cannot deduct these expenses even if a result of the legal proceeding is the loss of income-producing property.

Political Contributions

You cannot deduct contributions made to a political candidate, a campaign committee, or a newsletter fund.

Professional Accreditation Fees

You cannot deduct professional accreditation fees such as the following:

1) Accounting certificate fees paid for the initial right to practice accounting,
2) Bar exam fees and incidental expenses in securing admission to the bar, and
3) Medical and dental license fees paid to get initial licensing.

Professional Reputation

You cannot deduct expenses of radio and TV appearances to increase your personal prestige or establish your professional reputation.

Relief Fund Contributions

You cannot deduct contributions paid to a private plan that pays benefits to any covered employee who cannot work because of any injury or illness not related to the job.

Residential Telephone Service

You cannot deduct any charge (including taxes) for basic local telephone service for the first telephone line to your residence, even if it is used in a trade or business.

Stockholders' Meetings

You cannot deduct transportation and other expenses you pay to attend stockholders' meetings of companies in which you own stock but have no other interest. You cannot deduct these expenses even if you are attending the meeting to get information that would be useful in making further investments.

Tax-Exempt Income Expenses

You cannot deduct expenses to produce tax-exempt income. You cannot deduct interest on a debt incurred or continued to buy or carry tax-exempt securities.

If you have expenses to produce both taxable and tax-exempt income, but you cannot identify the expenses that produce each type of income, you must allocate the expenses to determine the amount that you can deduct.

Example. During the year, you received taxable interest of $4,800 and tax-exempt interest of $1,200. In earning this income, you had expenses of $500 during the year. If you cannot identify the amount of each expense item that is for each income item, you must allocate 80% ($4,800/$6,000) of the expense to taxable interest and 20% ($1,200/$6,000) to tax-exempt interest. You can deduct, subject to the 2% limit, expenses of $400 (80% of $500).

Travel Expenses for Another Individual

You generally cannot deduct travel expenses you pay or incur for your spouse, dependent, or other individual who accompanies you on business travel. However, you can deduct the travel expenses you pay or incur for an individual who accompanies you on business travel if the individual:

1) Is your employee,
2) Has a bona fide business purpose for the travel, and
3) Would otherwise be allowed to deduct the travel expenses.

See Chapter 28 for more information on deductible travel expenses.

Voluntary Unemployment Benefit Fund Contributions

You cannot deduct voluntary unemployment benefit fund contributions you make to a union fund or a private fund. However, contributions are deductible as taxes if state law requires you to make them to a state unemployment fund that covers you for the loss of wages from unemployment caused by business conditions.

Wristwatches

You cannot deduct the cost of a wristwatch, even if there is a job requirement that you know the correct time to properly perform your duties.

How to Report

You must itemize deductions on Schedule A (Form 1040) to be able to claim miscellaneous deductions.

If you have unreimbursed employee business expenses, generally you must first complete **Form 2106** or **Form 2106–EZ.** See Chapter 28 for more information on whether you must file Form 2106 or Form 2106–EZ.

Carry over the amount of unreimbursed employee business expenses from line 10 of Form 2106 or line 6 of Form 2106–EZ to line 20 of Schedule A (Form 1040). Attach the completed Form 2106 or Form 2106–EZ to Form 1040.

If you don't have to fill out Form 2106 or Form 2106–EZ, just list the type and amount of your unreimbursed employee business expenses on the dotted lines for line 20 of Schedule A (Form 1040). Enter one total on line 20.

Claim tax preparation fees on line 21, and any other miscellaneous deductions subject to the 2% limit on line 22 of Schedule A (Form 1040). List the type and amount of each expense on the dotted lines next to line 22. Enter one total on line 22.

If you have miscellaneous deductions not subject to the 2% limit, claim these amounts on line 28 of Schedule A (Form 1040).

Part Seven.

Figuring Your Taxes and Credits

The six chapters in this part explain how to figure your tax and how to figure the tax of certain children who have more than $1,200 of investment income. They also discuss tax credits. Credits, unlike deductions, are subtracted directly from your tax and, therefore, reduce your tax, dollar for dollar. There are tax credits for the elderly or the permanently and totally disabled, for the expense of having your child or disabled dependent cared for so that you can work, for the purchase of a qualified electric vehicle, and for other kinds of expenses. Chapter 35 discusses the earned income credit and how you might be able to get the credit paid to you in advance (from your employer) throughout the year rather than wait until you file your tax return.

31.

How to Figure Your Tax

Important Change for 1994

Earned Income Credit (EIC) added to Form 1040EZ. Beginning in 1994, you may be able to claim the EIC on Form 1040EZ. Prior to 1994, the credit could only be claimed on either Form 1040 or Form 1040A. See Chapter 35 for details.

Important Reminders

Deferred 1993 taxes due April 17, 1995. If you filed Form 8841, *Deferral of Additional 1993 Taxes,* so you could pay part of your 1993 tax in installments, the second installment is due April 17, 1995. See *Paying Deferred 1993 Taxes* in Chapter 1 for more information.

Expanded Form 1040EZ. If your filing status is married filing a joint return and you do not claim any dependents, you may be able to file Form 1040EZ for 1994. See *Which Form Should I Use?* in Chapter 1.

Increase in top tax rates. For 1994, the top tax rate is 36%. A 10% surtax is imposed on high-income taxpayers. These tax rates are included in the *Tax Rate Schedules* printed in the Form 1040 instructions.

Maximum tax rate on capital gains. The tax rates for individuals that are higher than 28% do not apply to net capital gains. The maximum income tax rate on net capital gain income is 28%. Net capital gain is the excess of net long-term capital gain for the year over net short-term capital loss for the year.

Limit on exemption amount. If your adjusted gross income is more than a specified amount based on your filing status, the amount of your deduction for exemptions is reduced. These amounts are explained later in this chapter under *Exemptions.*

Amount you owe. If you did not pay enough tax through either withholding or estimated tax payments, you may be charged a penalty for underpayment of estimated tax. If you determine that you owe tax, see *Underpayment Penalty* in Chapter 5.

Introduction

This chapter discusses the steps you need to take to figure your tax on:

- Form 1040EZ,
- Form 1040A, and
- Form 1040.

Also, this chapter discusses the requirements you must meet to have the IRS figure your tax.

Form 1040EZ

If you file Form 1040EZ, you must figure your adjusted gross income and taxable income before you can find your tax.

Adjusted gross income (line 3, Form 1040EZ). This is the total of your wages, salaries, tips, taxable scholarship or fellowship grants, and taxable interest income.

Taxable income (line 5, Form 1040EZ). Your taxable income is your adjusted gross income (line 3), minus the total of your standard deduction and the deduction for your personal exemption(s) (line 4). The amount of these deductions depends on whether you (or your spouse if married) can be claimed as a dependent on someone else's return, such as your parents'. The rules for determining whether you are a dependent are in Chapter 3.

Not a dependent. If you (and your spouse if married) cannot be claimed as a dependent by another taxpayer, the total of your standard deduction and your personal exemption(s) is $6,250 if single or $11,250 if married. Check the *No* box and enter the appropriate amount on line 4.

Dependent. If you (or your spouse if married) can be claimed as a dependent by another taxpayer, check the *Yes* box on line 4 and complete the worksheet on the back of Form 1040EZ. Enter the result from line G of the worksheet on line 4.

Tax withheld. After you have figured your taxable income, enter the total of your federal income tax withheld on line 6. This amount is shown in box 2 of your Form(s) W–2. Copy B of Form(s) W–2 must be attached to the return.

See the instructions for Form 1040EZ if withholding tax is shown in box 4 of any Form 1099–INT or Form 1099–OID you receive.

Earned income credit (EIC). If you can claim the EIC, enter your credit on line 7. Enter the amount and type of any nontaxable earned income in the boxes to the left of line 7. You may be able to claim the credit on Form 1040EZ if your income is less than $9,000 and you (or your spouse if filing jointly) were at least age 25 at the end of 1994. See Chapter 35 for more information about the EIC. You will also find examples of nontaxable earned income in Table 35-1 in that chapter.

Total payments (line 8, Form 1040EZ). This is the total of your federal income tax withheld (line 6) and any earned income credit (line 7) you can claim. If you paid any tax with a Form 4868, *Automatic Extension of Time to File U.S. Individual Income Tax Return,* include the amount in the total on line 8. Also, print ''Form 4868'' and the amount paid to the left of line 8.

Tax. To find your tax, use the Tax Table in the instructions for Form 1040EZ. Find the income line that includes your taxable income shown on line 5 of your Form 1040EZ. Next, find the column heading for your filing

status (single or married filing jointly) and read down the column. The amount shown where the income line and filing status column meet is your tax. Enter it on line 9.

Refund or amount you owe. If line 8 is larger than line 9, subtract line 9 from line 8 and enter the result on line 10. This is the amount of your refund. For information on refunds, see *Refunds* in Chapter 1.

If line 9 is larger than line 8, subtract line 8 from line 9 and enter the result on line 11. This is the amount you owe. For information on how to pay, see *Amount You Owe* in Chapter 1.

Filled-in form. A filled-in Form 1040EZ is shown in Chapter 37.

Form 1040A

If you file Form 1040A, you must find your adjusted gross income and taxable income before you can figure your tax.

Adjusted gross income (lines 16 and 17, Form 1040A). This is your total income (line 14) minus your IRA deduction, and your spouse's IRA deduction if you file a joint return. You can figure your IRA deduction by completing one of the IRA worksheets in the instructions for Form 1040A. Also see Chapter 18.

Taxable income (line 22 Form 1040A). This is your adjusted gross income (line 17) minus your standard deduction (line 19) and the deduction for your exemptions (line 21).

Standard deduction. Your standard deduction is based on your filing status, whether you are 65 or older or blind, and whether you can be claimed as a dependent on another person's return. For information, see *Standard Deduction,* later, and Chapter 21.

Exemptions. To figure the deduction for your exemptions, multiply $2,450 by the number of exemptions claimed on line 6e. If you can be claimed as a dependent on someone else's return, check the box on line 18b. You cannot claim an exemption for a person who can be claimed as a dependent by another taxpayer.

Tax, credits, and payments. Next, you must figure your tax. Subtract from your tax any credits or payments to determine whether you owe additional tax or are due a refund.

Tax. To find your tax, use the Tax Table in the instructions for Form 1040A. In the Tax Table, find the income line that includes your taxable income shown on line 22. Next, find the column heading that describes your filing status and read down the column. The amount shown where the income line and filing status column meet is your tax. Enter it on line 23 and check the box marked ''Tax Table.''

Note. If this is the return of a child under age 14 on January 1, 1995, with more than $1,200 of investment income, you cannot use the Tax Table. Instead, you must check the box marked ''Form 8615'' on line 23. Use **Form 8615,** *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,200,* to compute your tax. Form 8615 should not be filed if neither parent is alive at the end of the year. For more information, see Chapter 32.

Credits. There are three credits that can be claimed on Form 1040A. Credits, unlike deductions, are subtracted after you find your tax from the tax table and reduce your tax dollar for dollar. These credits are:

1) Credit for child and dependent care expenses,
2) Credit for the elderly or the disabled, and
3) Earned income credit.

The earned income credit is explained later under *Payments.*

If you claim the credit for child and dependent care expenses (line 24a), you must complete all parts of Schedule 2 (Form 1040A) that apply and attach it to your return. For information on the credit for child and dependent care expenses, see Chapter 33.

If you claim the credit for the elderly or the disabled (line 24b), you must complete Schedule 3 (Form 1040A) and attach it to your return. For information on the credit for the elderly or the disabled, see Chapter 34.

Add lines 24a and 24b and enter the result on line 24c. Subtract your total credits (line 24c) from your tax (line 23) and enter the result on line 25.

Total tax. If you received advance earned income credit payments, the amount will be shown on your Form(s) W–2, box 9. Enter the amount of these payments on line 26. For more information, see *Advance Earned Income Credit Payments* in Chapter 35.

Add the amounts on lines 25 and 26. Enter the total on line 27. Also, if you owe the alternative minimum tax, include that tax in the total on line 27. This sum is your total tax.

If the amount on line 17, plus any tax-exempt interest on line 8b is more than $45,000 if your filing status is married filing jointly or qualifying widow(er); more than $33,750 if your filing status is single or head of household; or more than $22,500 if your filing status is married filing separately, and the amount on line 21 is more than $9,400, complete the *Alternative minimum tax worksheet* in the Form 1040A instructions to see if you owe this tax and, if you do, the amount to include on line 27.

Caution. If filing for a child under age 14, add the amount on Form 1040A, line 17, to the child's tax-exempt interest from private activity bonds issued after August 7, 1986. If this amount is more than the total of $1,000 plus the amount on Form 1040A, line 7, do not file Form 1040A. Instead, file Form 1040 for the child. Use Form 6251 to see if the child owes the alternative minimum tax.

Payments. On line 28a, enter the total federal income tax withheld from your pay. This amount is shown in box 2 of your Form(s) W–2. If you have more than one employer, carefully add the amounts from these boxes and enter the total on line 28a.

If you received a Form 1099 showing income tax withheld on dividends, interest, IRA distributions, or pensions, check the box on line 28a and include the amount withheld in the total on line 28a. It is important to check all of your Form 1099 statements to see whether any income tax was withheld. A table showing the proper boxes that record withholding is included later. See *Payments* under *Form 1040.*

On line 28b, enter your 1994 estimated tax payments and any overpayment applied from your 1993 federal income tax return.

On line 28c, enter your ***earned income credit*** (EIC). You may be able to take this credit if lines 7 and 16 are less than $23,755 and you had one qualifying child (less than $25,296 if you had more than one qualifying child). A qualifying child is one that meets certain age and other requirements and lived with you. Also, you may be able to take this credit if lines 7 and 16 are less than $9,000 and you do not have a qualifying child. You (or your spouse if filing jointly) must have been at least age 25 but under age 65 at the end of your tax year. To find out if you can take the EIC, follow the Form 1040A instructions for line 28c. More information on the earned income credit is in Chapter 35.

Add the amounts on lines 28a, 28b, and 28c and enter this total on line 28d. This sum is your total payments.

Include on line 28d any excess social security or railroad retirement tax withheld. Write ''Excess SST'' and the amount in the space to the left of line 28d. See Chapter 36 for a discussion on this.

Also include on line 28d any tax you paid if you filed Form 4868 to get an automatic extension of time to file your Form 1040A. Write ''Form 4868'' and the amount in the space to the left of line 28d. Also include any amount paid with Form 2688.

Refund or Amount You Owe

After you have your total tax (line 27) and your total payments (line 28d), you can determine if you are due a tax refund or if you owe additional tax.

Refund

If line 28d is more than line 27, subtract line 27 from line 28d and enter the result on line 29. This is the amount of your overpayment. If you want the entire amount on line 29 refunded, enter that amount on line 30. Enter on line 30 the exact amount you want refunded. For information on refunds, see *Refunds* in Chapter 1.

If you want all or part of your refund applied to your 1995 estimated tax, you must

enter the appropriate amount on line 31. The amount on line 31 will be credited to your 1995 estimated taxes unless you request us to apply it to your spouse's account. This request should include your spouse's social security number. The amount on line 31 generally cannot be refunded to you until you file a tax return for 1995.

Amount You Owe

If line 27 is more than line 28d, subtract line 28d from line 27 and enter the result on line 32. This is the amount you owe. For information on how to pay, see *Amount You Owe* in Chapter 1.

Filled-in form. A filled-in Form 1040A is shown in Chapter 38.

Form 1040

If you file Form 1040, you must compute your adjusted gross income and taxable income before you can figure your tax.

Adjusted Gross Income (line 31, Form 1040)

Adjusted gross income (line 31, Form 1040) is your total income (line 22) minus any adjustments for the following:

1) IRA deduction for you (line 23a), and for your spouse (line 23b). See Chapter 18.
2) Moving expenses (line 24). See Chapter 19.
3) Deduction for one-half of your self-employment tax (line 25). See Publication 533, *Self-Employment Tax.*
4) Self-employed health insurance deduction (line 26). See Chapter 23.
   Caution: The self-employed health insurance deduction expired December 31, 1993. However, at the time this publication was being prepared for print, Congress was considering legislation that would allow a deduction for 1994. Get Publication 553, *Highlights of 1994 Tax Changes* for later information about this deduction. You **cannot** take this deduction unless it has been allowed by Congress before you file your tax return.
5) Keogh retirement plan and self-employed SEP deduction (line 27). See Publication 560, *Retirement Plans for the Self-Employed.*
6) Penalty on early withdrawal of savings (line 28). See Chapter 8.
7) Alimony paid. You must show the recipient's social security number in the space provided on line 29. See Chapter 20.
8) Other adjustments. Write in the following adjustments on the dotted line next to line 30 and include them in the total on line 30.
   a) Certain expenses of qualified performing artists. See Chapter 30.
   b) Jury duty pay given to your employer. See Chapter 13.
   c) Amortization of the costs of forestation or reforestation if you do not have to file Schedule C, C–EZ, or F. See Publication 535, *Business Expenses.*
   d) Certain required repayments of supplemental unemployment benefits. See Chapter 6.
   e) Contributions to a Section 501(c)(18) pension plan.
   f) Deduction for nonbusiness clean-fuel vehicle property. See Publication 535.
   g) Expenses from the rental of personal property.

Taxable Income (line 37, Form 1040)

There are two ways to figure the amount of your taxable income (line 37, Form 1040). You can choose to itemize your deductions on Schedule A (Form 1040) or take the standard deduction, whichever is greater.

Itemizing Your Deductions

You can itemize your deductions (such as medical expenses, taxes, mortgage interest, and casualty losses) on Schedule A (Form 1040).

Benefits of itemizing. You may benefit from itemizing your deductions on Schedule A if you:

1) Do not qualify for the standard deduction, or the amount you can claim is limited,
2) Had large uninsured medical and dental expenses during the year,
3) Paid interest and taxes on your home,
4) Had large unreimbursed employee business expenses or other miscellaneous deductions,
5) Had large casualty or theft losses not covered by insurance,
6) Made large contributions to qualified charities, or
7) Have total itemized deductions that are more than the highest standard deduction amount to which you otherwise are entitled.

Some taxpayers itemize deductions because they do not qualify for the standard deduction or the amount they qualify for is limited (see Chapter 21).

If you decide to itemize your deductions, complete and attach Schedule A to your return. Enter the amount from line 29 of Schedule A on line 34 of Form 1040.

Separate returns. If you and your spouse file separate returns, you can use the method that gives you the lowest total tax, even though one of you may pay more than the other. However, if one of you itemizes deductions, the other should also itemize because the standard deduction of a married individual filing a separate return where either spouse itemizes deductions is zero.

Changing your mind. If you do not itemize your deductions and later find you should have itemized—or if you itemize and later find you should not have—you can change your return by filing Form 1040X, *Amended U.S. Individual Income Tax Return.*

Separate returns. If you and your spouse filed separate returns, you can change methods of taking deductions only if you and your spouse make the same changes. Both of you must consent in writing to the assessment for any additional tax either one may owe as a result of the change.

Taxable income. If you itemize your deductions, your taxable income (line 37) is your adjusted gross income (line 32) minus your itemized deductions (line 34) and your exemptions (line 36).

Standard Deduction

The standard deduction is based on your filing status and whether you are 65 or older or blind.

65 or older or blind. If you were 65 or older or blind in 1994, you are entitled to a higher standard deduction than taxpayers under 65 and not blind. For information on who qualifies for the higher standard deduction for age and blindness, see Chapter 21. The standard deduction amounts are given in the standard deduction charts and worksheet in Chapter 21.

Special rules. Your standard deduction is ***zero*** if:

1) Your spouse itemizes deductions on a separate return,
2) You are a dual-status or nonresident alien, or
3) You have a short tax year on account of a change in your annual accounting period.

Dependent. If you can be claimed as a dependent on another person's return, your standard deduction may be limited. See *Standard Deduction for Dependents* in Chapter 21.

Amount of the standard deduction. If you decide to take the standard deduction, show the amount on line 34 of Form 1040.

The amount of the standard deduction for most people is shown on Form 1040 to the left of line 34. Others must use the standard deduction charts and worksheet in Chapter 21 or in the Form 1040 instructions to find their standard deduction.

Taxable income. If you take the standard deduction, your taxable income (line 37) is your adjusted gross income (line 32) minus your standard deduction (line 34) and your exemptions (line 36).

Exemptions

Whether you itemize your deductions or use the standard deduction, you can generally deduct $2,450 for each exemption you can claim. However, if your adjusted gross income (AGI) is more than the dollar amount for your filing status as shown in the following table, the amount of your deduction is less.

Filing Status	AGI more than:
Single	$ 111,800
Married filing jointly	167,700
Married filing separately	83,850
Head of household	139,750
Qualifying widow(er)	167,700

Use the *Deduction for Exemptions Worksheet — Line 36* in the Form 1040 Instructions to figure the amount of your deduction.

Enter the amount you figure for your exemptions on line 36.

Tax, Credits, and Payments

After finding your taxable income, the next step is to figure your tax liability. This tax amount is then reduced by any credits you may have. Finally, you apply any payments or other credits against your liability to determine whether you owe additional tax or are entitled to a refund.

Tax

Most people use the Tax Table to figure their tax. However, you must use the Tax Rate Schedules to figure your tax if your taxable income is $100,000 or more.

If you had a net capital gain or reported capital gain distributions on Form 1040, line 13, your tax may be less if you figure it using the *Capital Gain Tax Worksheet* in the Form 1040 instructions. Form 8615 may have to be used to figure the tax for a child under age 14 at the end of the year with more than $1,200 of investment income.

Tax Table. The Tax Table is shown in the instructions for Form 1040. To find your tax, read down the income column to the line that includes your taxable income as shown on line 37. Then read across the line to the column heading that describes your filing status. The amount shown where the income line and filing status column meet is your tax. Enter it on line 38 and check the box marked *Tax Table.*

Tax Rate Schedules. If your taxable income (line 37) is $100,000 or more, you must figure your tax by using Tax Rate Schedules X, Y–1, Y–2, or Z unless you can use the *Capital Gain Tax Worksheet* or must use Form 8615.

The Tax Rate Schedules are shown in the Form 1040 instructions. Enter your tax on line 38, and check the box marked *Tax Rate Schedules.*

Maximum tax rate on capital gains (Schedule D). The highest tax rate on taxable income is 39.6%. However, the highest tax rate on a net capital gain is 28%. A net capital gain is the excess of your net long-term capital gains over your net short-term capital losses. The maximum 28% rate applies if you have a long-term capital gain shown on line 17, Schedule D (Form 1040), and a net gain shown on line 18, Schedule D (Form 1040). This maximum rate also applies if you received capital gain distributions and do not need Schedule D for other capital transactions. If this is the case, enter those distributions on line 13 of Form 1040. Write "CGD" on the dotted line next to line 13.

You should complete the *Capital Gain Tax Worksheet* in the Form 1040 instructions to figure your tax only if your taxable income (line 37, Form 1040) is more than the amount shown for your filing status in the following table.

Filing Status	Amount
Married filing jointly	$ 91,850
Qualifying widow(er)	91,850
Head of household	78,700
Single	55,100
Married filing separately	45,925

If you use the *Capital Gain Tax Worksheet,* enter your tax from line 13 of the worksheet on line 38, Form 1040, and check the box marked *Capital Gain Tax Worksheet.*

Investment income of certain minor children. If a child under age 14 at the end of the year has more than $1,200 of interest, dividends, and other investment income, part of that income may be taxed at the parent's rate. The tax is figured using **Form 8615,** *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,200.*

Form 8615 should not be filed if neither parent is alive at the end of the year or if a parent chooses to include the child's interest and dividend income on his or her return. For more information, see Chapter 32.

Additional taxes. If you must attach **Form 4970,** *Tax on Accumulation Distribution of Trusts,* or **Form 4972,** *Tax on Lump-Sum Distributions,* check the box on line 39 that applies to you and enter the amount of additional taxes.

Credits

After you have figured your tax and entered the total of lines 38 and 39 on line 40, figure your credits and enter them on lines 41 through 45. Enter the total credits on line 45. Subtract line 45 from line 40. Enter the result on line 46. If line 45 is more than line 40, enter zero.

This chapter does not explain whether you are eligible for these credits. The following table is a summary of the credits and where to report them on Form 1040. Additional information is provided in the paragraphs that follow the table.

Credit	Line
Child Care	41
Elderly or Disabled	42
Foreign Tax	43
General Business	44
Empowerment Zone Employment	44
Mortgage Interest	44
Prior Year Minimum Tax	44
Qualified Electric Vehicle	44
Nonconventional Fuel Source	45

Credit for child and dependent care expenses. Enter on line 41 (Form 1040) the amount of this credit, which you figure on **Form 2441,** *Child and Dependent Care Expenses.* See Chapter 33 for information on this credit.

Credit for the elderly or the disabled. Enter on line 42 (Form 1040) the amount of this credit, which you figure on Schedule R. See Chapter 34 for more information.

Foreign tax credit. Enter on line 43 (Form 1040) the amount of foreign tax credit, which you figure on Form 1116. Foreign tax credit is discussed in Publication 514, *Foreign Tax Credit for Individuals.*

Other credits. Enter other credits on line 44 and check the appropriate box or enter the form number to identify which form you are attaching.

General business credit. The general business credit is made up of a number of separate business-related credits. If you have 2 or more of the separate credits, use **Form 3800,** *General Business Credit,* and check box ***a*** on line 44. If you have only one of these credits, check box ***d*** and enter the form number for that credit. See Form 3800 for more information.

Empowerment zone employment credit. Use **Form 8844,** *Empowerment Zone Employment Credit,* to figure the amount of this credit, check box ***d*** on line 44, and enter the form number.

Mortgage interest credit. Use **Form 8396**, *Mortgage Interest Credit,* to figure the amount of this credit and check box ***b*** on line 44. See *Mortgage Interest Credit* in Publication 530, *Tax Information for First-Time Homeowners.*

Credit for prior year minimum tax. Complete **Form 8801**, *Credit For Prior Year Minimum Tax—Individuals, Estates, and Trusts,* if you paid alternative minimum tax in 1993 on deferred preference items or have a carryforward of the minimum tax credit. Attach this form to your tax return and check box ***c*** on line 44.

Qualified electric vehicle credit. If you placed a qualified electric vehicle in service in 1994, use **Form 8834,** *Qualified Electric Vehicle Credit* to figure the amount of your credit. Check box ***d*** on line 44 and enter the

form number. See Chapter 36 for information on this credit.

Credit for fuel from a nonconventional source. Include this credit in the total for line 45. Write the amount and ''FNS'' on the dotted line next to line 45. Also attach a separate schedule showing how you figured the credit. See *Internal Revenue Code section 29* for further information.

Total credits. Add lines 41 through 44. Put the total on line 45. Line 45 is your total credits.

Other Taxes

If you owe any other taxes or if you received advance earned income credit payments, complete any of lines 47 through 52 that apply to you and enter your total tax on line 53.

This chapter does not explain these taxes. The following table is a summary of the taxes and where to report them on Form 1040. Additional information is provided in the paragraphs that follow the table.

Other Taxes	Line
Self-Employment Tax	47
Alternative Minimum Tax	48
Recapture Taxes	49
Social Security and Medicare Tax on Tips	50
IRA or Qualified Retirement Plan Penalty Tax	51
Advance Earned Income Credit Payments	52
Section 72(m)(5) Excess Benefits Tax	53
Uncollected Tax on Tips or Life Insurance Premiums	53
Tax on excess Golden Parachute Payments	53

Self-employment tax. You must file Schedule SE (Form 1040) if either of the following applies to you (or your spouse if you file a joint return):

1) You were self-employed, and your net earnings from self-employment were $400 or more, or
2) You had church employee income of $108.28 or more.

Complete Schedule SE (Form 1040) and show any tax you owe on line 47 (Form 1040). See Publication 533, *Self-Employment Tax,* for more information.

Alternative minimum tax. Use Form 6251 to see if you owe any alternative minimum tax. Enter the result on line 48 (Form 1040). This tax is briefly discussed later in this chapter and in depth in the *Instructions for Form 6251.*

Recapture taxes. If you must recapture an investment tax credit on Form 4255, a low-income housing credit on Form 8611, or a federal mortgage subsidy on Form 8828, enter the amount on line 49 (Form 1040) and check the appropriate box. If you must recapture a qualified electric vehicle credit, include it on line 49 and write 'QEV' on the dotted line next to the entry.

Social security and Medicare tax on tip income not reported to employer. Attach **Form 4137,** *Social Security and Medicare Tax on Unreported Tip Income,* and show on line 50 (Form 1040) the tax due on tip income you did not report to your employer. See Chapter 7 for more information.

IRA or qualified retirement plan penalty taxes. You may owe additional taxes on your IRA or other qualified retirement plan if you:

1) Received any early distributions from a qualified retirement plan, annuity, or modified endowment contract (entered into after June 20, 1988),
2) Received any excess distributions from a qualified retirement plan,
3) Made excess contributions to your IRA, or
4) Had excess accumulations in a qualified retirement plan.

If any of the above apply, get **Form 5329,** *Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts,* to see if you owe this tax and if you must file this form. Enter the tax from Form 5329 on line 51. See Chapter 18 for more information on IRAs.

Advance earned income credit payments. Include on line 52 any advance earned income credit payments you received in 1994. Your W–2 form(s) will show these payments in box 9.

Section 72(m)(5) excess benefits. If you are or were a 5% owner of a business and you received a distribution of excess benefits from a qualified pension or annuity plan, you may have to pay a penalty tax of 10% of the excess benefits distribution. Include the amount of the penalty in your total for line 53. Also write the amount and ''Section 72(m)(5)'' on the dotted line next to line 53. See Publication 560, *Retirement Plans for the Self-Employed,* for more information.

Uncollected employee social security and Medicare or RRTA tax on tips (or group-term life insurance). If you did not have enough wages to cover the social security tax and Medicare tax or railroad retirement (RRTA) tax due on tips you reported to your employer (or on group-term life insurance), include the tax due in the total for line 53. The amount of tax due will be shown on your Form W–2. Also write the amount and ''Uncollected Tax'' on the dotted line next to line 53. See Chapter 7 for more information.

Golden parachute payments. If you received an excess parachute payment (EPP), you must pay a tax equal to 20% of this excess payment. Include the amount of this tax in your total for line 53. Also write the amount and ''EPP'' on the dotted line next to line 53. See *Form 1040 Instructions* for *Line 53* for more information.

Total tax. Add lines 46 through 52 and any amounts entered next to line 53. Put the total on line 53. Line 53 is your total tax.

Payments

Once you have figured your total tax on line 53, figure your total payments. Enter the payments that apply to you on lines 54 through 59.

This chapter does not discuss all of these payments. The following table is a summary of the payments (and credits that are considered payments) and where to report them on Form 1040. Additional information is provided in the paragraphs that follow the table.

Payments	Line
Federal Income Tax Withheld	54
Estimated Tax Paid	55
Earned Income Credit	56
Tax Paid with Extension	57
Excess Tax Withheld	58
Regulated Investment Company Credit	59
Fuel Tax Credit	59

Federal income tax withheld. On line 54, enter your federal income tax withheld. This includes amounts from Forms W–2, W–2G, 1099–R, and any other Form 1099. It is important to check all of your statements to see whether any tax was withheld and to carefully add the amounts before making an entry on line 54. If any amount you include on line 54 is from a Form 1099, check the box next to the line. The following table shows the proper boxes that record income tax withholding.

FORM NUMBER	LOCATION
W–2	Box 2
W–2G	Box 2
1099–B	Box 4
1099–DIV	Box 2
1099–G	Box 4
1099–INT	Box 4
1099–MISC	Box 4
1099–OID	Box 4
1099–PATR	Box 4
1099–R	Box 4

Estimated tax payments. If you made estimated tax payments for 1994, enter the total of these payments on line 55. Also enter on line 55 any overpayment from your 1993 return that you applied to your 1994 estimated tax.

If you paid joint estimated tax but are now filing separate income tax returns or if you divorced in 1994, see *Estimated Tax* in Chapter 5 for further directions.

Earned income credit (EIC). Enter your earned income credit on line 56. You may be

able to take this credit if lines 7 and 31 are less than $23,755 and you had one qualifying child (less than $25,296 if you had more than one qualifying child). A qualifying child is one that meets certain age and other requirements and lived with you. Also, you may be able to take this credit if lines 7 and 31 are less than $9,000 and you do not have a qualifying child. You (or your spouse if filing jointly) must have been at least age 25 but under age 65 at the end of your tax year. To find out if you can take the EIC, follow the Form 1040 instructions for line 56. The earned income credit is explained in Chapter 35.

Tax paid with extension. If you paid any tax with Forms 4868, 2688, or 2350 (extensions of time to file), enter this amount on line 57.

Excess tax withheld. If you worked for more than one employer and had too much social security or railroad retirement tax withheld, enter the excess amount on line 58. This is explained in Chapter 36.

Regulated investment company credit. If you can take a regulated investment company credit, attach Copy B of **Form 2439,** *Notice to Shareholder of Undistributed Long-Term Capital Gains.* Include the amount of the credit on line 59 and check box **a.**

Fuel tax credit. If you can take a credit for tax on gasoline, diesel fuel, and other fuels used in your business, or for certain diesel-powered cars, vans, and light trucks, attach Form 4136. Include the amount of the credit on line 59 and check box **b.**

Total payments. Add lines 54 through 59 and enter this total on line 60. This sum is your total payments.

Refund or Amount You Owe

After you have your total tax (line 53) and your total payments (line 60), you must determine if you are due a tax refund or if you owe additional tax.

Refund

If the amount on line 60 is more than the amount on line 53, subtract line 53 from line 60 and enter the result on line 61. This is the amount of tax you have overpaid. If you want the entire amount refunded to you, enter the amount on line 62. If you want all of your overpayment applied to your 1995 estimated tax, enter the amount on line 63. If you want part of your overpayment applied to your 1995 estimated tax, you must complete both lines 62 and 63. The amount on line 63 will be credited to your 1995 estimated taxes unless you request us to apply it to your spouse's account. This request should include your spouse's social security number. For information on refunds (including how to apply your refund to any 1993 taxes you deferred paying by filing Form 8841), see *Refunds* in Chapter 1.

Amount You Owe

If the amount on line 53 is more than the amount on line 60, subtract line 60 from line 53 and enter the result on line 64. This is the amount you owe. For information on how to pay, see *Amount You Owe* in Chapter 1.

Filled-in form. A filled-in Form 1040 with certain forms and schedules is shown in Chapter 39.

Alternative Minimum Tax

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. Taxpayers who benefit from these laws may have to pay at least a minimum amount of tax through an additional tax. This additional tax is called the ***alternative minimum tax (AMT)***.

You may have to pay the alternative minimum tax if your taxable income for regular tax purposes, combined with any of the adjustments and tax preference items that apply to you, is more than:

$45,000 if your filing status is married filing a joint return (or a qualifying widow(er) with dependent child),

$33,750 if your filing status is single or head of household, or

$22,500 if your filing status is married filing a separate return.

Adjustments. Adjustments to taxable income include:

- Addition of ***personal exemptions,***
- Addition of the ***standard deduction*** (if claimed),
- Addition of ***itemized deductions*** claimed for state and local taxes, certain interest, most miscellaneous deductions, and part of medical expenses,
- Subtraction of any ***refund of state and local taxes*** included in gross income,
- Accelerated ***depreciation*** in excess of straight line,
- Change in method of determining income from ***long-term contracts*** entered into on or after March 1, 1986,
- Difference between ***gain or loss*** on the sale of property reported for regular tax purposes and AMT purposes,
- For stock acquired during the year through the exercise of an ***incentive stock option,*** add any excess fair market value of the stock over the amount you paid for it,
- Change in method of determining income from ***certain installment sales,*** and
- Change in method of determining ***passive activity loss*** deduction.

Tax preference items. Tax preference items include:

- That part of a deduction for certain ***depletion*** that is more than the adjusted basis of the property,
- Part of a deduction for certain ***intangible drilling costs*** if the deduction (minus the amount that could have been deducted if the cost were amortized over 120 months) is more than 65% of the net income from oil, gas, and geothermal properties, and
- ***Tax-exempt interest*** on certain private activity bonds.

More information. For more information about the alternative minimum tax, these and other adjustments and preference items, and how to figure the AMT, see the instructions for **Form 6251,** *Alternative Minimum Tax—Individuals.*

Tax Figured by IRS

If you want, the IRS will figure your tax for you on Form 1040EZ, Form 1040A, or Form 1040.

If the IRS figures your tax and you paid too much, you will receive a refund. If you did not pay enough, you will receive a bill for the balance. You may avoid interest or the penalty for late payment if you pay the bill within 30 days of the date of the bill or by the due date for your return, whichever is later.

Form 1040EZ

If you file Form 1040EZ by April 17, 1995, you may choose to have the IRS figure your tax. Put your name and address label on your return. If you do not have a label, print (do not type) your name, address, and social security number in the spaces provided.

What to complete. Read lines 1 through 7 and fill in the lines that apply to you. If you are filing a joint return, use the space under the "Note" to the left of line 5 to separately show your taxable income and your spouse's taxable income.

Earned income credit (EIC). If you can take the EIC as discussed in Chapter 35, the IRS will figure the credit for you. You must enter the amount and type of any nontaxable earned income in the boxes to the left of line 7. Print "EIC" in the space to the right of the words "earned income below."

Filing the return. Sign and date your return (both spouses must sign a joint return) and enter your occupation(s). Attach Copy B or the first copy of all your Forms W–2 to your return. Mail the return to the Internal Revenue Service Center for the area where you live.

Form 1040A

If you file Form 1040A by April 17, 1995, you may choose to have the IRS figure your tax. Place your name and address label on your return. If you do not have a label, fill in (print or type) your name, address, and social security number. If you are married, give the

social security numbers of both spouses even if you file separately.

If you must use **Form 8615,** *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,200,* or if you want any of your refund applied to your 1995 estimated tax, the IRS cannot figure your tax for you.

What to complete. Read lines 1 through 22 and fill in the lines that apply to you. If you file a joint return, use the space to the left of line 22 to separately show your own and your spouse's taxable income. Complete lines 24a, 26, 28a, and 28b if they apply to you. Also, enter any write-in information that applies to you in the space to the left of line 28d.

Credit for child and dependent care expenses. If you can take this credit, complete Schedule 2 and attach it to your return. You must show on Schedule 2 the name, address, and identifying number of the person or organization who provided the care. Enter the amount of the credit on line 24a (Form 1040A). The IRS will not figure this credit.

Credit for the elderly or the disabled. If you can take this credit, attach Schedule 3 to your return and write ''CFE'' in the space to the left of line 24b (Form 1040A). The IRS will figure this credit for you. Check the box on Schedule 3 for your filing status and age, and fill in lines 11 and 13 of Part III if they apply. Also, complete Part II of Schedule 3 if it applies. See Chapter 34 for more information about this credit.

Advance earned income credit payment. If you received any advance earned income credit payment during 1994, enter the amount on line 26. Your Form(s) W–2 will show these payments in box 9.

Payments. Place any income tax withheld that is shown in box 2 of Form W–2, or the appropriate box of Form 1099, on line 28a. Place any estimated tax payments you made on line 28b.

Earned income credit. If you can take the earned income credit, as discussed in Chapter 35, the IRS will figure the credit for you. Write ''EIC'' next to line 28c. Also, enter any nontaxable earned income in the space provided. If you have a qualifying child, fill in Schedule EIC and attach it to your return.

Form W–2. Attach Copy B or the first copy of all your Form(s) W–2 to your return. Also attach any Form 1099–R you received that has withholding tax in box 4.

Filing the return. Sign and date your return. Also fill in your occupation. If you are filing a joint return, both you and your spouse must sign it. Show both of your occupations on a joint return. Mail the return to the Internal Revenue Service Center for the area where you live.

Form 1040

If you file Form 1040 by April 17, 1995, you may choose to have the IRS figure your tax if you meet all of the conditions described below:

1) All of your income for 1994 was from wages, salaries, tips, interest, dividends, taxable social security benefits, unemployment compensation, IRA distributions, pensions, or annuities.
2) Your taxable income on line 37 is less than $100,000.
3) You do not itemize deductions.
4) You do not file any of the following forms:
   a) **Form 2555,** *Foreign Earned Income.*
   b) **Form 2555-EZ,** *Foreign Earned Income Exclusion.*
   c) **Form 4137,** *Social Security and Medicare Tax on Unreported Tip Income.*
   d) **Form 4970,** *Tax on Accumulation Distribution of Trusts.*
   e) **Form 4972,** *Tax on Lump-Sum Distributions.*
   f) **Form 6198,** *At-Risk Limitations.*
   g) **Form 6251,** *Alternative Minimum Tax—Individuals.*
   h) **Form 8615,** *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,200.*
   i) **Form 8814,** *Parents' Election To Report Child's Interest and Dividends.*
5) You do not want any of your refund applied to your 1995 estimated tax.

Name, address, and social security number. Put your name and address label on your return. If you do not have a label, fill in (print or type) your name, address, and social security number. If you are married, give the social security numbers of both spouses even if you file separately.

What to complete. Read lines 1 through 37 and fill in the lines that apply to you.

If you are filing a joint return, use the space under the words *Adjustments to Income* on the front of your return to show your taxable income and your spouse's taxable income separately.

Read lines 39 through 59. Fill in the lines that apply to you, but do not fill in the *Total* lines. Please be sure to fill in line 54 for federal income tax withheld.

Fill in any forms or schedules asked for on the lines you completed, and attach them to your return when you file it.

Credit for the elderly or the disabled. If you can take the credit for the elderly or the disabled, as discussed in Chapter 34, attach Schedule R. Write ''CFE'' on the dotted line next to line 42 of Form 1040. The IRS will figure the credit for you. On Schedule R, check the box for your filing status and age, and fill in lines 11 and 13 of Part III if they apply. Also complete Part II of Schedule R if it applies.

Earned income credit. If you can take the earned income credit, as discussed in Chapter 35, the IRS will figure it for you. Write ''EIC'' next to line 56 of Form 1040 and enter the amount and type of any nontaxable earned income in the space provided. Also, if you have a qualifying child, fill in Schedule EIC and attach it to your return.

Payments. Place any income tax withheld that is shown in box 2 of Form W–2, or the appropriate box of Form 1099, on line 54. Attach Copy B or the first copy of all your Form(s) W–2 to your return. Also attach any Form 1099–R you received that has withholding tax in box 4.

Place any estimated tax payments you made on line 55.

Filing the return. Be sure to sign and date your return and show your occupation(s). If you are filing a joint return, both you and your spouse must sign it. Mail your return to the Internal Revenue Service Center for the area where you live.

32.

Tax on Investment Income of Certain Minor Children

Introduction

This chapter discusses two special tax rules that apply to certain investment income of a child under age 14:

1) A child's parent may be able to choose to include the child's interest and dividend income on the parent's return so the child does not have to file a return. See *Parent's Election to Report Child's Unearned Income,* later.
2) If a child's interest, dividends, and other investment income total more than $1,200, part of that income may be taxed at the parent's tax rate instead of the child's tax rate. See *Child's Return Filed (Parent's Election Not Made),* later.

For this purpose, the term ''child'' includes a legally adopted child and a stepchild. These rules apply whether or not the child is a dependent.

These rules do ***not*** apply if:

- The child is not required to file a tax return, or
- Neither of the child's parents were living at the end of the tax year.

Useful Items

You may want to see:

Publication

❑ **929** Tax Rules for Children and Dependents

Form (and Instructions)

❑ **8615** Tax for Children Under Age 14 Who Have Investment Income of More Than $1,200

❑ **Form 8814** Parents' Election To Report Child's Interest and Dividends

Which Parent's Return To Use

For parents who do not file a joint return, the following discussions explain which parent's tax return must be used when applying the special tax rules for the investment income of a child under 14. Only that parent can make the election described later under *Parent's Election to Report Child's Unearned Income,* and only that parent's tax rate and other return information is used in the computations explained later under *Child's Return Filed (Parent's Election Not Made).*

Child's parents married. If the child's parents are married to each other and file separate returns, use the return of the parent with the greater taxable income. If they file a joint return, use the joint return.

Parents treated as not married. If a child's parents are married but not living together, and the parent with whom the child lives (the custodial parent) is considered unmarried, use the return of the custodial parent. If the custodial parent is not considered unmarried, use the return of the parent with the greater taxable income.

For an explanation of when a married person living apart from his or her spouse is considered unmarried, see *Head of Household* in Chapter 2.

Child's parents divorced. If a child's parents are divorced or legally separated, and the parent who had custody of the child for the greater part of the year (the custodial parent) has not remarried, use the return of the custodial parent.

Custodial parent remarried. If the custodial parent has remarried, the stepparent (rather than the noncustodial parent) is treated as the child's other parent. Therefore, the earlier discussion under *Child's parents married* applies.

Child's parents never married. If a child's parents did not marry each other, but lived together all year, use the return of the parent with the greater taxable income. If the parents did not live together all year, the rules explained earlier under *Child's parents divorced* apply.

Widows and widowers. Widows and widowers must use the rules explained earlier under *Child's parents divorced.*

Parent's Election to Report Child's Unearned Income

If you elect to include your child's interest and dividend income on your tax return, the child does not have to file a return.

You can make this election for 1994 only if ***all*** the following conditions are met.

1) Your child was under age 14 on January 1, 1995.
2) Your child is required to file a return for 1994 unless you make this election.
3) Your child had income only from interest and dividends (including Alaska Permanent Fund dividends).
4) The dividend and interest income was less than $5,000.
5) No estimated tax payment was made for 1994 and no 1993 overpayment was applied to 1994 under your child's name and social security number.
6) No federal income tax was withheld from your child's income under the backup withholding rules.
7) You are the parent whose return must be used when applying the special tax rules for children under 14. (See *Which Parent's Return To Use,* earlier.)

How to elect. Make the election by attaching **Form 8814** to your Form 1040 or Form 1040NR. Attach a separate Form 8814 for each child for whom you make the election.

Tax effect of election. The federal income tax on your child's income may be more if you make the Form 8814 election rather than file a return for the child. The Form 8814 Step 1 base amount ($1,000 not taxed at your higher rate) and the Step 2 nontaxable amount ($500) are not increased for inflation, as are the comparable tax benefits on the child's return. Also, by making the Form 8814 election, you cannot take certain deductions the child would be entitled to on his or her return, as explained next.

Deductions you cannot take. If you use Form 8814, you cannot take any of the following deductions that could have been taken on your child's return:

1) Standard deduction of $600 ($1,550 if your child was blind),
2) Deduction for penalty on early withdrawal of your child's savings, and
3) Itemized deductions (such as your child's investment expenses or charitable contributions).

Increased adjusted gross income. If you use Form 8814 to add your child's income to yours, your increased adjusted gross income may reduce certain items on your return, such as any itemized deductions for medical expenses, casualty and theft losses, and certain miscellaneous expenses.

Penalty for underpayment of estimated tax. If you make this election for 1994 and did not have enough tax withheld or pay enough estimated tax to cover the tax you owe, you may be subject to a penalty. If you plan to make this election for 1995, you may need to increase your federal income tax withholding or your estimated tax payments to avoid the penalty. See Chapter 5 for information.

More information. For more information about this election, get Publication 929.

Child's Return Filed (Parent's Election Not Made)

Part of a child's 1994 investment income may be subject to tax at the parent's tax rate if:

1) The child was under age 14 on January 1, 1995,
2) The child's investment income was more than $1,200, and
3) The child is required to file a return for 1994.

Figure 32–A illustrates this.

If the child's parent does not or cannot choose to include the child's income on his or her return, figure the child's tax on **Form 8615.** Attach the form to the child's Form 1040, Form 1040A, or Form 1040NR.

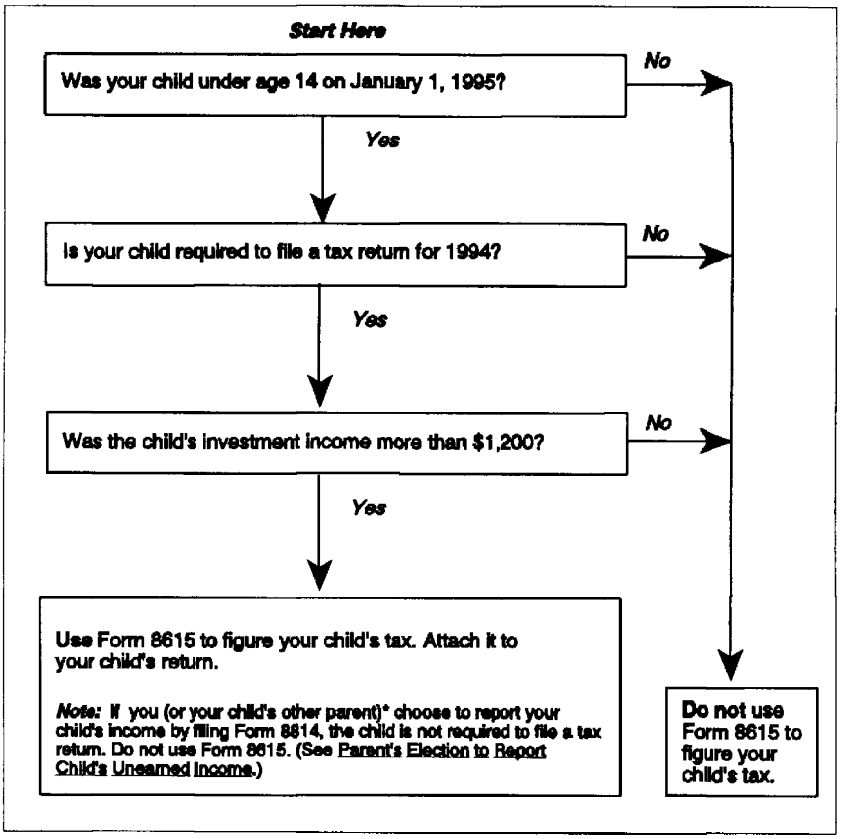
On Form 8615, enter the names and social security numbers of the child and the parent in the spaces provided. (If the parents filed a joint return, enter the name and social security number of the parent who is listed first on the joint return.) Check the box for the parent's filing status. Then figure the child's tax on Form 8615 in these three steps:

Step 1. Figure the child's net investment income.

Step 2. Figure a tentative tax on the net investment income based on the parent's tax rate.

Step 3. Figure the child's tax.

Figure 32-A. Do You Have to Use Form 8615 to Figure Your Child's Tax?



*See Which Parent's Return To Use

Alternative minimum tax. A child may be subject to alternative minimum tax (AMT) if he or she has certain items given preferential treatment under the tax laws or certain adjustments to taxable income that total more than an exemption amount. See *Alternative Minimum Tax* in Chapter 31.

AMT is figured on Form 6251. For information on special limits that apply to a child who files Form 6251, see *Limit on AMT* under *Alternative Minimum Tax* in Publication 929.

Parent's return information. See *Which Parent's Return To Use,* at the beginning of this chapter, for information on which parent's return information must be used on Form 8615.

Different tax years. If the parent and the child do not have the same tax year, complete Form 8615 using the information on the parent's return for the tax year that ends in the child's tax year.

Using estimates. If the information needed from the parent's return is not known by the time the child's return is due (usually April 15), you can file the return using estimates.

Any reasonable estimate can be used. This includes using information from last year's return. If you use an estimated amount on Form 8615, write "Estimated" on the line next to the amount.

When you get the correct information, file an amended return on Form 1040X, *Amended U.S. Individual Income Tax Return.* See *Parent's return information not available* under *Child's Return Filed (Parent's Election Not Made)* in Publication 929 for more information.

Step 1. Figuring Net Investment Income

The first step in figuring a child's tax using Form 8615 is to figure the child's net investment income. This is done on lines 1 through 5 of Form 8615. First figure the child's gross (total) investment income.

Investment Income

Investment income generally includes all income other than salaries, wages, and other amounts received as pay for work actually done. It includes taxable interest, dividends, capital gains, the taxable part of social security payments, and pension payments and certain distributions from trusts.

Nontaxable income. For this purpose, investment income includes only amounts that the child must include in total income. Nontaxable investment income, such as tax-exempt interest and the nontaxable part of social security and pension payments, is not included.

Sources of income. A child's investment income includes all income produced by property belonging to the child, regardless of whether the property was transferred to the child or purchased by the child, and regardless of when the property was transferred or purchased or who transferred it. Investment income includes amounts produced by assets the child obtained with earned income (such as interest on a savings account into which the child deposited wages).

A child's investment income includes income produced by property given as a gift to the child under the Uniform Gift to Minors Act.

Example. Amanda Black, 13, received the following income:

Dividends — $600

Wages — $2,100

Taxable interest — $1,200

Tax-exempt interest — $100

Net capital gains — $100.

The dividends were on stock given to her by her grandparents. Amanda's investment income is $1,900. This is the total of the dividends ($600), taxable interest ($1,200), and net capital gains ($100). Her wages are earned income (not investment) because they are pay received for work actually done. Her tax-exempt interest is not included because it is nontaxable.

Trust income. If a child is the beneficiary of a trust, distributions of taxable interest, dividends, capital gains, and other investment income from the trust are investment income to the child.

Net Investment Income

A child's net investment income is generally his or her gross (total) investment income reduced by the sum of the following three items:

1) Adjustments to income that are related to the investment income (such as the penalty on early withdrawal of savings), plus
2) $600, plus
3) The greater of $600 or the child's itemized deductions that are ***directly connected*** (defined later) with the production of his or her investment income.

Example 1. Eleanor, 8, has investment income of $16,000 and an early withdrawal penalty of $100. She has itemized deductions of $1,100 that are directly connected with the production of her investment income. Her net investment income is $14,200. This is her total investment income of $16,000, reduced by $1,800. The $1,800 is the sum of the early withdrawal penalty ($100), plus $600, plus the directly connected itemized deductions ($1,100).

Example 2. Roger, 12, has investment income of $8,000, no adjustments to income, and itemized deductions of $300 that are directly connected with his investment income. His net investment income is $6,800. This is his total investment income of $8,000, reduced by $1,200 ($600 + $600).

His investment income is reduced by $1,200 because he has no adjustments to income and his directly connected itemized deductions ($300) are not more than $600.

Directly connected itemized deductions. Itemized deductions are directly connected with the production of investment income if they are for expenses paid to produce or collect taxable income or to manage, conserve, or maintain property held for producing income. These expenses include custodian fees and service charges, service fees to collect taxable interest and dividends, and certain investment counsel fees. They are deducted on Schedule A (Form 1040) to the extent that they, plus certain other miscellaneous itemized deductions, are more than 2% of adjusted gross income. See Chapter 30 for more information about the 2% of adjusted gross income limit on miscellaneous itemized deductions.

Net investment income cannot be more than taxable income. A child's net investment income cannot be more than his or her taxable income. If the child's taxable income is less than net investment income, the child's net investment income is the same amount as the taxable income. See line 5 of Form 8615.

Step 2. Figuring Tentative Tax at Parent's Tax Rate

The tentative tax is the difference in the tax on the parent's taxable income figured with and without the child's net investment income. Figure it on lines 6 through 13 of Form 8615 as follows:

1) Figure the tax on the total of the parent's taxable income plus the child's net investment income at the parent's tax rate.
2) Figure the tax on the parent's taxable income without including the child's net investment income.
3) Subtract the tax in (2) from the tax in (1). This is the tentative tax.

Caution. When making these computations, do not take into account the child's net investment income in figuring any exclusion, deduction, or credit on the parent's return.

Special rule. See *Trusts* under *Step 2. Figuring Tentative Tax At Parent's Tax Rate* in Publication 929 for information about a special rule that may apply if the parent is the grantor of a trust.

More Than One Child

If the tax return information of the child's parent is used on Forms 8615 for other children (including adopted children and stepchildren), the net investment income of all these children is used in figuring the tentative tax. The tentative tax is then allocated to each child according to the child's share of the total net investment income.

If the net investment income of the other children is not available when the return is due, either file the return using estimates or use an extension of time to file. Extensions are discussed under *Extensions of Time to File* in Chapter 1.

Allocation of tentative tax. The tentative tax is allocated to each child by multiplying the total tentative tax by a fraction. The numerator (top number) of the fraction is the child's net investment income. The denominator (bottom number) is the total of the net investment income of all the children. The result of each multiplication is that child's share of the tentative tax.

Example. The Oaks' two children, Bill and Patty, ages 11 and 12, have $2,000 and $3,000 of net investment income. Tax on their incomes must be figured at their parents' rate. On Form 8615, Bill's and Patty's net investment incomes are combined and the total ($5,000) is added to their parents' taxable income shown on their joint tax return. The difference between (1) the tax figured on the total of their parents' taxable income plus the children's net investment income and (2) the actual tax on their parents' return is $1,750. This difference (the tentative tax) must be allocated between Bill and Patty.

The amount allocated to Bill is $700.

$$\frac{\$2,000}{\$5,000} \times \$1,750 = \$700$$

The amount allocated to Patty is $1,050.

$$\frac{\$3,000}{\$5,000} \times \$1,750 = \$1,050$$

Step 3. Figuring the Child's Tax

The final step in figuring a child's tax using Form 8615 is to determine the ***larger*** of:

1) The total of:
   a) The child's share of the tentative tax based on the parent's tax rate, plus
   b) The tax on the child's taxable income in excess of net investment income, figured at the child's tax rate, or
2) The tax on the child's taxable income, figured at the child's tax rate.

The child's tax is figured on lines 14 through 18 of Form 8615.

Illustrated Example

The following example includes a completed Form 8615.

John and Laura Brown have one child, Sara. She is 13 and has $2,500 taxable interest and dividend income and $1,500 earned income. She does not itemize deductions. John and Laura file a joint return with John's name and social security number listed first. They claim three exemptions, including an exemption for Sara, on their return.

Because Sara has both earned and unearned income and her gross income is more than $600, she must file a tax return. Because she is under age 14 and has more than $1,200 investment income, part of her income may be subject to tax at her parents' rate. A completed Form 8615 must be attached to her return.

Sara's father, John, fills out Sara's return for her.

John enters his name and social security number on Sara's Form 8615 because his name and number are listed first on the joint return he and Laura are filing. He checks the box for married filing jointly.

He enters Sara's investment income, $2,500, on line 1. Sara does not itemize deductions, so John enters $1,200 on line 2. He enters $1,300 on line 3 ($2,500 – $1,200).

Sara's taxable income, as shown on line 22 of her Form 1040A, is $2,500. This is her

total income ($4,000) minus her standard deduction ($1,500). Her standard deduction is limited to the amount of her earned income. John enters $2,500 on line 4.

John compares the amounts on lines 3 and 4 and enters the smaller amount, $1,300, on line 5.

John enters $48,000 on line 6. This is the taxable income from line 37 of John and Laura's joint Form 1040 return. Sara is an only child, so line 7 is blank. He adds the amounts on line 5 ($1,300), line 6 ($48,000), and line 7 and enters the $49,300 total on line 8.

Using the column for married filing jointly in the Tax Table, John finds the tax on $49,300. He enters the tax, $8,871, on line 9. He enters $8,507 on line 10. This is the tax from line 38 of John and Laura's Form 1040. He enters $364 on line 11 ($8,871 – $8,507).

John skips lines 12a and 12b and enters $364 on line 13.

John subtracts the amount on line 5 ($1,300) from the amount on line 4 ($2,500) and enters the result, $1,200, on line 14. Using the column for single filing status in the Tax Table, John finds the tax on $1,200. He enters this tax, $182, on line 15. He adds the amounts on lines 13 ($364) and 15 ($182) and enters the total, $546, on line 16.

Using the column for single filing status in the Tax Table, John finds the tax on $2,500 (the amount on line 4). He enters this tax, $377, on line 17.

John compares the amounts on lines 16 and 17 and enters the larger amount, $546, on line 18 of Sara's Form 8615. He also enters that amount on line 23 of Sara's Form 1040A and checks the box on that line for "Form 8615." John also completes Schedule 1 (Form 1040A) for Sara.

Form **8615**

Department of the Treasury
Internal Revenue Service

Tax for Children Under Age 14 Who Have Investment Income of More Than $1,200

▶ See instructions below and on back.
▶ Attach ONLY to the child's Form 1040, Form 1040A, or Form 1040NR.

OMB No. 1545-0998

1994

Attachment Sequence No. **33**

Child's name shown on return: Sara L. Brown

Child's social security number: 789 00 4351

A Parent's name (first, initial, and last). **Caution:** *See instructions on back before completing.*: John J. Brown

B Parent's social security number: 459 00 9962

C Parent's filing status (check one):

☐ Single ☑ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Step 1 Figure child's net investment income

1	Enter child's investment income, such as taxable interest and dividend income. See instructions. If this amount is $1,200 or less, **stop here;** do not file this form	1	2,500
2	If the child DID NOT itemize deductions on Schedule A (Form 1040 or Form 1040NR), enter $1,200. If the child ITEMIZED deductions, see instructions	2	1,200
3	Subtract line 2 from line 1. If the result is zero or less, **stop here;** do not complete the rest of this form but ATTACH it to the child's return	3	1,300
4	Enter child's **taxable** income from Form 1040, line 37; Form 1040A, line 22; or Form 1040NR, line 36	4	2,500
5	Enter the **smaller** of line 3 or line 4 ▶	5	1,300

Step 2 Figure tentative tax based on the tax rate of the parent listed on line A

6	Enter parent's **taxable** income from Form 1040, line 37; Form 1040A, line 22; Form 1040EZ, line 5; or Form 1040NR, line 36. If the parent transferred property to a trust, see instructions	6	48,000
7	Enter the total net investment income, if any, from Forms 8615, line 5, of ALL OTHER children of the parent identified above. **Do not** include the amount from line 5 above	7	
8	Add lines 5, 6, and 7	8	49,300
9	Tax on line 8 based on the **parent's** filing status. See instructions. If from Capital Gain Tax Worksheet, enter amount from line 4 of that worksheet here ▶	9	8,871
10	Enter parent's tax from Form 1040, line 38; Form 1040A, line 23; Form 1040EZ, line 9; or Form 1040NR, line 37. If from **Capital Gain Tax Worksheet,** enter amount from line 4 of that worksheet here ▶	10	8,507
11	Subtract line 10 from line 9. If line 7 is blank, enter on line 13 the amount from line 11; skip lines 12a and 12b	11	364
12a	Add lines 5 and 7 — 12a		
b	Divide line 5 by line 12a. Enter the result as a decimal (rounded to two places)	12b	x .
13	Multiply line 11 by line 12b ▶	13	364

Step 3 Figure child's tax—If lines 4 and 5 above are the same, enter -0- on line 15 and go to line 16.

14	Subtract line 5 from line 4 — 14: 1,200		
15	Tax on line 14 based on the **child's** filing status. See instructions. If from Capital Gain Tax Worksheet, enter amount from line 4 of that worksheet here ▶	15	182
16	Add lines 13 and 15	16	546
17	Tax on line 4 based on the **child's** filing status. See instructions. If from Capital Gain Tax Worksheet, check here ▶ ☐	17	377
18	Enter the **larger** of line 16 or line 17 here and on Form 1040, line 38; Form 1040A, line 23; or Form 1040NR, line 37. Be sure to check the box for "Form 8615" even if line 17 is more than line 16 ▶	18	546

General Instructions

Purpose of Form.—For children under age 14, investment income over $1,200 is taxed at the parent's rate if the parent's rate is higher than the child's rate. If the child's investment income is more than $1,200, use this form to figure the child's tax.

Investment Income.—As used on this form, "investment income" includes all taxable income other than earned income as defined on page 2. It includes income such as taxable interest, dividends, capital gains, rents, royalties, etc. It also includes pension and annuity income and income (other than earned income) received as the beneficiary of a trust.

Who Must File.—Generally, Form 8615 must be filed for any child who was under age 14 on January 1, 1995, had more than $1,200 of investment income, and is required to file a tax return. If neither parent was alive on December 31, 1994, do not use Form 8615. Instead, figure the child's tax in the normal manner.

Note: *The parent may be able to elect to report the child's interest and dividends on his or her return. If the parent makes this election, the child will not have to file a return or Form 8615. For more details, see the instructions for Form 1040 or Form 1040A, or get* ***Form 8814,*** *Parents' Election To Report Child's Interest and Dividends.*

Additional Information.—For more details, get **Pub. 929,** Tax Rules for Children and Dependents.

Incomplete Information for Parent.—If the parent's taxable income or filing status or the net investment income of the parent's other children is not known by the due date of the child's return, reasonable estimates may be used. Write "Estimated" on the appropriate line(s) of Form 8615. For more details, see Pub. 929.

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 64113U Form **8615** (1994)

33.

Child and Dependent Care Credit

Important Reminders

You may have to pay employment taxes. If you pay someone to come to your home and care for your dependent or spouse, you may be a household employer who has to pay employment taxes. Usually, you are ***not*** a household employer if the person who cares for your child or dependent does so at his or her home or place of business. See Publication 926, *Employment Taxes for Household Employers,* for a discussion of employment taxes and what forms you must file if you are a household employer.

Provider identification. You must provide certain information on all persons or organizations that care for your child or dependent. For information on this identification, see *Provider Identification Test,* later.

Introduction

This chapter discusses the credit for child and dependent care expenses and covers the following topics:

- Tests you must meet to claim the credit
- How to figure the credit
- How to claim the credit
- Employment taxes you may have to pay as a household employer

If you pay someone to care for your dependent under age 13, or your spouse or dependent who is not capable of self-care, you may be able to get a credit of up to 30% of your expenses. To qualify, you must pay these expenses so you can work or look for work. You must also meet certain other tests, which are explained in this chapter.

Useful Items

You may want to see:

Publication

- ❑ **503** Child and Dependent Care Expenses
- ❑ **926** Employment Taxes for Household Employers

Form (and Instructions)

- ❑ **W–10** Dependent Care Provider's Identification and Certification
- ❑ **940** Employer's Annual Federal Unemployment (FUTA) Tax Return
- ❑ **940–EZ** Employer's Annual Federal Unemployment (FUTA) Tax Return
- ❑ **942** Employer's Quarterly Tax Return for Household Employees
- ❑ **Schedule 2 (Form 1040A)** Child and Dependent Care Expenses for Form 1040A Filers
- ❑ **2441** Child and Dependent Care Expenses
- ❑ **6251** Alternative Minimum Tax—Individuals

Tests To Claim the Credit

To be able to claim the credit for child and dependent care expenses, you must meet **all** the following tests. These tests are presented in *Figure 33–A* and are also explained in detail in this chapter. You must file Form 1040 or Form 1040A, not Form 1040EZ.

1) The care must be for one or more qualifying persons. (See *Qualifying Person Test,* later.)
2) You (and your spouse if you are married) must keep up a home that you live in with the qualifying person or persons. (See *Keeping Up a Home Test,* later.)
3) You (and your spouse if you are married) must have earned income during the year. (However, under *Earned Income Test,* later, see *Rule for a student-spouse or spouse not capable of self-care.*)
4) You must pay child and dependent care expenses so you (and your spouse if you are married) can work or look for work. (See *Work-Related Expense Test,* later.)
5) Your filing status is Single, Head of household, Qualifying widow(er) with dependent child, or Married filing jointly. You must file a joint return if you are married, unless an exception discussed later under *Joint Return Test* applies to you.
6) You must identify the care provider on your tax return. (See *Provider Identification Test,* later.)
7) You must make payments for child and dependent care to someone you (or your spouse) cannot claim as a dependent. If you make payments to your child, he or she cannot be your dependent and must be age 19 or older by the end of the year. (See *Payments to Relatives,* later.)
8) You exclude less than $2,400 (less than $4,800 if two or more qualifying persons were cared for) of dependent care assistance benefits. (See *Reduced Dollar Limit,* later.)

Qualifying Person Test

Your child and dependent care expenses must be for the care of one or more members of your home who are qualifying persons. A qualifying person is:

1) Your dependent who was under age 13 when the care was provided and for whom you can claim an exemption,
2) Your spouse who was physically or mentally unable to care for himself or herself, or
3) Your dependent who was physically or mentally unable to care for himself or herself and for whom you can claim an exemption (or could claim an exemption except the person had $2,450 or more of gross income).

If you are divorced or separated, see *Child of Divorced or Separated Parents* to determine which parent may treat the child as a qualifying person.

Physically or mentally unable to care for oneself. Persons who are not able to dress, clean, or feed themselves because of physical or mental problems are considered not capable of self-care. Also, persons who require constant attention to prevent them from injuring themselves or others are considered not capable of self-care.

Person qualifying for part of year. You determine a person's qualifying status each day. For example, if the person you pay child and dependent care expenses for no longer qualifies on September 16, count only those expenses through September 15. Also see *Dollar Limit,* later.

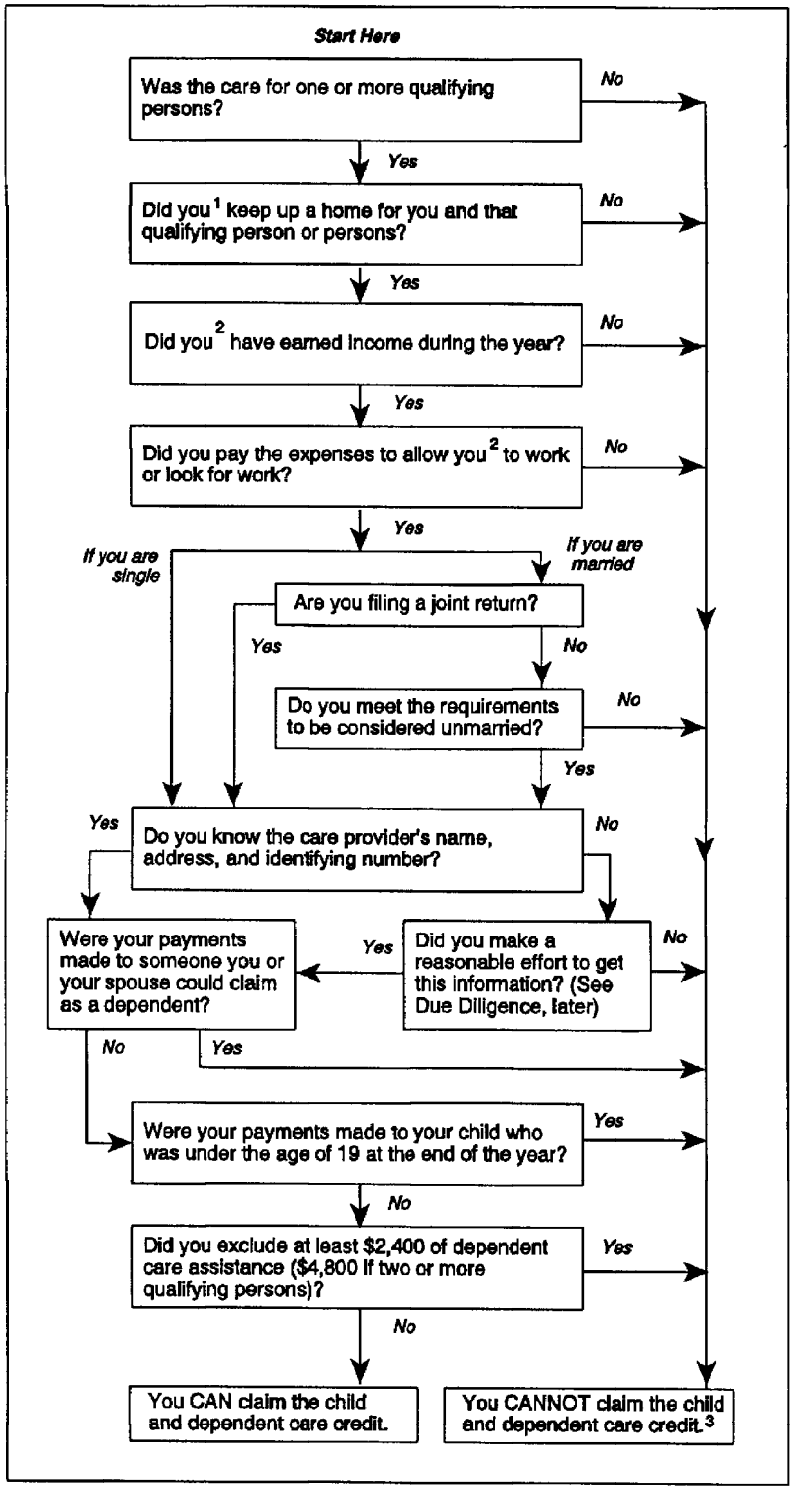
Child of Divorced or Separated Parents

To be a qualifying person, your child usually must be your dependent for whom you can claim an exemption. But an exception may apply if you are divorced or separated. Under the exception, if you are the custodial parent, you can treat your child as a qualifying person even if you cannot claim the child's exemption. If you are the noncustodial parent, you cannot treat your child as a qualifying person even if you can claim the child's exemption.

This exception applies if:

1) One or both parents had custody of the child for more than half of the year,
2) One or both parents provided more than half of the child's support for the year, and
3) Either—
   a) The custodial parent signed Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents,* or a similar statement, agreeing not to claim the child's exemption for the year, or
   b) The noncustodial parent provided at least $600 for the child's support and

Figure 33-A. **Can You Claim the Credit?**



1. You and your spouse if you were married.
2. This also applies to your spouse, unless your spouse was disabled or a full-time student.
3. If you had expenses that met the requirements for 1993, except that you did not pay them until 1994, you may be able to claim those expenses in 1994. See *Expenses not paid until the following year*, later.

can claim the child's exemption under a pre-1985 decree of divorce or separate maintenance, or written agreement.

You can use *Figure 33–B* to see whether this exception applies to you. If it applies, only the custodial parent can treat the child as a qualifying person. If the exception does not apply, follow the regular rules for a qualifying person under *Qualifying Person Test,* earlier.

If you can take the credit because of this exception, write your child's name in the space to the left of line 3, Form 2441 or Schedule 2 (Form 1040A).

Example. You are divorced and have custody of your 8-year-old child. You sign Form 8332 to allow your ex-spouse to take the exemption. You pay child care expenses so you can work. Your child is a qualifying person and you, the custodial parent, can claim the credit for those expenses, even though your ex-spouse claims an exemption for the child.

Custodial parent. You are the custodial parent if, during the year, you have custody of your child longer than your child's other parent has custody.

Divorced or separated. For purposes of determining whether your child is a qualifying person, you are considered divorced or separated if either of the following apply.

1) You are divorced or separated under a decree of divorce or separate maintenance or a written separation agreement, or
2) You lived apart from your spouse for all of the last 6 months of the year.

Keeping Up a Home Test

To claim the credit, you (and your spouse if you are married) must keep up a home that you live in with one or more qualifying persons. You are keeping up a home if you pay more than half the cost of running it for the year.

Home. The term ''home'' means the main home for both you and the qualifying person. Your home can be the main home even if the qualifying person does not live there all year because of his or her:

1) Birth,
2) Death, or
3) Temporary absence due to:
   a) Sickness,
   b) School,
   c) Business,
   d) Vacation,
   e) Military service, or
   f) Custody agreement.

Costs of keeping up home. The costs of keeping up a home normally include property taxes, mortgage interest, rent, utility charges, home repairs, insurance on the home, and food eaten at home.

The costs of keeping up a home do not include payments for clothing, education, medical treatment, vacations, life insurance, transportation, and mortgage principal. They also do not include the purchase, permanent improvement, or replacement of property. For example, you cannot include the cost of replacing a water heater. However, you can include the cost of repairing a water heater.

Earned Income Test

To claim the credit, you (and your spouse if you are married) must have earned income during the year.

Earned income includes wages, salaries, tips, other employee compensation, and net earnings from self-employment. Earned income also includes strike benefits and any disability pay you report as wages. Earned income is reduced by any net loss from self-employment.

Members of the clergy and religious workers. Certain income earned by ministers, members of religious orders, and Christian Science practitioners may not be considered earned income for this purpose. See Publication 503.

Earned income does not include pensions or annuities, social security payments, workers' compensation, interest, dividends, or unemployment compensation. It also does not include scholarship or fellowship grants, except for amounts paid to you for teaching, research, or other services.

Rule for a student-spouse or spouse not capable of self-care. Your spouse is treated as having earned income for any month that he or she is:

1) A full-time student, or
2) Physically or mentally not capable of self-care.

Figure the earned income of the nonworking spouse as shown under *Earned Income Limit,* under *How To Figure the Credit,* later.

This rule applies to only one spouse for any one month. If, in the same month, both you and your spouse do not work and are either full-time students or physically or mentally not capable of self-care, only one of you can be treated as having earned income in that month.

Full-time student. You are a full-time student if you are enrolled at and attend a school for the number of hours or classes that the school considers full time. You must have been a student for some part of each of 5 calendar months during the year. (The months need not be consecutive.) If you attend school only at night, you are not a full-time student. However, as part of your full-time course of study, you may attend some night classes.

The term ''school'' includes elementary schools, junior and senior high schools, colleges, universities, and technical, trade, and mechanical schools. It does not include on-the-job training courses, correspondence schools, and night schools.

Work-Related Expense Test

Child and dependent care expenses must be work related to qualify for the credit. Expenses are considered work related only if:

- They allow you (and your spouse if you are married) to work or look for work, and
- They are for a qualifying person's care.

Working or Looking for Work

To be work related, your expenses must allow you to work or look for work. If you are married, generally both you and your spouse must work or look for work. Your spouse is treated as working during any month he or she is a full-time student or is physically or mentally not capable of self-care.

Whether your expenses allow you to work or look for work depends on the facts. For example, the cost of a sitter while you and your spouse go out to eat is not normally a work-related expense. Also, expenses are not considered work related merely because you had them while you were working.

Your work can be for others or in your own business or partnership. It can be either full time or part time. Work also includes actively looking for work. However, if you do not find a job and have no earned income for the year, you cannot take this credit. See *Earned Income Test,* earlier. Unpaid volunteer work or volunteer work for a nominal salary does not qualify.

Work for part of year. If you work or actively look for work during only part of the period covered by the expenses, then you must figure your expenses for each day. For example, if you work all year and pay care expenses of $120 a month ($1,440 for the year), all the expenses are work related. However, if you work or look for work for only 2 months and 15 days during the year and pay expenses of $120 a month, your work-related expenses are limited to $300 (2½ months × $120).

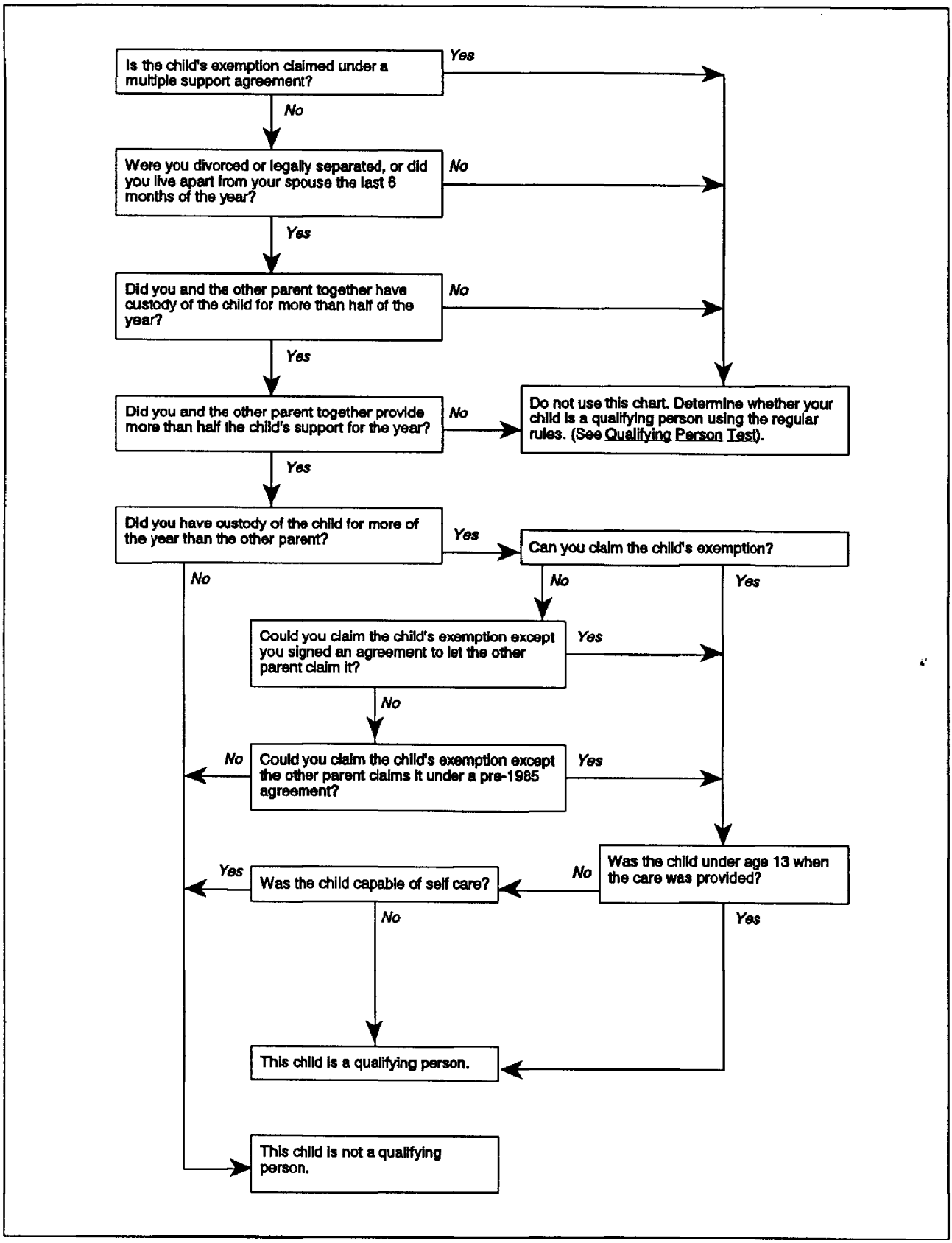
Payments while you are out sick. Do not count as work-related expenses amounts you pay for child and dependent care while you are off work because of illness. These amounts are not paid to allow you to work. This applies even if you get sick pay and are still considered an employee.

Care of a Qualifying Person

To be work related, your expenses must be to provide care for a qualifying person. You do not have to choose the least expensive way of providing the care.

Expenses for household services qualify if part of the services is for the care of qualifying persons. See *Household services,* later.

Figure 33-B. **Is a Child of Divorced or Separated Parents a Qualifying Person?**



Expenses are for the care of a qualifying person only if their main purpose is the person's well-being and protection. Expenses for care do not include amounts you pay for food, clothing, and entertainment. However, if these amounts are incident to and cannot be separated from the cost of caring for the qualifying person, you can count the total cost.

Schooling. You can count the total cost of sending your child to school if:

1) Your child is not in the first grade or any higher grade, ***and***
2) The amount you pay for schooling is incident to and cannot be separated from the cost of care.

You can use the total cost of schooling below first grade only if the cost of schooling cannot be separated from the cost of the child's care. If your child is in the first grade or higher, or if the cost of schooling can be separated, you must divide the total cost between the cost of care and the cost of schooling. You can count only the cost of care in figuring your credit.

Example 1. You take your 3-year-old child to a nursery school that provides lunch and educational activities as a part of its preschool child care service. You can count the total cost in figuring the credit.

Example 2. Your 5-year-old child goes to kindergarten in the morning. In the afternoon, she attends an after-school day care program at the same school. Your total cost for sending her to the school is $3,000, of which $1,800 is for the after-school program. Only the $1,800 qualifies for figuring the credit.

Example 3. You place your 10-year-old child in a boarding school so you can work full time. Only the part of the boarding school expense that is for the care of your child is a work-related expense. You cannot count any part of the amount you pay the school for your child's education.

Care outside your home. You can count the cost of care provided outside your home if the care is for your dependent under age 13, or any other qualifying person who regularly spends at least 8 hours each day in your household.

Dependent care center. You can count care provided outside your home by a dependent care center if the center complies with all applicable state and local regulations. A dependent care center is a place that provides care for more than six persons (other than persons who live there) and receives a fee, payment, or grant for providing services for any of those persons, even if the center is not run for profit.

Camp. The cost of sending your child to an overnight camp is ***not*** considered a work-related expense.

Transportation. The cost of getting a qualifying person from your home to the care location and back, or from the care location to school and back, is ***not*** considered a work-related expense. This includes the costs of bus, subway, taxi, or private car. Also, if you pay the transportation cost for the care provider to come to your home, you cannot count this cost as a work-related expense.

Household services. Expenses you pay for household services meet the work-related expense test if they are at least ***partly*** for the well-being and protection of a qualifying person.

Household services are ordinary and usual services done in and around your home that are necessary to run your home. They include the services of a housekeeper, maid, or cook. However, they do not include the services of a chauffeur, bartender, or gardener. See *Household Services* in Publication 503, for more information.

Taxes paid on wages. If you pay wages for household help, you may have to pay the employer's portion and withhold the employee's portion of social security and Medicare taxes. You may also have to pay federal unemployment (FUTA) tax and similar state taxes. The taxes you pay on wages for qualifying child and dependent care services are work-related expenses. See *Employment Taxes for Household Employers,* later.

Payments to Relatives

You can count work-related payments you pay to relatives who are not your dependents, even if they live in your home. However, do not count any amounts you pay to:

1) A dependent for whom you (or your spouse if you are married) can claim an exemption, or
2) Your child who was under age 19 at the end of the year, even if he or she is not your dependent.

Joint Return Test

Generally, married couples must file a joint return to take the credit. However, if you are legally separated or living apart from your spouse, you may be able to file a separate return and still take the credit.

Legally separated. You are not considered married if you are legally separated from your spouse under a decree of divorce or separate maintenance. You are eligible to take the credit on a separate return.

Married and living apart. You are not considered married and are eligible to take the credit if **all** the following apply:

1) You file a separate return.
2) Your home is the home of a qualifying person for more than half the year.
3) You pay more than half the cost of keeping up your home for the year.
4) Your spouse does not live in your home for the last 6 months of the year.

Death of spouse. If your spouse died during the year and you do not remarry before the end of the year, you generally must file a joint return to take the credit. If you do remarry before the end of the year, the credit can be claimed on your deceased spouse's separate return.

Provider Identification Test

You must identify all persons or organizations that provide care for your child or dependent. Do this on the same form you use to claim the credit. If you file Form 1040, use Part I of Form 2441 to report the required information. If you file Form 1040A, use Part I of Schedule 2.

Information required. To identify the care provider, you must give the provider's:

1) Name,
2) Address, and
3) Taxpayer identification number.

If the care provider is an individual, the taxpayer identification number is his or her social security number. If the care provider is an organization, then it is the employer identification number (EIN).

The taxpayer identification number is not required if the care provider is one of certain tax-exempt organizations (such as a church or school). In this case, write ''Tax-Exempt'' in the space where the tax form calls for the number.

If you cannot provide all of the information required, or the information is incorrect, you must be able to show that you used due diligence (discussed later) in trying to furnish the required information.

Getting the information. You can use **Form W–10** to request the required information from the care provider. If you do not use Form W–10, you can get the required information from:

1) A copy of the provider's social security card,
2) A copy of the provider's driver's license (in a state where the license includes the social security number),
3) A copy of the provider's completed Form W–4 if he or she is your household employee,
4) A copy of the statement furnished by your employer if the provider is your employer's dependent care assistance program, or
5) A letter or invoice from the provider if it shows the information.

You should keep the required information about the care provider with your tax records. Do not send Form W–10 (or other document containing this information) to the Internal Revenue Service.

Due diligence. If the care provider information you give is incorrect or incomplete, your credit may not be allowed. However, if you can show that you used due diligence in trying to supply the required information, you can still claim the credit.

You can show due diligence by getting and keeping the provider's completed Form W–10 or one of the other sources of information listed above. Care providers can be penalized if they do not provide this information to you or if they provide incorrect information.

Provider refusal. If the provider refuses to give you the required information, you should report whatever information you have (such as the name and address) on the form you use to claim the credit. Write "See page 2" in the columns calling for the information you do not have. On the bottom of page 2, explain that you requested the information from the care provider, but the provider did not give you the information. This statement will show that you used due diligence in trying to furnish the required information.

How To Figure the Credit

Your credit is a percentage of your work-related expenses. Your expenses are subject to the earned income limit and the dollar limit. The percentage is based on your adjusted gross income.

Figuring Total Work-Related Expenses

To figure the credit for 1994 work-related expenses, count only those you paid by December 31, 1994.

Expenses prepaid in an earlier year. If you pay for services before they are provided, you can count the prepaid expenses only in the year the care is received. Fill out your Form 2441 or Schedule 2 (Form 1040A) for the later year as if the prepaid expense was actually paid in the later year.

Expenses not paid until the following year. Do ***not*** count 1993 expenses that you paid in 1994 as work-related expenses for 1994. You may be able to claim an additional credit for them on your 1994 return, but you must figure it separately. See *Payments for previous year's expenses* in Publication 503.

If you had expenses in 1994 that you did not pay until 1995, you cannot count them when figuring your 1994 credit. You may be able to claim a credit for them on your 1995 return.

Expenses reimbursed. If a state social services agency pays you a nontaxable amount to reimburse you for some of your child and dependent care expenses, you cannot count the expenses that are reimbursed as work-related expenses.

Example. You paid work-related expenses of $3,000. You are reimbursed $2,000 by a state social services agency. You can use only $1,000 to figure your credit.

Employer's dependent care assistance plan. Do ***not*** count as work-related expenses any child and dependent care benefits provided by your employer that you do not include in your income. You can exclude benefits from your income only if they are paid under a qualified plan. Your employer can tell you whether your benefit plan qualifies. If it does, you must complete Part III of either Form 2441 or Schedule 2 (Form 1040A) to claim the exclusion.

The amount you can exclude cannot be more than the smallest of:

1) Your earned income,
2) Your spouse's earned income, or
3) $5,000 ($2,500 if married filing separately).

Statement for employee. Your employer must give you a Form W–2, *Wage and Tax Statement* (or similar statement), showing in box 10 the total amount of dependent care assistance benefits provided to you during the year.

Forfeitures. Forfeitures are amounts credited to your dependent care assistance account and included in the amount shown in box 10 of your Form W–2, but which you did not receive because you did not incur the expense. You must subtract any forfeitures from the total dependent care benefits reported by your employer. To do this, enter the forfeited amount on line 12 of Form 2441 or Schedule 2 (Form 1040A). Forfeitures do not include amounts that you expect to receive in the future.

Medical expenses. Some expenses for the care of a qualifying person who is not capable of self-care may qualify as work-related expenses and also as medical expenses. You can use them either way, but you cannot use the same expenses to claim both a credit and a medical expense deduction.

If you use these expenses to figure the credit and they are more than the earned income limit or the dollar limit, discussed later, you can add the excess to your medical expenses. However, if you use your total expenses to figure your medical expense deduction, you cannot use any part of them to figure your credit.

Note. Amounts excluded from your income under your employer's dependent care assistance plan ***cannot*** be used to claim a medical expense deduction.

Earned Income Limit

The amount of work-related expenses you use to figure your credit cannot be more than:

1) Your earned income for the year, if you are ***single*** at the end of the year, or
2) The smaller of your earned income or your spouse's earned income for the year, if you are ***married*** at the end of the year.

For purposes of item (2), use your spouse's earned income for the entire year, even if you were married for only part of the year.

Separated spouse. If you are legally separated or married and living apart from your spouse (as described under *Joint Return Test,* earlier), you are not considered married for purposes of the earned income limit. Use only your income in figuring the earned income limit.

Surviving spouse. If your spouse died during 1994 and you file a joint return as a surviving spouse, you are not considered married for purposes of the earned income limit. Use only your income in figuring the earned income limit.

Earned income. Earned income is defined under *Earned Income Test,* earlier. If you are self-employed, see Publication 503 to determine your earned income from self-employment.

Community property laws. You should disregard community property laws when you figure earned income for this credit.

Student-spouse or spouse not capable of self-care. Your spouse who is either a full-time student or not capable of self-care is treated as having earned income. His or her earned income for each month is considered to be at least $200 if there is one qualifying person in your home, or at least $400 if there are two or more. If your spouse works during that month, use the higher of $200 (or $400) or his or her actual earned income for that month. If your spouse is a full-time student or not capable of self-care for only part of a month, the full $200 (or $400) still applies.

If, in the same month, both you and your spouse are either full-time students or not capable of self-care, only one spouse can be considered to have this earned income of $200, or $400, for that month.

Dollar Limit

There is a dollar limit on the amount of your work-related expenses you can use to figure the credit. This limit is $2,400 for one qualifying person, or $4,800 for two or more qualifying persons.

Yearly limit. The dollar limit is a yearly limit. The amount of the limit remains the same no matter how long you have a qualifying person in your household. Use the $2,400 limit if you paid work-related expenses for the care of one qualifying person at any time during the year. Use $4,800 if you paid work-related expenses for the care of more than one qualifying person at any time during the year.

Reduced Dollar Limit

If you received child and dependent care benefits from your employer that you exclude from your income, you must subtract that amount from the dollar limit that applies to you. See *Employer's dependent care assistance plan,* earlier, for information on excluding these benefits.

Example. You are a widower with one child and earn $20,000 a year. You pay work-related expenses of $1,600 for your 4-year-old child and qualify to claim the credit for child and dependent care expenses. Your employer pays an additional $1,000 under a dependent care assistance plan. This $1,000 is excluded from your income. The dollar limit for your work-related expenses is $2,400 (one qualifying person). However, your credit is figured on only $1,400 of the $1,600 work-related expenses you paid because the dollar limit is reduced to $1,400 by the excludable benefits as follows:

Dollar limit: Maximum allowable expenses for one qualifying person ...	$2,400
Minus: Dependent care benefits you can exclude from income	1,000
Reduced limit on expenses you can use for the credit	$1,400

Amount of Credit

To determine the amount of your credit, multiply your work-related expenses (after applying the earned income and dollar limits) by a percentage. This percentage depends on your adjusted gross income shown on line 32 of Form 1040 or line 17 of Form 1040A. The following table shows the percentage to use based on adjusted gross income.

Adjusted Gross Income			Applicable Percentage
Over		But not over	
$ 0	—	$10,000	30%
10,000	—	12,000	29%
12,000	—	14,000	28%
14,000	—	16,000	27%
16,000	—	18,000	26%
18,000	—	20,000	25%
20,000	—	22,000	24%
22,000	—	24,000	23%
24,000	—	26,000	22%
26,000	—	28,000	21%
28,000	—	No Limit	20%

Payments for previous year's expenses. If you had work-related expenses in 1993 that you paid in 1994, you may be able to increase the credit on your 1994 return. There is a worksheet in Publication 503 to figure this amount.

Alternative minimum tax limit. Your credit may be limited because of the alternative minimum tax. See the instructions for Form 1040A or Form 1040 to determine if you need to figure the limit.

How To Claim the Credit

To claim the credit, you can file Form 1040 or Form 1040A. You cannot claim the credit on Form 1040EZ.

Form 1040. You must complete **Form 2441,** and attach it to your Form 1040. Enter the credit on line 41 of your Form 1040.

Form 1040A. You must complete **Schedule 2** and attach it to your Form 1040A. Enter the credit on line 24a of your Form 1040A. See Chapter 38 for an example of a filled-in Schedule 2.

Tax credit not refundable. Your credit for child and dependent care expenses cannot be more than the amount of your tax liability. This means that you cannot get a refund for any part of the credit that is more than your tax.

Records. You should keep records of your work-related expenses. Also, if your dependent or spouse is not capable of self-care, your records should show both the nature and the length of the disability. Other records you should keep to support your claim for the credit are described earlier under *Provider Identification Test.*

Examples

The following examples show how to figure the credit. Example 2 is illustrated by the filled-in Form 2441 at the end of this chapter.

Example 1: Child Care—Two Children. Ann and Jerry Jones are married and keep up a home for their two preschool children, ages 2 and 4. They claim their children as dependents and file a joint return using Form 1040A. Their adjusted gross income (line 17) is $22,500. Ann earned $12,500 and Jerry earned $10,000.

During the year, they pay work-related expenses of $3,000 for child care at a neighbor's home and $2,200 for child care at Pine Street Nursery School.

They figure the credit on Schedule 2 as follows:

Child care by neighbor	$3,000
Child care by nursery school	2,200
Total work-related expenses	$5,200
Dollar limit	$4,800
Amount of credit (23% of $4,800)	$1,104

Example 2: Dependent Care Assistance Benefits. Joan Thomas is divorced and has two children, ages 3 and 9. She works at ACME Computers. Her adjusted gross income is $29,000, and the entire amount is earned income.

Joan's younger child stays at her employer's on-site child care center while she works. The benefits from this child care center qualify to be excluded from her income. Her employer reports the value of this service as $3,000 for the year. This $3,000 is shown in box 10 of her Form W–2, but is not included in taxable wages in box 1.

A neighbor cares for Joan's older child after school, on holidays, and during the summer. She pays her neighbor $2,400 for this care.

Joan figures her credit on Form 2441 as follows:

Work-related expenses Joan paid	$2,400
Dollar limit	$4,800
Minus: Dependent care benefits excluded from income	3,000
Reduced dollar limit	$1,800
Amount of credit (20% of $1,800)	$ 360

Note. The dollar limit for two or more qualifying persons ($4,800) is reduced by the amount of excluded benefits, as discussed earlier under *Reduced Dollar Limit.*

This example, using Form 2441 (Form 1040), is illustrated at the end of this chapter. The illustration shows how to claim the child and dependent care credit, how to exclude the dependent care benefits, and how to report the identification of the care provider.

Employment Taxes for Household Employers

Generally, if you pay someone to work in your home, such as a babysitter, that person is your household employee. If the individuals who work in your home are self-employed, you are not liable for any of the taxes discussed in this section. Self-employed persons who are in business for themselves are not household employees.

If you use a placement agency to get a babysitter or companion who works in your home, that person is not your employee if the agency sets the fee and exercises control over the sitter. This control could include providing rules of conduct and appearance and requiring regular reports. In this case, you do not have to pay employment taxes. But, if an association merely gives you a list of sitters and you hire one from that list, the sitter may be your employee.

If you have a household employee you may be subject to:

1) Social security and Medicare taxes,
2) Federal unemployment tax, and
3) Federal income tax withholding.

Social security and Medicare taxes are withheld from the employee's pay and matched by the employer. Federal unemployment tax (FUTA tax) is paid by the employer only and

is for the employee's unemployment insurance. Federal income tax is withheld from the employee's total pay if the employee asks you to do so and you agree.

Get Publication 926 for more specific information.

You may also be subject to state withholding tax and state unemployment tax. You should contact your state unemployment tax office for information on how to file the state tax returns and for a state reporting number.

Form **2441**

Department of the Treasury
Internal Revenue Service (1)

Child and Dependent Care Expenses

▶ Attach to Form 1040.

▶ See separate instructions.

OMB No. 1545-0068

1994

Attachment Sequence No. **21**

Name(s) shown on Form 1040: Joan Thomas

Your social security number: 559 00 3436

You need to understand the following terms to complete this form: **Qualifying Person(s), Dependent Care Benefits, Qualified Expenses,** and **Earned Income.** See **Important Terms** on page 1 of the Form 2441 instructions.

Part I **Persons or Organizations Who Provided the Care**—You **must** complete this part. (If you need more space, use the bottom of page 2.)

1 (a) Care provider's name	(b) Address (number, street, apt. no., city, state, and ZIP code)	(c) Identifying number (SSN or EIN)	(d) Amount paid (see instructions)
Pat Green	12 Ash Avenue Hometown, TX 75240	240-00-3811	2,400
ACME Computers	(See W-2)		

2 Add the amounts in column (d) of line 1 . . . . . 2 — 2,400

3 Enter the number of **qualifying persons** cared for in 1994 . . . . . ▶ 2

Did you receive **dependent care benefits?**
- NO ▶ Complete only Part II below.
- YES ▶ Complete Part III on the back now.

Part II **Credit for Child and Dependent Care Expenses**

4 Enter the amount of **qualified expenses** you incurred and paid in 1994. DO NOT enter more than $2,400 for one qualifying person or $4,800 for two or more persons. If you completed Part III, enter the amount from line 25 . . . . . 4 — 1,800

5 Enter YOUR **earned income** . . . . . 5 — 29,000

6 If married filing a joint return, enter YOUR SPOUSE'S earned income (if student or disabled, see the instructions); **all others,** enter the amount from line 5 . . . . . 6 — 29,000

7 Enter the **smallest** of line 4, 5, or 6 . . . . . 7 — 1,800

8 Enter the amount from Form 1040, line 32 . . . . . 8 — 29,000

9 Enter on line 9 the decimal amount shown below that applies to the amount on line 8

If line 8 is— Over	But not over	Decimal amount is	If line 8 is— Over	But not over	Decimal amount is
$0	10,000	.30	$20,000	22,000	.24
10,000	12,000	.29	22,000	24,000	.23
12,000	14,000	.28	24,000	26,000	.22
14,000	16,000	.27	26,000	28,000	.21
16,000	18,000	.26	28,000	No limit	.20
18,000	20,000	.25			

9 — × .20

10 Multiply line 7 by the decimal amount on line 9. Enter the result. Then, see the instructions for the amount of credit to enter on Form 1040, line 41 . . . . . 10 — 360

Caution: *If you paid $50 or more in a calendar quarter to a person who worked in your home, you must file an employment tax return. Get* **Form 942** *for details.*

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11862M Form **2441** (1994)

Part III Dependent Care Benefits—Complete this part **only** if you received these benefits.

11	Enter the total amount of **dependent care benefits** you received for 1994. This amount should be shown in box 10 of your W-2 form(s). DO NOT include amounts that were reported to you as wages in box 1 of Form(s) W-2			11	3,000
12	Enter the amount forfeited, if any. See the instructions			12	
13	Subtract line 12 from line 11			13	3,000
14	Enter the total amount of **qualified expenses** incurred in 1994 for the care of the qualifying person(s)	14	5,400		
15	Enter the **smaller** of line 13 or 14	15	3,000		
16	Enter YOUR **earned income**	16	29,000		
17	If married filing a joint return, enter YOUR SPOUSE'S earned income (if student or disabled, see the line 6 instructions); if married filing a separate return, see the instructions for the amount to enter; **all others,** enter the amount from line 16	17	29,000		
18	Enter the **smallest** of line 15, 16, or 17	18	3,000		
19	**Excluded benefits.** Enter here the **smaller** of the following: • The amount from line 18, or • $5,000 ($2,500 if married filing a separate return **and** you were required to enter your spouse's earned income on line 17).			19	3,000
20	**Taxable benefits.** Subtract line 19 from line 13. Also, include this amount on Form 1040, line 7. On the dotted line next to line 7, write "DCB"			20	-0-

To claim the child and dependent care credit, complete lines 21–25 below, and lines 4–10 on the front of this form.

21	Enter the amount of qualified expenses you incurred and paid in 1994. DO NOT include on this line any excluded benefits shown on line 19			21	2,400
22	Enter $2,400 ($4,800 if two or more qualifying persons)	22	4,800		
23	Enter the amount from line 19	23	3,000		
24	Subtract line 23 from line 22. If zero or less, **STOP**. You cannot take the credit. **Exception.** If you paid 1993 expenses in 1994, see the line 10 instructions			24	1,800
25	Enter the **smaller** of line 21 or 24 here **and** on line 4 on the front of this form			25	1,800

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34.

Credit for the Elderly or the Disabled

Introduction

This chapter discusses:

- Who qualifies for the credit for the elderly or the disabled, and
- How to figure this credit.

The maximum credit available is $1,125. You may be able to claim this credit if you:

- Are age 65 or older, or
- Are retired on permanent and total disability.

Internal Revenue Service (IRS) will figure your credit. If you choose to have the IRS figure your tax on Form 1040 or Form 1040A, and you qualify for the credit for the elderly or the disabled, the IRS will also figure the credit for you. See *Credit Figured for You,* later.

Useful Items

You may want to see:

Publication

- ❑ **524** Credit for the Elderly or the Disabled
- ❑ **554** Tax Information for Older Americans

Forms (and Instructions)

- ❑ **Schedule 3 (Form 1040A)** Credit for the Elderly or the Disabled for Form 1040A Filers
- ❑ **Schedule R (Form 1040)** Credit for the Elderly or the Disabled

Can You Take the Credit?

You can take the credit for the elderly or the disabled if you are a qualified individual and if your income is not more than certain limits. *Figure 34–A* and *Figure 34–B* can be used as guides to see if you qualify.

Read *Figure 34–A* first to see if you are a qualified individual. If you are, go to *Figure 34–B* to make sure your income is not too high. If your income is too high, you cannot take the credit. If it is not too high, you will qualify for the credit and this chapter will help you figure the correct amount.

You can claim the credit only if you file Form 1040 or Form 1040A. You cannot claim the credit if you file Form 1040–EZ. You figure the credit on Schedule R (Form 1040), *Credit for the Elderly or the Disabled,* or on Schedule 3 (Form 1040A), *Credit for the Elderly or the Disabled for Form 1040A Filers.*

If you want, the IRS will figure the credit for you. See *Credit Figured for You,* later.

Qualified Individual

You are a qualified individual for this credit if you are a U.S. citizen or resident and:

1) You are age 65 or older by the end of the tax year, or
2) You are under age 65 at the end of the tax year, and
   a) You are retired on permanent and total disability,
   b) You did not reach mandatory retirement age before 1994, and
   c) You received taxable disability benefits in 1994.

Age 65. You are considered 65 on the day before your 65th birthday. Therefore, you are 65 by the end of 1994 if your 65th birthday is on January 1, 1995.

U.S. citizen or resident. You must be a U.S. citizen or resident to claim the credit. Generally, you may not claim the credit if you were a nonresident alien at any time during the tax year. However, if you are a nonresident alien who is married to a U.S. citizen or resident at the end of the tax year and you both choose to be treated as U.S. residents and be taxed on your worldwide income, you may be able to claim the credit.

Also, if you were a nonresident alien at the beginning of the year and a resident at the end of the year, and you were married to a U.S. citizen or resident at the end of the year, you may both choose to be treated as U.S. residents for the entire year and thus be allowed to claim the credit. For information on these choices, see Chapter 1 of Publication 519, *U.S. Tax Guide for Aliens.*

Married Persons

Generally, if you are married at the end of the tax year, you and your spouse must file a joint return to claim the credit. If you and your spouse did not live in the same household at any time during the tax year, you may file either joint or separate returns and still take the credit.

If you are married, living with your child and apart from your spouse, you may be considered unmarried. See *Head of Household* in Chapter 2 for the tests you must meet.

Qualified Individual Under Age 65

If you are under age 65, you may qualify for the credit only if you are retired on permanent and total disability.

You are retired on permanent and total disability if:

1) You were permanently and totally disabled when you retired, and
2) You retired on disability before the close of the tax year.

If you retired on disability before 1977 and were not permanently and totally disabled at that time, you can qualify for the credit if you were permanently and totally disabled on January 1, 1976, or January 1, 1977.

You are considered retired on disability, even if you do not retire formally, when you have stopped working because of your disability.

Permanent and total disability. You are permanently and totally disabled if you cannot engage in any substantial gainful activity because of your physical or mental condition. A physician must certify that the condition has lasted or can be expected to last continuously for 12 months or more, or that the condition can be expected to result in death. See *Physician's statement,* later.

Substantial gainful activity. Substantial gainful activity is the performance of significant duties over a reasonable period of time while working for pay or profit, or in work generally done for pay or profit.

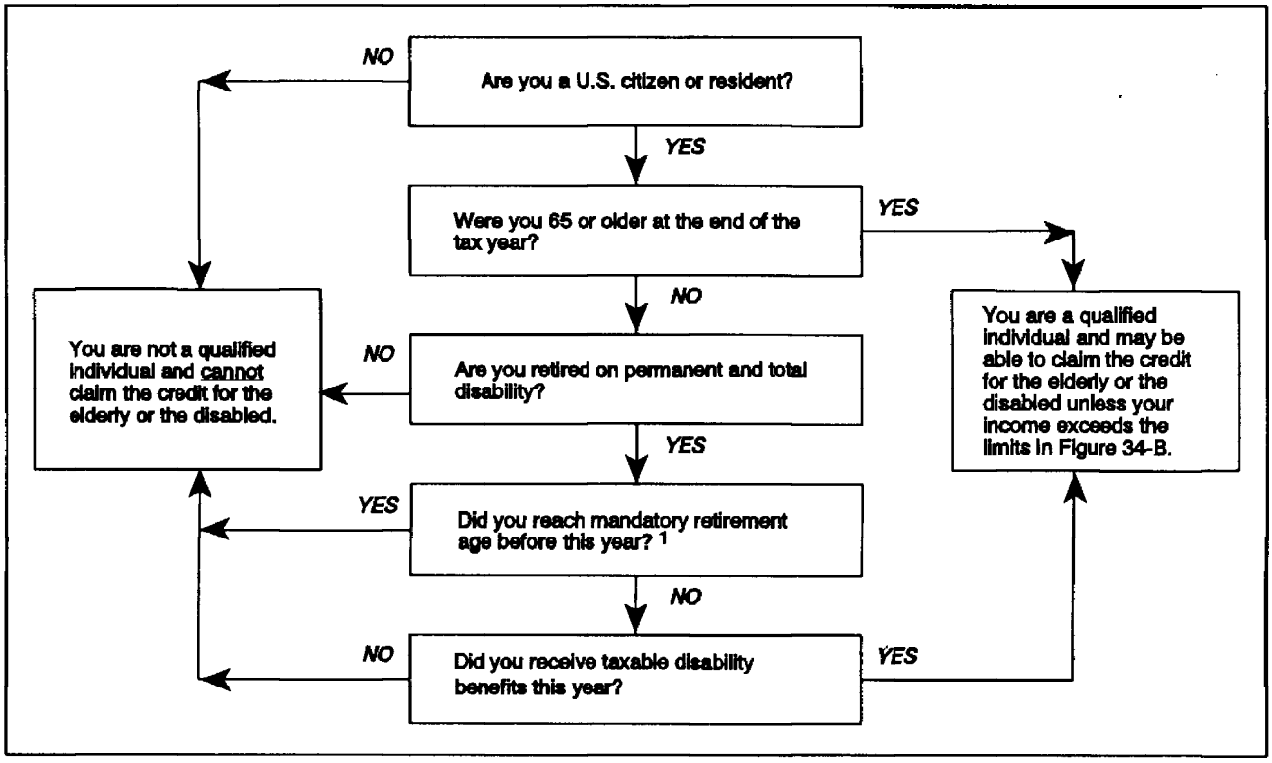
Full-time work (or part-time work done at your employer's convenience) in a competitive work situation for at least the minimum wage conclusively shows that you are able to engage in substantial gainful activity. The minimum wage is $4.25 an hour.

Substantial gainful activity is not work you do to take care of yourself or your home. It is not unpaid work on hobbies, institutional therapy or training, school attendance, clubs, social programs, and similar activities. However, the kind of work you do may show that you are able to engage in substantial gainful activity. The fact that you have not worked for some time is not, of itself, conclusive evidence that you cannot engage in substantial gainful activity. The following examples illustrate the tests of substantial gainful activity.

Example 1. Trisha, a sales clerk, retired on disability. She is 53 years old and now works as a full-time babysitter for the minimum wage. Even though Trisha is doing different work, she is able to do the duties of her new job in a full-time competitive work situation for the minimum wage. She is able to engage in substantial gainful activity and, therefore, cannot take the credit.

Example 2. Tom, a bookkeeper, retired on disability. He is 59 years old and now drives a truck for a charitable organization. He sets his own hours and is not paid. Duties of this nature generally are performed for pay or profit. Some weeks he works 10 hours, and some weeks he works 40 hours. Over the year he averages 20 hours a week. The kind of work and his average hours a week conclusively show that Tom is able to engage in substantial gainful activity. This is true even though Tom is not paid and he sets his own hours. He cannot take the credit.

Figure 34-A. Are You a Qualified Individual?



1 Mandatory retirement is the age set by your employer at which you would have been required to retire, had you not become disabled.

Figure 34-B. Income Limits

If your income is more than the limits in this Figure, you cannot claim the credit.

If you are:	You cannot take the credit if the amount from Form 1040A, line 17 or Form 1040, line 32 is:
Single, Head of household, or Qualifying widow(er) with dependent child	**$17,500** or more, or you received $5,000 or more of nontaxable social security or other nontaxable pensions
Married filing a joint return and only one spouse qualifies in Figure 34-A	**$20,000** or more, or you received $5,000 or more of nontaxable social security or other nontaxable pensions
Married filing a joint return and both spouses qualify in Figure 34-A	**$25,000** or more, or you received $7,500 or more of nontaxable social security or other nontaxable pensions
Married filing a separate return and you did not live with your spouse all year	**$12,500** or more, or you received $3,750 or more of nontaxable social security or other nontaxable pensions

Example 3. John, who retired on disability, took a job with a former employer on a trial basis. The purpose of the job was to see if John could do the work. The trial period lasted for 6 months during which John was paid the minimum wage. Because of John's disability, he was assigned only light duties of a nonproductive ''make-work'' nature. The activity was gainful because John was paid at least the minimum wage. But the activity was not substantial because his duties were nonproductive. These facts do not, by themselves, show that John is able to engage in substantial gainful activity.

Example 4. Joan, who retired on disability from employment as a bookkeeper, lives with her sister who manages several motel units. Joan assists her sister for one or two hours a day by performing duties such as washing dishes, answering phones, registering guests, and bookkeeping. Joan can select the time of day when she feels most fit to perform the tasks undertaken. Work of this nature, performed off and on during the day at Joan's convenience, is not activity of a ''substantial and gainful'' nature even if she is paid for the work. The performance of these duties does not, of itself, show that Joan is able to engage in substantial gainful activity.

Sheltered employment. Certain work offered at qualified locations to physically or mentally impaired persons is considered sheltered employment. These locations are in sheltered workshops, hospitals and similar institutions, homebound programs, and Department of Veterans Affairs (VA) sponsored homes. Compared to commercial employment, pay is lower for sheltered employment. Therefore, one usually does not look for sheltered employment if he or she can get other employment. The fact that one has accepted sheltered employment is not proof of that person's ability to engage in substantial gainful activity.

Physician's statement. If you are under 65, you must have your physician complete a statement certifying that you are permanently and totally disabled. Attach the statement to your return. You may use the physician's statement in Part II of either Schedule R (Form 1040) or Schedule 3 (Form 1040A). However, check the box on line 2 and do not attach a physician's statement if:

1) You filed a physician's statement for this disability for 1983 or an earlier year, or you filed a statement for tax years after 1983 and your physician signed line B on the statement, and
2) Due to your continued disabled condition, you were unable to engage in any substantial gainful activity in 1994.

If you have not filed a physician's statement in a previous year, or if the statement you filed did not meet these conditions, your doctor must complete the statement.

Veterans. If the Department of Veterans Affairs (VA) certifies that you are permanently and totally disabled, you can file VA Form 21–0172, *Certification of Permanent Total Disability,* instead of the physician's statement. VA Form 21–0172 must be signed by a person authorized by the VA to do so. You can get this form from your local VA regional office.

Disability income. If you are under age 65, you may qualify for the credit only if you have disability income.

Disability income must meet the following two requirements:

1) The income must be paid under your employer's accident or health plan or pension plan.
2) The income must be wages or payments in lieu of wages for the time you are absent from work because of permanent and total disability.

Any payment you receive from a plan that does not provide for disability retirement is not disability income. Any lump-sum payment for accrued annual leave that you receive when you retire on disability is a salary payment and is not disability income.

For purposes of the credit for the elderly or the disabled, disability income does **not** include amounts you receive after you reach mandatory retirement age. Mandatory retirement age is the age set by your employer at which you would have been required to retire, had you not become disabled.

Reporting your disability income. For purposes of reporting your disability income, disability payments are taxable as wages only until you reach minimum retirement age. After you reach the minimum retirement age set by your employer, disability income is taxable as a pension. Minimum retirement age is generally the earliest age at which you may receive a pension whether or not you are disabled. Minimum retirement age does not affect the treatment of disability income for the credit for the elderly or the disabled. For more information, see Publication 525, *Taxable and Nontaxable Income.*

Figuring the Credit

You can figure the credit yourself (see the explanation that follows), or the IRS will figure it for you. See *Credit Figured for You,* later.

Figuring the credit yourself. If you figure the credit yourself, fill out the front of either Schedule R (if you are filing Form 1040) or Schedule 3 (if you are filing Form 1040A). Next, fill out Part III of either Schedule R or Schedule 3. There are three steps to follow in Part III to determine the amount on which you figure your credit:

1) Determine your ***base amount*** (lines 10–12, of either Schedule R or Schedule 3).
2) Total any ***nontaxable social security or railroad retirement benefits*** and other nontaxable pensions and disability benefits you received (lines 13a, 13b, and 13c of either Schedule R or Schedule 3).
3) Determine your ***excess adjusted gross income*** (lines 14–17, of either Schedule R or Schedule 3).

These three steps are discussed later.

Amount of credit. If (1) is more than the total of (2) and (3), multiply the difference by 15% to get the amount of your credit. If the total of (2) and (3) is more than (1), you cannot claim the credit. This computation is found in Part III, lines 18–21, of either Schedule R or Schedule 3. In certain cases the amount of your credit may be limited. See *Limits on Credit,* later.

Step 1. Base Amount

To figure the credit, you must first determine your base amount. See *Table 34–1* for the base amount figures.

Base amounts for persons under age 65. If you are a qualified individual under age 65, your base amount cannot be more than your taxable disability income. This limit affects you ***only if***:

1) Your filing status is single, head of household, or qualifying widow(er) with dependent child and your taxable disability income is less than $5,000,
2) Your filing status is married filing a joint return and:
   a) Your spouse is also a qualified individual under 65 and your combined taxable disability income is less than $7,500,
   b) Your spouse is under 65 and ***not*** a qualified individual and your taxable disability income is less than $5,000, or
   c) Your spouse is 65 or older and your taxable disability income is less than $2,500, or
3) Your filing status is married filing separately and your taxable disability income is less than $3,750.

Step 2. Total Certain Nontaxable Income

Once you have determined your base amount, you must reduce it by the total amount of nontaxable social security and certain other nontaxable payments (covered later) you receive during the year.

Enter these nontaxable payments on line 13a or 13b of either Schedule R or Schedule 3, and total them on line 13c. If you are married filing a joint return, you must enter the combined amount of nontaxable payments both you and your spouse receive.

Worksheets are provided in the Form 1040 or Form 1040A instructions to help you determine if any part of your social security benefits (or equivalent railroad retirement benefits) is taxable. The nontaxable portions are used to reduce your base amount.

Table 34-1. **Base Amounts for Schedule R and Schedule 3**

If your filing status is:	Your Base Amount to enter on line 10 of Schedule R or Schedule 3 is:
Single, an unmarried head of household, or a qualifying widow or widower and	
• 65 or older	$5,000
• under 65 and retired on permanent and total disability [1]	$5,000
Married filing a joint return and	
• both of you are 65 or older	$7,500
• both of you are under 65 and one of you retired on permanent and total disability [1]	$5,000
• both of you are under 65 and both of you retired on permanent and total disability [1]	$7,500
• one of you is 65 or older, and the other is under 65 and retired on permanent and total disability [2]	$7,500
• one of you is 65 or older, and the other is under 65 and ***not*** retired on permanent and total disability	$5,000
Married filing a separate return and did not live with your spouse at any time during the year and	
• 65 or older	$3,750
• under 65 and retired on permanent and total disability [1]	$3,750

[1] Your base amount cannot be more than your total taxable disability income.

[2] Your base amount is $5,000 plus the taxable disability income of the spouse under age 65, but not more than $7,500.

The following payments reduce your base amount.

- Nontaxable social security payments. This is the nontaxable part of the amount of benefits shown in box 5 of Form SSA–1099, which includes disability benefits, before deducting any amounts withheld to pay premiums on supplementary Medicare insurance, and before any reduction because of receipt of a benefit under worker's compensation.

  Do not include a lump-sum death benefit payment you may receive as a surviving spouse, or a surviving child's insurance benefit payments you may receive as a guardian.
- Social security equivalent part of tier 1 railroad retirement pension payments that are not taxed. This is the nontaxable part of the amount of benefits shown in box 5 of Form RRB–1099.
- Nontaxable pension or annuity payments or disability benefits that are paid under a law administered by the Department of Veterans Affairs (VA). Do not include amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service, or as a disability annuity under section 808 of the Foreign Service Act of 1980.
- Pension or annuity payments or disability benefits that are excluded from income under any provision of federal law other than the Internal Revenue Code. Amounts that are a return of your cost of a pension or annuity do not reduce your base amount.

In order to avoid mistakes in figuring the credit which could result in additional tax to you later, it is important to correctly report all these nontaxable amounts. These amounts are verified by the IRS through information supplied by other government agencies.

Step 3. Determine Excess Adjusted Gross Income

You also have to subtract the amount of your excess adjusted gross income from the base amount used to figure your credit.

You figure your **excess adjusted gross income** as follows:

1) Subtract from your adjusted gross income the amount shown for your filing status in the following list:
   a) **$7,500** if you are single, a head of household, or a qualifying widow(er) with a dependent child,
   b) **$10,000** if you are married filing a joint return, or
   c) **$5,000** if you are married filing a separate return and you and your spouse did not live in the same household at any time during the tax year.
2) Divide the result of (1) by 2.

Figure your excess adjusted gross income on lines 14 through 17 of either Schedule R or Schedule 3.

If the total of your nontaxable social security or other nontaxable pensions or disability benefits (line 13c of either Schedule R or Schedule 3) plus your excess adjusted gross income (line 17 of either Schedule R or Schedule 3) equals or is more than your base amount, you will not be able to take the credit.

Example. You are 66 years old and your spouse is 64. Your spouse is not disabled. You file a joint return on Form 1040. Your adjusted gross income is $14,630. Together you received $3,200 from social security, which was nontaxable. You figure the credit as follows:

1) Base amount		$5,000
2) Subtract the total of:		
a) Social security and other nontaxable pensions	$3,200	
b) Excess adjusted gross income [($14,630 – $10,000) ÷ 2]	2,315	5,515
3) Balance (Not less than –0–)		–0–
4) Credit		–0–

You may not take the credit since your nontaxable social security (line 2a) plus your excess adjusted gross income (line 2b) is more than your base amount (line 1).

Limits on Credit

The amount of your credit may be limited if:

1) You file Schedule C, C–EZ, D, E, or F (Form 1040), and
2) The amount on Form 1040, line 22, is more than:

   $33,750 if single or head of household,

   $45,000 if married filing jointly or qualifying widow(er) with a dependent child, or

   $22,500 if married filing separately.

For purposes of (2), any tax-exempt interest from private activity bonds issued after August 7, 1986, and any net operating loss deduction must be added to the amount from Form 1040, line 22.

If both (1) and (2) do not apply, your credit is not subject to this limit. Enter the amount of the credit from Schedule R, line 21, on Form 1040, line 42.

If you meet both (1) and (2), get Form 6251, *Alternative Minimum Tax—Individuals,* and complete it through line 24. The limit on your credit will be the smaller of:

1) Your credit as computed, or
2) Your regular tax minus—
   a) Any credit for child and dependent care expenses, and
   b) Any amount shown on line 24, Form 6251.

Enter the smaller of (1) or (2) on Form 1040, line 42. If (2) is the smaller amount, also write ''AMT'' on the dotted line next to line 42, Form 1040, and replace the amount on Schedule R, line 21, with that amount.

Tax credit not refundable. Your credit for the elderly or the disabled cannot be more than the amount of your tax liability. Therefore, you cannot get a refund for any part of the credit that is more than your tax.

Credit Figured for You

If you file Form 1040 and you want the IRS to figure your credit, see *Form 1040* under *Tax Figured by IRS* in Chapter 31.

If you file Form 1040A and you want the IRS to figure your credit, see *Form 1040A* under *Tax Figured by IRS* in Chapter 31.

Examples

The following examples illustrate the credit for the elderly or the disabled. Assume that none of the taxpayers in these examples had to file a Form 6251. The base amounts are taken from *Table 34–1,* shown earlier.

Example 1. Jerry Ash is 68 years old and single, and files Form 1040A. He received the following income for the year:

Nontaxable social security	$3,120
Interest (taxable)	215
Pension (all taxable)	3,600
Wages from a part-time job	4,245

Jerry's adjusted gross income is $8,060 ($4,245 + $3,600 + $215). Jerry figures the credit on Schedule 3 (Form 1040A) as follows:

1) Base amount		$5,000
2) Subtract the total of:		
a) Social security and other nontaxable pensions	$3,120	
b) Excess adjusted gross income [($8,060 – $7,500) ÷ 2]	280	3,400
3) Balance		$1,600
4) Credit (15% of $1,600)		$ 240

Jerry's credit is $240. He files Schedule 3 (Form 1040A) and shows this amount on line 24b of Form 1040A.

Example 2. James Davis is 58 years old and single, and files Form 1040. Two years ago he retired on permanent and total disability, and he is still permanently and totally disabled. He filed the required physician's statement with his return for the year he retired on disability, so this year he checks the box in Part II of Schedule R.

He received the following income for the year:

Nontaxable social security	$3,000
Interest (taxable)	100
Taxable disability pension	8,400

James' adjusted gross income is $8,500 ($8,400 + $100). He figures the credit on Schedule R as follows:

1) Base amount	$5,000
2) Taxable disability pension	$8,400

3) Smaller of (1) or (2)		$5,000
4) Subtract the total of:		
a) Nontaxable disability benefits (social security)	$3,000	
b) Excess adjusted gross income [($8,500 – $7,500) ÷ 2]	500	3,500
5) Balance (Not less than 0)		$1,500
6) Credit (15% of $1,500)		$ 225

His credit is $225. He enters $225 on line 42 of Form 1040.

Example 3. William White is 53. His wife Helen is 49. William had a stroke in 1986 and retired on permanent and total disability. He is still permanently and totally disabled because of the stroke. In November of 1994, Helen was injured in an accident at work and retired on permanent and total disability.

William received nontaxable social security disability benefits of $3,000 this year and a taxable disability pension of $6,000. Helen earned $9,200 from her job and received a taxable disability pension of $1,000. Their joint return on Form 1040 shows adjusted gross income of $16,200 ($6,000 + $9,200 + $1,000).

Helen got her doctor to complete Part II of Schedule R. William had filed a physician's statement with their return for the year he had the stroke. His doctor had signed on line B to certify that William was permanently and totally disabled. William does not have to file another physician's statement this year. He must fill out Part II of a separate Schedule R (not shown) and attach it to the joint return. He checks the box in Part II and writes his first name in the space above line 2.

William and Helen use Schedule R to figure their $135 credit for the elderly or the disabled. They enter this amount on line 42 of Form 1040. See their filled-in Schedule R on the next two pages.

Schedule R (Form 1040)

Department of the Treasury Internal Revenue Service (T)

Credit for the Elderly or the Disabled

▶ Attach to Form 1040. ▶ See separate instructions for Schedule R.

OMB No. 1545-0074

1994

Attachment Sequence No. **16**

Name(s) shown on Form 1040: William M. White and Helen A. White

Your social security number: 222 00 3333

You may be able to take this credit and reduce your tax if by the end of 1994:

- You were age 65 or older, **OR** • You were under age 65, you retired on **permanent and total** disability, and you received taxable disability income.

But you must also meet other tests. See the separate instructions for Schedule R.

Note: *In most cases, the IRS can figure the credit for you. See page 24 of the Form 1040 instructions.*

Part I Check the Box for Your Filing Status and Age

If your filing status is:	And by the end of 1994:		Check only one box:
Single, Head of household, or Qualifying widow(er) with dependent child	1	You were 65 or older 1	☐
	2	You were under 65 and you retired on permanent and total disability . . . 2	☐
Married filing a joint return	3	Both spouses were 65 or older 3	☐
	4	Both spouses were under 65, but only one spouse retired on permanent and total disability 4	☐
	5	Both spouses were under 65, and both retired on permanent and total disability 5	☑
	6	One spouse was 65 or older, and the other spouse was under 65 and retired on permanent and total disability 6	☐
	7	One spouse was 65 or older, and the other spouse was under 65 and **NOT** retired on permanent and total disability 7	☐
Married filing a separate return	8	You were 65 or older and you lived apart from your spouse for all of 1994 . . 8	☐
	9	You were under 65, you retired on permanent and total disability, and you lived apart from your spouse for all of 1994 9	☐

If you checked box 1, 3, 7, or 8, skip Part II and complete Part III on the back. All others, complete Parts II and III.

Part II Statement of Permanent and Total Disability (Complete only if you checked box 2, 4, 5, 6, or 9 above.)

IF: 1 You filed a physician's statement for this disability for 1983 or an earlier year, or you filed a statement for tax years after 1983 and your physician signed line B on the statement, **AND**

2 Due to your continued disabled condition, you were unable to engage in any substantial gainful activity in 1994, check this box . . . . . ▶ ☐

- If you checked this box, you do not have to file another statement for 1994.
- If you **did not** check this box, have your physician complete the statement below.

Physician's Statement (See instructions at bottom of page 2.)

I certify that HELEN A. WHITE
Name of disabled person

was permanently and totally disabled on January 1, 1976, or January 1, 1977, **OR** was permanently and totally disabled on the date he or she retired. If retired after December 31, 1976, enter the date retired. ▶ NOVEMBER 2, 1994

Physician: Sign your name on **either** line A or B below.

A The disability has lasted or can be expected to last continuously for at least a year . . . .

B There is no reasonable probability that the disabled condition will ever improve . . . .

Physician's signature: John A Doctor — Date: 2-7-95

Physician's signature — Date

Physician's name: JOHN A. DOCTOR

Physician's address: 101 GREEN ST., HOMETOWN, MD 20000

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11359K **Schedule R (Form 1040) 1994**

Part III Figure Your Credit

10	**If you checked (in Part I):** Box 1, 2, 4, or 7 — $5,000; Box 3, 5, or 6 — $7,500; Box 8 or 9 — $3,750 (**Enter:**)		10	7,500
	Did you check box 2, 4, 5, 6, or 9 in Part I? — **Yes** → You **must** complete line 11. — **No** → Enter the amount from line 10 on line 12 and go to line 13.			
11	**If you checked:** • Box 6 in Part I, add $5,000 to the taxable disability income of the spouse who was under age 65. Enter the total. • Box 2, 4, or 9 in Part I, enter your taxable disability income. • Box 5 in Part I, add your taxable disability income to your spouse's taxable disability income. Enter the total. **TIP:** For more details on what to include on line 11, see the instructions.		11	7,000
12	If you completed line 11, enter the **smaller** of line 10 or line 11; **all others,** enter the amount from line 10		12	7,000
13	Enter the following pensions, annuities, or disability income that you (and your spouse if filing a joint return) received in 1994:			
a	Nontaxable part of social security benefits, and Nontaxable part of railroad retirement benefits treated as social security. See instructions.	13a	3,000	
b	Nontaxable veterans' pensions, and Any other pension, annuity, or disability benefit that is excluded from income under any other provision of law. See instructions.	13b		
c	Add lines 13a and 13b. (Even though these income items are not taxable, they **must** be included here to figure your credit.) If you did not receive any of the types of nontaxable income listed on line 13a or 13b, enter -0- on line 13c	13c	3,000	
14	Enter the amount from Form 1040, line 32	14	16,200	
15	**If you checked (in Part I):** Box 1 or 2 — $7,500; Box 3, 4, 5, 6, or 7 — $10,000; Box 8 or 9 — $5,000 (**Enter:**)	15	10,000	
16	Subtract line 15 from line 14. If zero or less, enter -0-	16	6,200	
17	Divide line 16 above by 2	17	3,100	
18	Add lines 13c and 17			18 6,100
19	Subtract line 18 from line 12. If zero or less, **stop;** you **cannot** take the credit. Otherwise, go to line 21			19 900
20	Decimal amount used to figure the credit			20 × .15
21	Multiply line 19 above by the decimal amount (.15) on line 20. Enter the result here and on Form 1040, line 42. **Caution:** *If you file Schedule C, C-EZ, D, E, or F (Form 1040), your credit may be limited. See the instructions for line 21 for the amount of credit you can claim*			21 135

Instructions for Physician's Statement

Taxpayer

If you retired after December 31, 1976, enter the date you retired in the space provided in Part II.

Physician

A person is permanently and totally disabled if **both** of the following apply:

1. He or she cannot engage in any substantial gainful activity because of a physical or mental condition, and

2. A physician determines that the disability has lasted or can be expected to last continuously for at least a year or can lead to death.

35.

Earned Income Credit

Important Changes for 1994

Health insurance credit and the extra credit for a child born during the year. These credits are no longer available.

Child and dependent care credit. You may be entitled to the child and dependent care credit in addition to the earned income credit in 1994. See Chapter 33 for more information.

More people may get the earned income credit. The earned income credit has expanded to include some persons who work, earn under $9,000, and do not have a qualifying child. The credit could be as much as $306. See *Persons Who Work and Do Not Have a Qualifying Child* to see if you can get this credit.

Increased earned income credit amount. If you have one qualifying child, the maximum credit you could get has increased from $1,434 in 1993 to $2,038 in 1994. If you have two or more qualifying children, the maximum credit you could get has increased from $1,511 in 1993 to $2,528 in 1994.

Increased amount you can earn. The amount of income you can earn and still get the credit has increased. If you have one qualifying child, you can earn less than $23,755. If you have two or more qualifying children, you can earn less than $25,296.

Form 1040EZ. Beginning with your 1994 tax return, if you do not have a qualifying child, you can use Form 1040EZ to claim the credit. See *How To Claim the Credit,* later.

Schedule EIC and the Earned Income Credit Worksheet (EIC Worksheet). Beginning in 1994, not everyone who gets the credit has to fill out Schedule EIC, *Earned Income Credit.* Only persons who have a qualifying child must fill out Schedule EIC and attach it to Form 1040 or Form 1040A. Schedule EIC contains only information about qualifying children. Do not use Schedule EIC to figure the credit. You must use an EIC Worksheet to figure the amount of the credit. The Worksheet can be found in the instructions for Form 1040, 1040A, or 1040EZ.

Important Reminders

Advance payment of the earned income credit in your paycheck. If you qualify for the earned income credit, you can receive part of it in each paycheck throughout the year. See *Advance Earned Income Credit Payments,* later, for more information.

Social security number. You **must** provide a correct and valid social security number (SSN) for each person listed on your tax return who is age 1 or older at the end of your tax year (usually December 31). The processing of your tax return will be delayed if a social security number is missing or incorrect. See *Social Security Number,* later, for more information.

Credit has no effect on certain welfare benefits. The earned income credit and the advance earned income credit payments you receive will not be used to determine whether you are eligible for the following benefit programs, or how much you can receive from the programs:

- Aid to Families With Dependent Children (AFDC),
- Medicaid,
- Supplemental Security Income (SSI),
- Food Stamps, and
- Low-income housing.

Introduction

This chapter discusses the earned income credit. The earned income credit is a special credit for certain persons who work. The credit reduces the amount of tax you owe (if any) and is intended to offset some of the increases in living expenses and social security taxes.

To get the credit you must:

1) File a tax return—even if
   - You do not owe any tax, or
   - You did not earn enough money to file a return.
2) Meet certain rules. These rules are explained in *Who May Take the Credit?*
3) Fill out the EIC Worksheet to figure the credit amount and where to enter it on Form 1040, 1040A, or 1040EZ. Only fill out Schedule EIC and attach it to Form 1040 or 1040A if you have a qualifying child.
4) ***An easier way—*** Let the Internal Revenue Service figure the credit for you. See *IRS will figure your credit for you,* later.

This chapter will explain the following:

- Who may qualify for the credit,
- What is earned income,
- How to figure the credit, and
- What form you will need to claim the credit.

Useful Items

You may want to see:

Publication

- ❑ **504** Divorced or Separated Individuals
- ❑ **533** Self-Employment Tax
- ❑ **596** Earned Income Credit

Form (and Instructions)

- ❑ **Schedule EIC** Earned Income Credit

Who May Take the Credit?

Beginning with your 1994 tax return, the earned income credit is available to persons with a qualifying child and to persons without a qualifying child. This section will list separately the rules that persons with a qualifying child must meet to get the credit and the rules that persons without a qualifying child must meet to get the credit. Some of the rules are the same, but some of the rules only apply to persons with a qualifying child or to persons without a qualifying child. Use the discussion that applies to you. A ''qualifying child'' is explained later, under *Who Is a Qualifying Child.*

Persons Who Work and Have One or More Qualifying Children

In order to take the earned income credit if you have a qualifying child, you must meet ***all*** the following rules:

1) You must have a qualifying child who lived with you in the United States for more than half the year (the whole year for an eligible foster child). See *Birth or death of a child* and *Social Security Number,* later, for more information.
2) You must have earned income during the year.
3) Your earned income and adjusted gross income must each be less than:
   - $23,755 if you have one qualifying child, or
   - $25,296 if you have more than one qualifying child.
4) Your return must cover a 12-month period. This does not apply if you file a short period return because of an individual's death.
5) Your filing status can be any filing status ***except*** married filing a separate return. See *Married persons,* later.
6) You cannot be a qualifying child of another person.

7) Your qualifying child cannot be the qualifying child of another person whose adjusted gross income is more than yours.
8) You usually must claim as a dependent a qualifying child who is married. See *Qualifying child who is married,* later, for an exception.
9) You are not filing Form 2555, *Foreign Earned Income* (or Form 2555–EZ, *Foreign Earned Income Exclusion*). These forms are filed to exclude from your gross income any income earned in foreign countries, or to deduct or exclude a foreign housing amount. U.S. possessions are not foreign countries. See Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad,* for more information.

Important note. If you meet ***all*** these rules, fill out Schedule EIC and attach it to either Form 1040 or Form 1040A. Also complete the EIC Worksheet to figure the amount of your credit. If you ***do not*** meet ***all*** these rules, enter ''NO'' next to line 56, Form 1040 (or next to line 28c, Form 1040A). If you have a qualifying child, you cannot file Form 1040EZ.

Married persons. Married persons living apart usually must file a joint return to claim the earned income credit. Even though you are married, you may file as head of household and claim the credit on your return if:

1) Your spouse did not live in your home at any time during the last 6 months of the year,
2) You paid more than half the cost to keep up your home for the entire year, and
3) Your home was, for more than half the year, the main home of your child, stepchild, adopted child, or foster child. You also must be entitled to claim an exemption for your child.

You will meet (3) even if you cannot claim your child as an exemption because:

1) You released your claim in writing to the other parent by filling out ***Form 8332,*** *Release of Claim to Exemption for Child of Divorced or Separated Parents,* or
2) There is a pre–1985 agreement (decree of divorce or separate maintenance or written agreement) granting the exemption to your child's other parent.

Persons Who Work and Do Not Have a Qualifying Child

In order to take the earned income credit if you do not have a qualifying child, you must meet ***all*** the following rules:

1) You must have earned income during 1994.
2) Your earned income and adjusted gross income must each be less than $9,000.
3) Your return must cover a 12-month period. This does not apply if you file a short period return because of an individual's death.
4) Your filing status can be any filing status **EXCEPT** married filing a separate return. See *Married Persons Exception,* later, for an exception.
5) You cannot be a qualifying child of another person. See *Qualifying Child of Another Person* under *Explanation of Rules for Persons Without a Qualifying Child,* later.
6) You (or your spouse, if filing a joint return) must be at least age 25 but under age 65 before the close of your tax year (usually December 31). See *Age Rule,* later.
7) You cannot be eligible to be claimed as a dependent on anyone else's return. See *Dependent Rule,* later.
8) Your main home must be in the United States for more than half the year. See *Main Home Rule,* later.
9) You are not filing Form 2555, *Foreign Earned Income,* or Form 2555–EZ, *Foreign Earned Income Exclusion.* These forms are filed to exclude from your gross income any income earned in foreign countries, or to deduct or exclude foreign housing amounts. U.S. possessions are not foreign countries. See Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad,* for more information.

Important note. If you meet ***all*** these rules, fill out the EIC Worksheet to figure the amount of your credit. If you ***do not*** meet all these rules, enter ''No'' next to line 56 (Form 1040), next to line 28c (Form 1040A), or next to line 7 (Form 1040EZ).

Explanation of Rules For Persons With a Qualifying Child

In this section you will find explanations and examples for some of the rules listed under *Who May Take the Credit* for persons who have a qualifying child.

Who Is a Qualifying Child?

You have a qualifying child if your child meets three tests. They are:

1) Relationship,
2) Residency, and
3) Age.

Each test has separate rules. The three tests are explained next, one at a time.

Important note. Your qualifying child does not necessarily have to be your dependent. If your child does not meet all three tests for a qualifying child, then you cannot claim the credit. However, you might qualify for the credit if you do not have a qualifying child and your earned income is under $9,000. See *Persons Who Work and Do Not Have a Qualifying Child* for more information. If you cannot claim the credit, then enter ''NO'' next to line 56, Form 1040 (or next to line 28c, Form 1040A).

1. Relationship Test

To meet the relationship test, the child must be your:

- Son, daughter, or adopted child (or a descendant of your son, daughter, or adopted child—for example, your grandchild)
- Stepson or stepdaughter, or
- Eligible foster child (this could include a niece, nephew, brother, sister, cousin, etc.).

Adopted child. Your adopted child includes a child placed with you for adoption by an authorized placement agency.

Eligible foster child. For purposes of the earned income credit, a person is your eligible foster child if:

1) The child lived with you and was a member of your household for the whole year, **and**
2) You cared for that child as you would your own child.

As long as both (1) and (2) are met, any person can be your ''eligible foster child.'' The eligible foster child does not necessarily have to be related to you.

Qualifying child who is married. You generally **must** claim as a dependent your married qualifying child. If you cannot claim your married qualifying child as a dependent, you may still get the earned income credit if you meet either of the following:

1) You cannot claim your child as a dependent because you gave that right to your child's other parent by filling out **Form 8332, or**
2) You cannot claim your child as a dependent because you gave that right to your child's other parent in a pre–1985 agreement (such as a separation agreement or divorce decree).

If you meet either (1) or (2), you could claim the credit. If you need more information about either of these statements and when you can claim your child as a dependent, see Chapter 3.

2. Residency Test

To meet the residency test, there are two rules:

1) You must have a child who lived with you for more than half the year (the whole year if your child is an eligible foster child), and

2) The home must be in the United States (one of the 50 states or the District of Columbia).

To meet the residency test, you do not need a traditional home. For example, if your child lived with you for more than half the year in a homeless shelter, the residency test is met.

Birth or death of a child. You will meet the rule for a child living with you for more than half the year if:

- The child was alive for half the year or less during the year, ***and***
- The child lived with you for the part of the year he or she was alive.

If your qualifying child is an eligible foster child, you will meet the rule for a child living with you for the whole year if:

- The child was born or died during the year, ***and***
- The child lived with you for the part of the year he or she was alive.

Temporary absences. You will meet the residency test if you or the child is away from home on a temporary absence due to a special circumstance. Examples of a temporary absence include:

- Illness,
- Attending school,
- Business,
- Vacation, or
- Military service.

Military personnel. See Publication 3, *Tax Information for Military Personnel (Including Reservists Called to Active Duty),* for information on claiming the earned income credit.

3. Age Test

To meet the age test, your child must meet one of three rules.

1) The child must be under age 19 at the end of the year,
2) The child must be a full-time student under age 24 at the end of the year, or
3) The child must be permanently and totally disabled at any time during the tax year, regardless of age.

Full-time student. Your child is a full-time student if he or she:

- Was enrolled as a student at a school during any 5 months of 1994 for the number of hours or classes that the school considers to be full time, or
- Took a full-time, on-farm training course during any 5 months of 1994. The course had to be given by a school or a state, county, or local government agency.

School. A school includes technical, trade, and mechanical schools. It does not include on-the-job training courses or correspondence schools.

Permanently and totally disabled. Your child is permanently and totally disabled during the tax year if he or she cannot engage in any substantial gainful activity because of his or her physical or mental condition. The condition must have lasted or be expected to last continuously for 12 months or more, or to result in death.

Other Rules for a Qualifying Child

The next two items explain what happens if:

1) You are a qualifying child of another person, and
2) You and someone else have the same qualifying child.

1. Qualifying Child of Another Person

If you are a qualifying child of another person, then you cannot claim the earned income credit—no matter how many qualifying children you have.

Example. In 1994, you and your daughter lived with your mother. You are 22 years old and attended beauty school full time. You had a part-time job and earned $5,700. You had no other income. Your mother worked and earned $16,000.

Your daughter is your qualifying child.

Your mother meets all the rules for the earned income credit. Both you and your daughter are qualifying children of your mother.

You cannot take the earned income credit in 1994 because you are your mother's qualifying child.

2. Qualifying Child of More Than One Person

If you and someone else have the same qualifying child, then only the person with the higher adjusted gross income can have the qualifying child and may be eligible to take the credit. This is true even if the person with the higher adjusted gross income does not meet all the rules to claim the credit. Adjusted gross income is the amount on Form 1040, line 31, or Form 1040A, line 16.

Example 1. You and your son lived with your mother in 1994. You are 25 years old. Your only income was $9,100 from a part-time job. Your mother's only income was $15,000 from her job.

Your son is a qualifying child of both you and your mother. However, because you both have the same qualifying child, only one of you can take the credit. Because your mother's adjusted gross income ($15,000) is more than your adjusted gross income ($9,100), only your mother can take the earned income credit in 1994. You cannot take the credit in 1994.

Example 2. Use the same facts from Example 1, except that your mother's adjusted gross income is $26,000.

Your son is still a qualifying child for both you and your mother. Only your mother can take the credit because her adjusted gross income is higher than yours. However, your mother cannot take the earned income credit because her adjusted gross income is more than $23,755. Even though your mother cannot take the earned income credit, you cannot take the credit either, because your mother's adjusted gross income is more than yours.

Example 3. You and your sister shared a house for all of 1994. You have 3 young children who lived in the household all year. Your sister does not have any children. However, she cares for your children as if they were her own. You earn $12,000 and your sister earns $13,000.

The children meet the age and residency test for both you and your sister. They meet the relationship test for you because they are your children. They also meet the relationship test for your sister because they lived with her in the same household for the whole year. She cared for them as if they were her own. Therefore, they qualify as her eligible foster children.

Your children are qualifying children for both you and your sister. However, because your sister's adjusted gross income is higher than yours, she is the only one who can take the credit.

Remember — Schedule EIC has spaces to enter the names of only 2 children. In this example there are 3 children. You cannot split the qualifying children. Your sister's higher adjusted gross income entitles her to the credit for all 3 qualifying children whether or not their names appear on Schedule EIC.

Important note. If the other person is your spouse and you file a joint return, this rule does not apply.

Social Security Number

You must provide a correct and valid social security number (SSN) for each person listed on your tax return who is age 1 or over at the end of the your tax year (usually December 31). Enter an SSN for your qualifying child on Schedule EIC, line 4. If your qualifying child is also your dependent, enter the SSN on Schedule EIC, line 4, and also on line 6c of Form 1040 or 1040A.

If you need to get an SSN, apply for one by filing ***Form SS–5*** with your local Social Security Administration (SSA). It takes approximately two weeks to receive an SSN.

Refund could be delayed. If you do not provide correct and valid social security numbers, the processing of your return will be delayed.

If the filing deadline is approaching and you still do not have an SSN, you have two choices:

1) Request an automatic extension (Form 4868) to August 15. This extension does not give you extra time to pay any amount you expect to owe. You should pay any amount you expect to owe to avoid interest or penalty charges (see the instructions for Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return),* or
2) File the return on time, without Schedule EIC; then file an amended return (Form 1040X) after receiving the SSN.

Explanation of Rules for Persons Without a Qualifying Child

In this section you will find explanations and examples for some of the rules listed under *Who May Take the Credit* for persons who do not have a qualifying child. The following rules are discussed:

Married Persons Exception

Qualifying Child of Another Person

Age Rule

Dependent Rule

Main Home Rule

Married Persons Exception

Married persons living apart usually must file a joint return to claim the earned income credit. Even though you are married, you may file as head of household and claim the credit on your return if:

1) Your spouse did not live in your home at any time during the last 6 months of the year,
2) You paid more than half the cost to keep up your home for the entire year, and
3) Your home was, for more than half of the year, the main home of your child, adopted child, stepchild, or foster child. You also must be entitled to claim an exemption for your child.

You will meet (3) even if you cannot claim an exemption for your child because:

- You released your claim in writing to the other parent by filling out ***Form 8332,*** or
- There is a pre–1985 agreement (decree of divorce or separate maintenance or written agreement) granting the exemption to your child's other parent.

If the child who qualifies you for head of household status also meets the requirements of your qualifying child, you cannot take the credit under ''Persons Who Work and Do Not Have a Qualifying Child.''

Example 1. You are married. You and your spouse lived apart for all of 1994. You earned $8,000 in 1994. Your 19-year-old son lived with you all year. You provided more than half the cost of maintaining your home. Your son had a part-time job and earned $2,000. He was not a full-time student or permanently and totally disabled. You qualify for the ''head of household'' filing status and claim your son as a dependent. You can get the earned income credit under the rules for *Persons Who Work and Do Not Have a Qualifying Child.* Your son does not meet the age test for a qualifying child. Your son is 19, not a full-time student, and is not permanently and totally disabled. Even though your son is your dependent, he is not your qualifying child when figuring the earned income credit.

Example 2. The facts are the same as Example 1, except your son is 18. In that case, your son is your dependent and a qualifying child. You would qualify for the credit under the rules for *Persons Who Work and Have One or More Qualifying Children.* You would not qualify for the credit under the rules for *Persons Who Work and Do Not Have a Qualifying Child* because your son is your qualifying child.

Qualifying Child of Another Person

If you are a qualifying child of another person, then you cannot claim the earned income credit.

Example. In 1994, you lived with your mother. You are age 26 and permanently and totally disabled. Your only income in 1994 was from a community center where you went twice a week to answer telephones. You were paid a small fee of $1,500 for the year. Your mother worked and earned $16,000.

You are a qualifying child of your mother. She can claim the earned income credit if she meets all the other rules. Because you are a qualifying child of your mother, you cannot claim the earned income credit for 1994.

Age Rule

You must be at least age 25 but under age 65 before the end of your tax year. If you are married filing a joint return, either you or your spouse must be at least age 25 but under age 65 before the end of your tax year. It does not matter which spouse meets the age rule, as long as one of the spouses does. The end of the tax year for most people is December 31.

Example 1. You are single, age 28, and do not have any children. You meet the ''Age Rule'' for claiming the earned income credit.

Example 2. You are married and will file a joint return. You are age 23 and your spouse is age 27. You meet the ''Age Rule'' for claiming the earned income credit, because your spouse is at least age 25 but under age 65.

Example 3. You are married and will file a joint return. You are age 62 and your spouse is 66. You meet the ''Age Rule'' for claiming the earned income credit because you are at least age 25 but under age 65.

Example 4. You are married and file a joint return. You worked and your spouse was a full-time student. You are age 29 and your spouse is age 24. You meet the age test because you are at least 25 but under 65. It does not matter if only one of you has earned income. As long as you meet all the other rules, you can still get the credit.

Dependent Rule

You must be able to claim an exemption for yourself on your tax return. If someone else can claim you as a dependent on their return, you cannot claim the earned income credit. If someone else can claim you as a dependent on their return but does not, you still cannot claim the credit.

Example 1. You are age 25, single, and living at home with your parents. You work and are not a student. You earned $7,500. Your parents cannot claim you as a dependent. When you file your return, you claim an exemption for yourself. Therefore, you meet the ''Dependent Rule.''

Example 2. You are age 25, single, and living at home with your parents. You work and earned $2,000. Your parents can claim you as a dependent but decide not to. You cannot claim the credit because your parents could have claimed you as a dependent.

Example 3. You file as head of household. Your mother is your dependent. You maintain your own home. You worked and earned $8,500. No one can claim you as a dependent. You claim an exemption for yourself when you file your return. You meet the ''Dependent Rule.''

Main Home Rule

Your main home must be in the United States for more than half the year. Your main home can be ***any location*** where you regularly live. For example, some homeless individuals live in shelters. Such individuals are entitled to claim the credit if they also meet all the other rules for eligibility.

What Is Earned Income?

You have just learned about some of the rules you must meet if you want to claim the earned income credit. Another rule everyone must meet to get the credit is to have earned income. There are two ways to get earned income.

1) You work for someone who pays you, or
2) You work in a business you own.

That's why this credit is called the earned income credit. What is ''earned income?'' This section will explain what counts as earned income in order to get the earned income credit. For examples of what is or is not earned income see *Table 35–1.* The paragraphs which follow will explain some

Table 35-1. **Examples of Earned Income When Figuring the Earned Income Credit**

Earned Income	
Includes:	**Does not include:**
TAXABLE EARNED INCOME (Enter on EIC Worksheet, line 1)*	
Wages, salaries, and tips	Interest and dividends
Union strike benefits	Social security and railroad retirement benefits
Long-term disability benefits received prior to minimum retirement age	Welfare benefits (including AFDC payments)
Net earnings from self-employment (enter on line 5 of the Form 1040 EIC Worksheet)	Pensions or annuities
NONTAXABLE EARNED INCOME (Enter on EIC Worksheet, line 4)*	Veterans' benefits
* Voluntary salary deferrals (for example: 401(k) plans or the Federal Thrift Savings Plan)	Workers' compensation benefits
* Pay earned in a combat zone	Alimony
* Basic quarter and subsistence allowances and in-kind quarters and subsistence from the U.S. military	Child support
* The value of meals or lodging provided by an employer for the convenience of the employer	Unemployment compensation (insurance)
* Housing allowance or rental value of a parsonage for the clergy (see ''Ministers and members of religious orders'')	Taxable scholarship or fellowship grants that were not reported on Form W-2
* Excludable dependent care benefits	Variable housing allowance for the military
* Voluntary salary reductions such as under a cafeteria plan	
Anything else of value you get from someone for services you performed even if it is not taxable	

* If you want IRS to figure your credit for you, enter the amount and type of your nontaxable earned income on line 7 (Form 1040EZ), line 28c (Form 1040A), or line 56 (Form 1040). For more information see, ''IRS will figure your credit for you'' in this chapter.

areas that are considered earned income when figuring the credit.

Earned income that is not taxed. As you can see, *Table 35–1* includes some examples of earned income that is not taxed. Earned income that is not taxed still counts as earned income when figuring the amount of your earned income credit.

To figure the earned income credit, you add the amounts of earned income that were not taxed to any amounts of taxable earned income you received during the year. You do this by putting the amount of the earned income that is not taxed on line 4 of the EIC Worksheet. Also, enter the type and amount of earned income that is not taxed in the spaces next to line 56 (Form 1040), line 28c (Form 1040A), or line 7 (Form 1040EZ). More information on how to do this is in the section called *How To Figure the Credit.* However, if you are a minister, see *Ministers and members of religious orders,* later, under *If You Own Your Business.*

Special note for military personnel. Each member of the military should receive a *Leave and Earnings Statement (LES)* at the end of the year. This statement should include specific allowance information. If the statement does not provide enough information or you need additional help, contact your legal assistance office or unit tax advisor. See Publication 945, *Tax Information for Those Affected by Operation Desert Storm,* or Publication 3, *Tax Information for Military Personnel (Including Reservists Called to Active Duty).*

Disability payments. If you retired on disability, payments you receive are considered earned income until you reach minimum retirement age. Minimum retirement age generally is the earliest age at which you can receive a pension or annuity if you are not disabled. You must report your taxable disability payments on line 7 of either Form 1040 or Form 1040A, until you reach minimum retirement age.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension and are not considered earned income. Report the pension payments on Form 1040, lines 16a and 16b (or Form 1040A, lines 11a and 11b).

Cafeteria plans. If your employer offers a benefit plan that allows you to ''pick and choose'' among two or more benefits consisting of cash and certain employee benefits that are not taxed, you are probably participating in a cafeteria plan. Some of the benefits that may be offered include:

- Accident or health insurance, and
- Dependent care assistance.

If you choose a benefit that is not taxed (such as accident and health insurance) and agree to a voluntary salary reduction for the benefit, the amount of the salary reduction is earned income for purposes of this credit.

Community property laws. If you live in a state that has community property laws for married persons, do not follow those community property laws when using your earned income to figure your earned income credit.

Important note. If you are not self-employed or a statutory employee (explained later), skip *If You Own Your Business* and begin reading the section called *How To Figure the Credit.*

If You Own Your Business

If you own your business, you are self-employed. You must include your net earnings from self-employment in earned income, even if the amount is less than $400. Net earnings is the amount you get after you subtract your business expenses and half of your self-employment taxes from your business gross (total) income. If this figure is a net loss, you must subtract the loss from your total earned income.

You may figure the amount of your net earnings by using either the regular or optional methods shown on Schedule SE (Form 1040), *Self-Employment Tax.* Publication 533, *Self-Employment Tax,* and the instructions for Schedule SE explain these methods. If you are eligible to choose the optional method, you may use up to $1,600 as the amount of earned income.

Example. You had $20,000 in gross farm income and a net farm ***loss*** of $5,000 for the year. You had no other income. Since your gross farm income was more than $2,400 and your net earnings (a loss of $5,000) from farming were less than $1,733, you can choose the farm optional method of figuring self-employment tax.

Even though you had a net loss for the year, you can enter $1,600 as net earnings from self-employment on Schedule SE. The $1,600 is earned income for purposes of figuring the earned income credit.

Net earnings from self-employment. Your net earnings from self-employment is earned income. You report these earnings on Schedule SE (Form 1040), Section A, line 3, or Section B, line 3. From this amount you must subtract the amount you claimed (or should have claimed) on Form 1040, line 25. This net amount is your earned income to use in figuring the earned income credit. If you do not have to file Schedule SE (because your net earnings from self-employment minus half of your self-employment tax is under $400), include the net amount in earned income on line 5 of the EIC Worksheet in the Form 1040 instructions. However, see *Table 35–2* for instructions about figuring the amount to enter on line 5 of the EIC Worksheet.

Table 35–2. If you were self-employed or you reported your income and expenses on Schedule C (or Schedule C–EZ) as a statutory employee, use Table 35–2 to figure the amount to enter on the EIC Worksheet, line 5, in the Form 1040 instructions.

Ministers and members of religious orders. If you can claim the earned income credit and are filing Schedule SE and the amount on line 2 of that schedule includes an amount that was also reported on Form 1040, line 7, follow these special rules.

1) Write ''Clergy'' to the right of line 56, Form 1040.
2) Determine how much of the income reported on Form 1040, line 7, was also reported on Schedule SE, line 2.
3) Subtract that income from the amount on Form 1040, line 7. Enter only the difference on the EIC Worksheet, line 1.
4) Complete Table 35–2 to determine the amount to enter on the EIC Worksheet, line 5 in the Form 1040 instructions. Use the figures from your completed Schedule SE to enter on Table 35–2.

Table 35-2. **How To Figure Line 5 of the EIC Worksheet**
(Keep for your records)

1.	**If You Are Filing Schedule SE:**		
a.	Enter the amount from Schedule SE, Section A, line 3, or Section B, line 3, whichever applies	**1a.** _____	
b.	Enter the amount, if any, from Schedule SE, Section B, line 4b	**1b.** _____	
c.	Add lines 1a and 1b	**1c.** _____	
d.	Enter the amount from Form 1040, line 25	**1d.** _____	
e.	Subtract line 1d from line 1c		**1e.** _____
2.	**If you are not filing Schedule SE because your net earnings from self-employment were less than $400 or you had a net (loss)** complete lines 2a through 2c. But do not include on these lines any amount exempt from self-employment tax as the result of the filing and approval of Form 4029 or 4361.		
a.	Enter any net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	**2a.** _____	
b.	Enter any net profit or (loss) from Schedule C, line 31, Schedule C-EZ, line 3, and Schedule K-1 (Form 1065), line 15a (other than farming)	**2b.** _____	
c.	Add lines 2a and 2b. Enter the total even if a loss		**2c.** _____
3.	**If you are filing Schedule C or C-EZ as a statutory employee,** enter the amount from line 1 of that Schedule C or C-EZ		**3.** _____
4.	Add lines 1e, 2c, and 3. Enter the total here and on line 5 of the EIC Worksheet, even if a loss. If the result is a loss, enter it in parentheses and read the **Caution** below		**4.** _____

Caution: *If line 5 of the* **Earned Income Credit Worksheet** is a loss, subtract it from the total of lines 3 and 4 of that Worksheet and enter the result on line 6 of that Worksheet. If the result is zero or less, you ***can't*** *take the earned income credit.*

If you received a housing allowance or were provided housing, do not include the allowance or rental value of the parsonage as nontaxable earned income on the EIC Worksheet, line 4, in the Form 1040 instructions (or in the space provided on line 56 of Form 1040). This income should already be included on Schedule SE, line 2.

Important note. If you are filing a joint return and your spouse was also self-employed or reported income and expenses on Schedule C (or Schedule C–EZ) as a statutory employee, add your spouse's amounts to yours to figure the amount to enter on the EIC Worksheet, line 5, in the Form 1040 instructions.

Statutory employee. Statutory employees are generally considered self-employed. However, the amounts received by statutory employees have social security and Medicare taxes withheld. For purposes of the earned income credit, statutory employees are treated as employees. Therefore, the gross (total) amount received from employment is included in earned income. The four types of statutory employees are:

1) An agent (or commission) driver who delivers food or beverages (other than milk) or laundry or dry cleaning for someone else.
2) A full-time life insurance salesperson.
3) A homeworker who works by the guidelines of the person for whom the work is done, with materials furnished by and returned to that person or to someone that person designates.
4) A traveling or city salesperson (other than an agent-driver or commission-driver) who works full time (except for sideline sales activities) for one firm or person getting orders from customers. The order must be for items for resale or use as supplies in the customer's business. The customers must be retailers, wholesalers, contractors, or operators of hotels, restaurants, or other businesses dealing with food or lodging.

If you were a statutory employee and you reported your income and expenses on Schedule C (Form 1040) (or Schedule C–EZ), your earned income includes the amount on line 1 of Schedule C (or Schedule C–EZ).

If you need further information about statutory employees, see Publication 937, *Employment Taxes.*

Approved Form 4361 and Form 4029. This section is for persons who have an approved:

- Form 4361, *Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners,* or

- Form 4029, *Application for Exemption from Social Security and Medicare Taxes and Waiver of Benefits.*

Each approved form exempts certain income from the self-employment tax. Each form is discussed in this section in terms of what is or is not earned income for purposes of the earned income credit.

Form 4361. If you have an approved Form 4361, amounts you received for performing ministerial duties as an employee are earned income. This includes wages, salaries, tips, and other employee compensation. Other employee compensation includes nontaxable compensation such as housing allowances or the rental value of a parsonage that you receive as part of your pay for services as an employee.

Amounts you received in the exercise of ministerial duties, but not as an employee, are not earned income. Examples include fees for performing marriages and honoraria for delivering speeches.

Any compensation you received from an undertaking unrelated to the ministry is earned income. This is so whether you received the amounts as an employee or as a self-employed individual.

Form 4029. If you have an approved Form 4029, all wages, salaries, tips, and other employee compensation are earned income. Amounts you received as a self-employed individual are not earned income. Also, losses from Schedule C, C–EZ, or F cannot be subtracted from wages on line 7 of Form 1040.

How To Figure the Credit

Once you know that you qualify for the earned income credit, you need to know how to figure the amount of the credit. You have two choices of how to figure the credit.

1) Have the IRS figure the credit for you. If you would like to do this, see *IRS Will Figure Your Credit For You,* under *How To Claim the Credit,* or
2) If you want to figure the credit yourself, do the following:
   a) Complete the EIC Worksheet and enter the amount of the credit on line 56 (Form 1040), line 28c (Form 1040A), or on line 7 (Form 1040EZ).
   b) Complete Schedule EIC and attach it to your Form 1040 or Form 1040A, if you have a qualifying child.

Earned income credit table. For 1994, there is one earned income credit table. You use this table to find the amount of your credit. The table is located at the end of this chapter.

Alternative minimum tax (AMT). The tax laws give special treatment to some kinds of income and expenses. This special treatment could substantially reduce or eliminate an individual's income tax. So that taxpayers who benefit from these laws will pay at least a minimum amount of tax, there is a special tax called the AMT.

You may have to pay the AMT if your taxable income for regular tax purposes, combined with any of the adjustments and preference items that apply to you, totals more than:

- **$45,000** if you are married filing a joint return (or a qualifying widow(er) with dependent child)
- **$33,750** if your filing status is head of household or single

You ***must*** reduce your earned income credit by the amount of any AMT you have for the tax year. If you owe the AMT (Form 1040, line 48), reduce the amount which you enter on line 10 of the Form 1040 EIC Worksheet by the amount on line 48 of Form 1040. Next, enter the result (if more than zero) on Form 1040, line 56. Then replace the amount on the EIC Worksheet, line 10, with the amount entered on Form 1040, line 56.

If you file Form 1040A and included AMT on line 27, subtract your AMT from the amount on line 9 of the Form 1040A EIC Worksheet. Next, enter the result (if more than zero) on Form 1040A, line 28c. Then replace the amount on the Form 1040A EIC Worksheet, line 9, with the amount entered on Form 1040A, line 28c. See Form 6251, *Alternative Minimum Tax—Individuals.*

How To Claim the Credit

If you want the IRS to figure your credit for you, skip this part and go to *IRS Will Figure Your Credit For You.* If you want to figure the credit yourself, you must do the following:

- File either Form 1040, 1040A, or 1040EZ.
- Complete the EIC Worksheet to figure the amount of your credit. Do not attach the Worksheet to your return. You should, however, keep it with your tax records. The instructions for Form 1040, 1040A, and 1040EZ contain an EIC Worksheet for your use.
- If you received advance earned income credit payments in 1994, you ***must*** file Form 1040 or 1040A. Form W–2, box 9, shows the amount of advance payments you received during 1994. Include the advance payments you received in 1994 on line 52, Form 1040, or line 26, Form 1040A. To find out if you can get advance payments of the earned income credit, see *Advance Earned Income Credit Payments,* later.
- Enter your earned income credit on line 56 (Form 1040), line 28c (Form 1040A), or line 7 (Form 1040EZ).
- Attach a completed Schedule EIC to either Form 1040 or 1040A if you have a qualifying child. If you have a qualifying child, you cannot use Form 1040EZ.

When and Where to File Your Return

You can file your tax return any time between January 1, 1995, and April 17, 1995. The earlier you file, the sooner you will receive your payment. Mail your filled-in return and all attachments to the Internal Revenue Service Center designated for the state or area where you live. Use the addressed envelope that came with your tax package, or use one of your own if you do not have the addressed envelope. If you do not have the addressed envelope, or if you moved during the year, see *Where Do I File?* in your Form 1040, 1040A, or 1040EZ instructions.

IRS Will Figure Your Credit For You

There are certain instructions you must follow before IRS can figure the credit for you.

Form 1040

If you are filing Form 1040 and you want the IRS to figure the credit for you, you must fill out parts of Form 1040 and:

- Enter any advance earned income credit payments received in 1994 on line 52,
- Complete Schedule EIC if you have a qualifying child, and
- Write ***"EIC"*** next to line 56. Also, if you have any earned income that is not taxed, enter the amount and type of income in the spaces provided on line 56. See Table 35–1 for examples of earned income that is not taxed.

To see which lines on Form 1040 you must fill out, go to the Form 1040 instructions under *The IRS Will Figure Your Tax and Some of Your Credits.*

Form 1040A

If you are filing Form 1040A and you want the IRS to figure the credit for you, you must:

1) Fill in the parts of Form 1040A through line 22 that apply to you.
2) If you file a joint return, use the space to the left of line 22 to separately show your own taxable income and your spouse's taxable income.
3) Complete lines 24a, 24b, 26, 28a, 28b, and any write-ins on line 28d, if they apply to you. If you received any advance earned income credit payments, show the amount of the payment on line 26.
4) Attach the first copy or Copy B of all your W–2 and 1099–R forms that show Federal income tax withheld.
5) Fill in and attach any schedules or forms asked for on the lines you completed.
6) Complete Schedule EIC if you have a qualifying child.
7) Write ***"EIC"*** next to line 28c. Also, if you have earned income that is not taxed, enter the amount and type of income in the spaces provided. See Table 35–1,

earlier, for examples of earned income that is not taxed.

8) Sign and date your return (both spouses must sign a joint return) and enter your occupations.

9) Mail your return by April 17, 1995.

Important note. Fill in and attach Schedule EIC to either Form 1040 or Form 1040A only if you have a qualifying child.

Form 1040EZ

If you are filing Form 1040EZ and you want the IRS to figure the credit for you, you must:

1) Fill in lines 1–6.

2) If you file a joint return, use the space under the ''Note'' to the left of line 5 to separately show your own and your spouse's taxable income.

3) Fill in the amount and type of any earned income that is not taxed in the spaces marked ''Type'' and ''$'' to the left of line 7.

4) Write ''EIC'' in the space to the right of the words ''earned income below'' on line 7 if you can take the credit.

5) Attach the first copy or Copy B of all your W–2 forms.

6) Sign and date your return and enter your occupation. If filing a joint return, both spouses must sign.

7) Mail your return by April 17, 1995.

How To Figure the Credit Yourself

There are certain instructions you must follow if you want to figure the credit yourself.

Form 1040A, EIC Worksheet, and Schedule EIC

Figure the amount of your credit on the EIC Worksheet if you meet the rules under *Who May Take the Credit* and your total earned income (line 7, Form 1040A) and your adjusted gross income (line 16, Form 1040A) are each less than:

- $ 9,000 if you do not have a qualifying child,
- $23,755 if you have one qualifying child, or
- $25,296 if you have more than one qualifying child.

If you ***do not*** meet all the rules, then you do not qualify for the earned income credit. If you do not qualify, enter ''No'' next to line 28c, Form 1040A. If you qualify for the credit and have a qualifying child, you must also fill out Schedule EIC and attach it to your Form 1040A. Do not attach the EIC Worksheet to your return. If you want the IRS to figure your credit, see *IRS Will Figure Your Credit For You,* earlier.

Important note. If Form 1040A, line 7, includes an amount for a taxable scholarship or fellowship grant that was not reported on your W–2, enter the total line 7 amount on line 1 of the EIC Worksheet. Next, enter the amount of the scholarship or fellowship grant (that was not reported on your W–2) in the box for line 2 of the Form 1040A EIC Worksheet. Then subtract line 2 from line 1 of the EIC Worksheet and enter the result on line 3.

Form 1040, EIC Worksheet, and Schedule EIC

Figure the amount of your credit on the EIC Worksheet if you meet the rules under *Who May Take the Credit* and your total earned income (line 7, Form 1040) and your adjusted gross income (line 31, Form 1040) are each less than:

- $ 9,000 if you do not have a qualifying child,
- $23,755 if you have one qualifying child, or
- $25,296 if you have more than one qualifying child.

If you ***do not*** meet all the rules, then you do not qualify for the earned income credit. If you do not qualify, enter ''No'' next to line 56, Form 1040.

If you qualify for the credit and have a qualifying child, you must also fill out Schedule EIC and attach it to your Form 1040. Do not attach the EIC Worksheet to your return.

If you want the IRS to figure your credit, see *IRS Will Figure Your Credit For You,* earlier.

Important note. If Form 1040, line 7, includes an amount for a taxable scholarship or fellowship grant that was not reported on your Form W–2, enter the total line 7 amount on line 1 of the EIC Worksheet. Next, enter the amount of the scholarship or fellowship grant (that was not reported on your W–2) on line 2 of the Form 1040 EIC Worksheet. Then subtract line 2 from line 1 and enter the result on line 3.

Form 1040EZ and EIC Worksheet

Figure the amount of your credit on the EIC Worksheet if you meet the rules under *Who May Take the Credit* and your total earned income (line 1, Form 1040EZ) and your adjusted gross income (line 3, Form 1040EZ) are each less than $9,000. Do not attach the EIC Worksheet to your Form 1040EZ return.

If you want the IRS to figure your credit, see *IRS Will Figure Your Credit For You,* earlier.

Important note. If Form 1040EZ, line 1, includes an amount for a taxable scholarship or fellowship grant that was not reported on your W–2, enter the Form 1040EZ, line 1, amount on line 1 of the EIC Worksheet. Next, enter the amount of the scholarship or fellowship grant (that was not on your W–2) on line 2 of the EIC Worksheet. Then subtract line 2 from line 1 and enter the result on line 3.

Examples

This part of the chapter contains two comprehensive examples that illustrate how to claim the credit. The first example is about David and Judy Brown who have 3 children. The second example is about Kelly Green who does not have a qualifying child.

Example 1

At the end of 1994, David and Judy Brown have three children—Karl B., age 3, and twins Trisha K. and Mary B., age 11 months. The children lived with David and Judy for all of 1994. David worked and earned $16,000. He also received $1,500 in unemployment compensation. Judy made crafts and sold them at a flea market. Her net earnings from self-employment were $350. In addition, they earned $50 interest from a savings account.

Their total earned income is $16,350 ($16,000 + $350). Their adjusted gross income is $17,900 ($16,000 + $350 + $1,500 + $50). David and Judy will file a joint return using Form 1040. They qualify for the earned income credit and complete Schedule EIC and the EIC Worksheet.

They take the following steps to complete the forms. Their completed Schedule EIC and the EIC Worksheet follow this example.

Step 1 — Schedule EIC

The Browns complete Schedule EIC because they have qualifying children. They enter ''David H. Brown and Judy K. Brown'' and David's social security number on the line provided at the top of Schedule EIC. They enter the social security number that appears first on Form 1040.

Step 2 — Schedule EIC

The Browns fill out *Information About Your Qualifying Child or Children* (lines 1–6).

Important note. If you have more than two qualifying children, list only two of the children on Schedule EIC.

Line 1. The Browns enter the first names, middle initials (if any), and last names of the children. They enter only Karl's and Trisha's names. They do not enter Mary's name. However, Mary is still a qualifying child even though her name is not on Schedule EIC.

Line 2. The Browns enter the year of birth for Karl (1991) in the column ''(a) Child 1'' and for Trisha (1994) in the column ''(b) Child 2.''

Lines 3(a) and 3(b). The Browns skip these lines because the children were born after 1975.

Line 4. The Browns enter Karl's social security number. They do not have to enter a social security number for Trisha, because she was under age 1 at the end of 1994. If the Browns did not have a social security

number for Karl, they would follow the instructions under *Social Security Number* earlier. If they omit Karl's social security number, the processing of the Brown's tax return would be delayed.

Line 5. The Browns enter ''son'' for Karl and ''daughter'' for Trisha. This line shows the children's relationship to the Browns.

Line 6. The Browns enter ''12'' for Karl and ''12'' for Trisha. This line shows how many months in 1994 the children lived with the Browns.

Step 3 — Schedule EIC

The Browns will attach Schedule EIC to Form 1040 when they send their completed return to IRS.

Step 4 — EIC Worksheet

In Steps 1–3 the Browns completed the information about their qualifyng children. Next, they will complete the EIC Worksheet to figure their earned income credit amount.

Line 1. The Browns enter David's earned income ($16,000) from Form 1040, line 7.

Line 2. The Browns leave this line blank because they did not have any taxable scholarship or fellowship grant income.

Line 3. They subtract line 2 from line 1 and enter $16,000.

Line 4. Because all of David's and Judy's earned income is taxable, they leave this line blank.

Line 5. Because Judy was self-employed, she completed *Table 35–2* and entered the result, $350, here. *Table 35–2* can be found earlier in this chapter. A filled-in *Table 35–2* is not shown in this example.

Line 6. They add lines 3, 4, and 5 and enter $16,350. This is their total earned income.

Line 7. To find the amount of their credit, the Browns go to the **Earned Income Credit Table** at the end of the chapter. They have two qualifying children listed on Schedule EIC—Karl and Trisha. They find their earned income of $16,350 (from EIC Worksheet, line 6) in the range of $16,350 to $16,400. They follow this line across to the column ''Two children'' and find $1,577. They enter $1,577 on line 7.

Line 8. The Browns enter their adjusted gross income of $17,900 (from Form 1040, line 31).

Line 9. The Browns check the box for ***No*** and follow the instruction because their adjusted gross income of $17,900 is more than $11,000. They again go to the **Earned Income Credit Table** to find the amount of their credit based on their adjusted gross income (EIC Worksheet, line 8). They find the $17,900 in the range of $17,900 to $17,950. They follow this line across to the column ''Two children'' and find $1,303. They enter $1,303 on line 9.

Line 10. Because they checked ***No*** on line 9, they compare the amounts on line 7 ($1,577) and line 9 ($1,303). They enter the smaller amount on line 10 and also on Form 1040, line 56. The $1,303 is the Brown's earned income credit.

Example 2—Form 1040EZ

Kelly Green is age 30 and a full-time student. She lived with her parents in the United States for all of 1994. She had a part-time job and earned $6,040. She earned $20 interest on a savings account. She is not a dependent on her parents' return because she does not meet the gross income test. She does not have any children. Kelly qualifies for the earned income credit. Kelly will file Form 1040EZ and complete the EIC Worksheet. The steps she uses and her completed EIC Worksheet follow.

Completing the EIC Worksheet

Kelly figures the amount of her earned income credit on the *Earned Income Credit Worksheet* as follows:

Line 1. She enters $6,040 from Form 1040EZ, line 1 here.

Line 2. Kelly leaves this line blank because she did not receive any scholarships or fellowship grants.

Line 3. She subtracts line 2 from line 1 and enters $6,040 here.

Line 4. Kelly leaves this line blank because all her income is taxable.

Line 5. She adds lines 3 and 4 and enters $6,040 here. This is her total earned income.

Line 6. To find her credit, Kelly goes to the *Earned Income Credit Table* at the end of the chapter. She finds her earned income of $6,040 (from line 5 above) in the range of $6,000 to $6,050. Kelly follows this line across to the column ''No children'' and finds $228.

Line 7. She enters $6,060 from Form 1040EZ, line 3.

Line 8. Kelly checks the box for ***Yes*** and follows the instruction, because her adjusted gross income of $6,060 is more than $5,000. Kelly again goes to the *Earned Income Credit Table* to find the amount of the credit based on her adjusted gross income. She finds $6,060 in the range of $6,050 to $6,100. Kelly follows this line across to the column ''No children'' and finds $224. Kelly enters $224 here.

Line 9. Because Kelly checked the ''Yes'' box for line 8, she enters the smaller of $228 (line 6) or $224 (line 8). She enters $224 here and on Form 1040EZ, line 7. The $224 is Kelly's earned income credit.

Advance Earned Income Credit Payments

Would you like to get part of your earned income credit now instead of waiting until after the end of the year? If you work for someone and expect to qualify for the earned income credit in 1995, you can choose to get part of the credit in advance. Give your employer a 1995 Form W–5 and he or she will include part of the credit regularly in your pay.

Who can get the advance payment of the earned income credit? There are certain basic rules you must meet to see if you can get part of the earned income credit paid to you throughout the year in your paycheck. You must:

1) Work and earn less than a certain amount. The amount in 1994 was $23,755. The amount for 1995 will be higher (see Form W–5 for the 1995 amount),
2) Have a qualifying child, and
3) Meet all the rules under *Persons Who Work and Have One or More Qualifying Children,* earlier, or in the instructions for the W–5 to get the credit.

Advance earned income credit payments received in 1994. If you received advance payments of the earned income credit in 1994, you must file a tax return to report the payments. Report the amount on line 52, Form 1040 (or line 26, Form 1040A). Your Form W–2, box 9 will show the amount you received. You cannot use Form 1040EZ to report your advance payments.

Example. Gene and Mary White expect to file a joint return for 1994. Gene earned $15,000 in 1994. Mary did not work but received $110 in interest from her savings account. They have a son, Guy, who lived with them all year. The Whites qualify for the earned income credit and wanted to receive it in advance during 1994. Gene gave a 1994 Form W–5 to his employer. If Gene wants to receive the advance credit in 1995, he must fill out a 1995 Form W–5 and give it to his employer.

During 1994, Gene received $832 of advance earned income credit in his weekly pay. This amount is shown in box 9 of Gene's 1994 Form W–2. The Whites must file a return to report the $832. They file a joint return on Form 1040A and enter the $832 on line 26.

When they file their return, they will claim a credit of $1,379. They subtract the $832 advance payment from their earned income credit. They find they will get a refund of $547 (they have no income tax liability on their income of $15,110). The Whites fill out Schedule EIC (because they have a qualifying child) and attach it to their tax return. They also fill out the Form 1040A EIC Worksheet to figure the amount of their credit but do not attach the Worksheet to their return.

Persons who are not entitled to receive the advance payments. Under certain circumstances, even if you meet the rules for receiving part of the earned income credit in advance, you may not be entitled to get it. If your wages are not subject to federal income tax, social security tax, or Medicare tax withholding, you cannot get the advance payment of the earned income credit. If you are a farm worker and are paid on a daily basis, your employer is not required to pay you the advance amount of the credit.

SCHEDULE EIC
(Form 1040A or 1040)
Department of the Treasury
Internal Revenue Service (1)

Earned Income Credit
(Qualifying Child Information)

▶ Attach to Form 1040A or 1040.
▶ See instructions on back.

OMB No. 1545-0074
1994
Attachment Sequence No. **43**

Name(s) shown on return: David H. Brown and Judy K. Brown

Your social security number: 333 00 3333

Before You Begin . . .

- Answer the questions on page 44 (1040A) or page 27 (1040) to see if you can take this credit.
- If you can take the credit, fill in the worksheet on page 45 (1040A) or page 28 (1040) to figure your credit. **But if you want the IRS to figure it for you, see page 40 (1040A) or page 24 (1040).**

Then, complete and attach Schedule EIC only if you have a qualifying child (see boxes on back).

Information About Your Qualifying Child or Children

If you have more than two qualifying children, you only have to list two to get the maximum credit.

Caution: *If you don't fill in all the lines that apply, it will take us longer to process your return and issue your refund.*	(a) Child 1	(b) Child 2
1 Child's name (first, initial, and last name)	Karl B. Brown	Trisha K. Brown
2 Child's year of birth	1991	1994
3 If child was born **before 1976** AND—		
a was a student **under age 24** at the end of 1994, check the "Yes" box, **OR**	☐ Yes	☐ Yes
b was permanently and totally disabled (see back), check the "Yes" box	☐ Yes	☐ Yes
4 If child was born **before 1994,** enter the child's social security number	000 00 1234	
5 Child's relationship to you (for example, son, grandchild, etc.)	Son	Daughter
6 Number of months child lived with you in the U.S. in 1994	12 months	12 months

TIP: Do you want the earned income credit added to your take-home pay in 1995? To see if you qualify, get **Form W-5** from your employer or by calling the IRS at 1-800-TAX-FORM (1-800-829-3676).

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions. Cat. No. 13339M **Schedule EIC (Form 1040A or 1040) 1994**

Earned Income Credit Worksheet—Line 56 (keep for your records)

Caution: *If you are a minister or member of a religious order, see* ***Special Rules*** *on page 29 before completing this worksheet.*

1. Enter the amount from Form 1040, line 7 . . . . . 1. 16,000
2. If you received a taxable scholarship or fellowship grant that wasn't reported on a W-2 form, enter that amount here . . 2. _____
3. Subtract line 2 from line 1 . . . . . 3. 16,000
4. Enter any **nontaxable earned income** (see page 29). Types of nontaxable earned income include contributions to a 401(k) plan, which should be shown in box 13 of your W-2 form, and military housing and subsistence . . . . . 4. _____
5. If you were self-employed or used Schedule C or C-EZ as a statutory employee, enter the amount from the worksheet on page 29 . . . . . 5. 350
6. Add lines 3, 4, and 5 . . . . . 6. 16,350
7. Look up the amount on **line 6** above in the **EIC Table** on pages **30–31** to find your credit. Enter the credit here 7. 1,577

   If line 7 is zero, **stop.** You cannot take the credit. Enter "No" next to Form 1040, line 56.
8. Enter the amount from Form 1040, line 31 . . . . . 8. 17,900
9. **Is line 8 less than—**
   - $5,000 if you don't have a qualifying child?
   - $11,000 if you have at least one qualifying child?

   ☐ **YES.** Go to line 10 now.

   ☑ **NO.** Look up the amount on **line 8** above in the **EIC Table** on pages **30–31** to find your credit. Enter the credit here . . 9. 1,303
10. **Earned income credit.**
    - If you checked "YES" on line 9, enter the amount from line 7.
    - If you checked "NO" on line 9, enter the **smaller** of line 7 or line 9 . . . . . 10. 1,303

    Next: Take the amount from line 10 above and enter it on Form 1040, line 56.

    AND

    If you had any nontaxable earned income (see line 4 above), enter the amount and type of the income in the spaces provided on line 56.

    AND

    Complete Schedule EIC and attach it to your return ONLY if you have a qualifying child.

Note: *If you owe the alternative minimum tax (Form 1040, line 48), subtract it from the amount on line 10 above. Then, enter the result (if more than zero) on Form 1040, line 56. Also, replace the amount on line 10 above with the amount entered on Form 1040, line 56.*

Earned income credit worksheet—Line 7 (keep for your records)

1. Enter the amount from Form 1040EZ, line 1. 1. 6,040
2. If you received a taxable scholarship or fellowship grant that wasn't reported on a W-2 form, enter that amount here. 2. _____
3. Subtract line 2 from line 1. 3. 6,040
4. Enter any **nontaxable earned income** (see page 18). Types of nontaxable earned income include contributions to a 401(k) plan, which should be shown in box 13 of your W-2 form, and military housing and subsistence. 4. _____
5. Add lines 3 and 4. 5. 6,040

   Caution: *If line 5 is $9,000 or more, you **cannot** take the credit. Print "NO" next to line 7 of Form 1040EZ.*
6. Look up the amount on **line 5** above in the **EIC Table** on page 19 to find your credit. Enter the credit here. 6. 228
7. Enter the amount from Form 1040EZ, line 3. 7. 6,060
8. **Is line 7 $5,000 or more?**

   ☑ **YES.** Look up the amount on **line 7** above in the **EIC Table** on page 19 to find your credit. Enter the credit here. 8. 224

   ☐ **NO.** Go to line 9.
9. **Earned income credit.**
   - If you checked "YES" on line 8, enter the **smaller** of line 6 or line 8.
   - If you checked "NO" on line 8, enter the amount from line 6. 9. 224

Next: Take the amount from line 9 above and enter it on Form 1040EZ, line 7.

AND

If you had any nontaxable earned income (see line 4 above), enter the type and amount of that income in the spaces marked "Type" and "$" on line 7.

How to Get Advance Payments for 1995

To get part of the credit in advance, you must fill out a 1995 Form W–5.

After you have read the instructions and answered the questions on Form W–5, give the bottom part of the form to your employer. Keep the top part for your records.

If you have more than one employer, give a certificate to only one of them. If you are married and both you and your spouse are employed and expect to qualify for the credit, you may give a Form W–5 to your employer and your spouse may give one to his or her employer.

Important note. If you receive advance earned income credit payments in 1995, you must file Form 1040 or Form 1040A for 1995. You must file a return to report what you already received and to take advantage of any additional earned income credit that you may qualify for.

Caution. The advance earned income credit payment is available only to persons who have at least one qualifying child.

If you receive advance payments of the earned income credit and later find out that you do not qualify for the credit, you will have to pay back any advance payment you received when you file your Form 1040 or Form 1040A.

The 1995 Form W–5 you give to your employer is valid until December 31, 1995. If you expect to qualify for the earned income credit in 1996 and you want to receive advance payments, you must give your employer a ***new*** Form W–5 in 1996. You do this each year you think you are eligible for the credit.

When to give your employer a new Form W–5. If your situation changes after you give your employer a Form W–5, and you no longer qualify for the earned income credit, you must give your employer a new Form W–5. Check the ***NO*** box in question 1 on the new form to show that you are not eligible to get advance payments.

If your spouse files a Form W–5 with his or her employer, you must file a new Form W–5 with your employer. Check the ***Yes*** box in question 4 that your spouse has filed a Form W–5.

If you no longer want to get advance payments of the earned income credit, you must fill out another Form W–5 and give it to your employer. Check the ***NO*** box in question 1 on the new form to show that you no longer want to get advance payments.

Checklist and Table for Figuring the Credit

The pages which follow have some helpful information you may need. They are:

- Eligibility Checklist. This is your final check to see if you really do qualify for the earned income credit.
- The Earned Income Credit Table immediately follows the *Eligibility Checklist.*

CAN YOU REALLY CLAIM THE EARNED INCOME CREDIT?
(For use in preparing 1994 tax returns)

You may claim the earned income credit if you answer YES to all the following questions.*

	YES	NO
1. Is the total of your taxable and nontaxable earned income at least $1 but less than: • $ 9,000 if you do not have a qualifying child • $23,755 if you have one qualifying child • $25,296 if you have more than one qualifying child	❑	❑
2. Is your adjusted gross income (Form 1040, line 31; Form 1040A, line 16; Form 1040EZ, line 3) less than: • $ 9,000 if you do not have a qualifying child • $23,755 if you have one qualifying child • $25,296 if you have more than one qualifying child	❑	❑
3. Is your filing status married filing jointly, head of household, qualifying widow(er), or single?	❑	❑
4. Answer **YES** if you are not a qualifying child of another person? (See **Qualifying child of another person** in this chapter.)	❑	❑
5. Answer **YES** if you did not file Form 2555 or Form 2555-EZ to exclude from your gross income any income earned in foreign countries or to deduct or exclude a foreign housing amount?	❑	❑
6. Does your return cover a 12-month period? (If you filed a short period return because of an individual's death, answer **YES**.)	❑	❑

STOP: If you have a qualifying child, answer question 7 and skip 8. If you do not have a qualifying child skip 7 and answer 8. (Qualifying child is explained in this chapter.)*

7. • Did your qualifying child live with you in the United States for more than half the year (the whole year if an eligible foster child)?	❑	❑
• Answer **YES** if your qualifying child is also a qualifying child for another person and your adjusted gross income is higher than the other persons. Answer **YES** if your child is only a qualifying child for you.	❑	❑
• If your qualifying child is married, did you claim the child as a dependent? If your qualifying child is not married, check **YES** (See **Qualifying child who is married** in this chapter for an exception.)	❑	❑
OR		
8. • Was your main home in the United States for more than half the year?	❑	❑
• Were you (or your spouse, if filing a joint return) at least age 25 but less than 65 before the end of your tax year?	❑	❑
• No one can claim you as a dependent on their return? If you are not eligible to be a dependent on anyone else's return, check **YES**. If you are eligible to be claimed as a dependent on someone else's return, check **NO**.	❑	❑

*** PERSONS WITH A QUALIFYING CHILD:** If you answered **YES** to questions 1 through 7, you can claim the credit. Remember to fill out Schedule EIC and attach it to your return. Also, use the EIC Worksheet to figure your credit.

PERSONS WITHOUT A QUALIFYING CHILD: If you answered **YES** to questions 1 through 6 and 8, you can claim the credit. Use the EIC Worksheet to figure your credit. Remember, you can now use Form 1040EZ.

IF YOU ANSWERED NO TO ANY QUESTION: You are not eligible for the credit. Enter **NO** next to line 56, Form 1040, next to line 28c, Form 1040A, or next to line 7, Form 1040EZ.

1994 Earned Income Credit (EIC) Table

Caution: This is **not** a tax table.

To find your credit: Read down the "At least — But less than" columns under the **INCOME FROM EIC WORKSHEET** column below and find the line that includes the amount entered on line 5 or 7, Form 1040EZ or Form 1040A EIC Worksheet, or line 6 or 8, Form 1040 EIC Worksheet. Then read across to the column that fits your circumstance and enter the credit from that column on line 8 or line 8, Form 1040EZ or 1040A EIC Worksheet, or line 7 or 9, Form 1040 EIC Worksheet.

INCOME FROM EIC WORKSHEET— see "To find your credit" above		And you have—			INCOME FROM EIC WORKSHEET— see "To find your credit" above		And you have—			INCOME FROM EIC WORKSHEET— see "To find your credit" above		And you have—			INCOME FROM EIC WORKSHEET— see "To find your credit" above		And you have—		
At least	But less than	No children	One child	Two children	At least	But less than	No children	One child	Two children	At least	But less than	No children	One child	Two children	At least	But less than	No children	One child	Two children
		Your credit is—					Your credit is—					Your credit is—					Your credit is—		
$1	$50	$2	$7	$8	3,000	3,050	231	796	908	6,000	6,050	228	1,585	1,808	9,000	11,000	0	2,038	2,528
50	100	6	20	23	3,050	3,100	235	809	923	6,050	6,100	224	1,598	1,823	11,000	11,050	0	2,034	2,523
100	150	10	33	38	3,100	3,150	239	822	938	6,100	6,150	220	1,611	1,838	11,050	11,100	0	2,026	2,514
150	200	13	46	53	3,150	3,200	243	835	953	6,150	6,200	216	1,624	1,853	11,100	11,150	0	2,018	2,505
200	250	17	59	68	3,200	3,250	247	848	968	6,200	6,250	212	1,637	1,868	11,150	11,200	0	2,010	2,497
250	300	21	72	83	3,250	3,300	251	861	983	6,250	6,300	208	1,650	1,883	11,200	11,250	0	2,002	2,488
300	350	25	85	98	3,300	3,350	254	874	998	6,300	6,350	205	1,663	1,898	11,250	11,300	0	1,994	2,479
350	400	29	99	113	3,350	3,400	258	888	1,013	6,350	6,400	201	1,677	1,913	11,300	11,350	0	1,986	2,470
400	450	33	112	128	3,400	3,450	262	901	1,028	6,400	6,450	197	1,690	1,928	11,350	11,400	0	1,978	2,461
450	500	36	125	143	3,450	3,500	266	914	1,043	6,450	6,500	193	1,703	1,943	11,400	11,450	0	1,970	2,452
500	550	40	138	158	3,500	3,550	270	927	1,058	6,500	6,550	189	1,716	1,958	11,450	11,500	0	1,962	2,444
550	600	44	151	173	3,550	3,600	273	940	1,073	6,550	6,600	186	1,729	1,973	11,500	11,550	0	1,954	2,435
600	650	48	164	188	3,600	3,650	277	953	1,088	6,600	6,650	182	1,742	1,988	11,550	11,600	0	1,946	2,426
650	700	52	178	203	3,650	3,700	281	967	1,103	6,650	6,700	178	1,756	2,003	11,600	11,650	0	1,938	2,417
700	750	55	191	218	3,700	3,750	285	980	1,118	6,700	6,750	174	1,769	2,018	11,650	11,700	0	1,930	2,408
750	800	59	204	233	3,750	3,800	289	993	1,133	6,750	6,800	170	1,782	2,033	11,700	11,750	0	1,922	2,399
800	850	63	217	248	3,800	3,850	293	1,006	1,148	6,800	6,850	166	1,795	2,048	11,750	11,800	0	1,914	2,390
850	900	67	230	263	3,850	3,900	296	1,019	1,163	6,850	6,900	163	1,808	2,063	11,800	11,850	0	1,906	2,382
900	950	71	243	278	3,900	3,950	300	1,032	1,178	6,900	6,950	159	1,821	2,078	11,850	11,900	0	1,898	2,373
950	1,000	75	256	293	3,950	4,000	304	1,045	1,193	6,950	7,000	155	1,834	2,093	11,900	11,950	0	1,890	2,364
1,000	1,050	78	270	308	4,000	4,050	306	1,059	1,208	7,000	7,050	151	1,848	2,108	11,950	12,000	0	1,882	2,355
1,050	1,100	82	283	323	4,050	4,100	306	1,072	1,223	7,050	7,100	147	1,861	2,123	12,000	12,050	0	1,874	2,346
1,100	1,150	86	296	338	4,100	4,150	306	1,085	1,238	7,100	7,150	143	1,874	2,138	12,050	12,100	0	1,866	2,337
1,150	1,200	90	309	353	4,150	4,200	306	1,098	1,253	7,150	7,200	140	1,887	2,153	12,100	12,150	0	1,858	2,329
1,200	1,250	94	322	368	4,200	4,250	306	1,111	1,268	7,200	7,250	136	1,900	2,168	12,150	12,200	0	1,850	2,320
1,250	1,300	98	335	383	4,250	4,300	306	1,124	1,283	7,250	7,300	132	1,913	2,183	12,200	12,250	0	1,842	2,311
1,300	1,350	101	348	398	4,300	4,350	306	1,137	1,298	7,300	7,350	128	1,926	2,198	12,250	12,300	0	1,835	2,302
1,350	1,400	105	362	413	4,350	4,400	306	1,151	1,313	7,350	7,400	124	1,940	2,213	12,300	12,350	0	1,827	2,293
1,400	1,450	109	375	428	4,400	4,450	306	1,164	1,328	7,400	7,450	120	1,953	2,228	12,350	12,400	0	1,819	2,284
1,450	1,500	113	388	443	4,450	4,500	306	1,177	1,343	7,450	7,500	117	1,966	2,243	12,400	12,450	0	1,811	2,276
1,500	1,550	117	401	458	4,500	4,550	306	1,190	1,358	7,500	7,550	113	1,979	2,258	12,450	12,500	0	1,803	2,267
1,550	1,600	120	414	473	4,550	4,600	306	1,203	1,373	7,550	7,600	109	1,992	2,273	12,500	12,550	0	1,795	2,258
1,600	1,650	124	427	488	4,600	4,650	306	1,216	1,388	7,600	7,650	105	2,005	2,288	12,550	12,600	0	1,787	2,249
1,650	1,700	128	441	503	4,650	4,700	306	1,230	1,403	7,650	7,700	101	2,019	2,303	12,600	12,650	0	1,779	2,240
1,700	1,750	132	454	518	4,700	4,750	306	1,243	1,418	7,700	7,750	98	2,032	2,318	12,650	12,700	0	1,771	2,231
1,750	1,800	136	467	533	4,750	4,800	306	1,256	1,433	7,750	7,800	94	2,036	2,333	12,700	12,750	0	1,763	2,223
1,800	1,850	140	480	548	4,800	4,850	306	1,269	1,448	7,800	7,850	90	2,038	2,348	12,750	12,800	0	1,755	2,214
1,850	1,900	143	493	563	4,850	4,900	306	1,282	1,463	7,850	7,900	86	2,038	2,363	12,800	12,850	0	1,747	2,205
1,900	1,950	147	506	578	4,900	4,950	306	1,295	1,478	7,900	7,950	82	2,038	2,378	12,850	12,900	0	1,739	2,196
1,950	2,000	151	519	593	4,950	5,000	306	1,308	1,493	7,950	8,000	78	2,038	2,393	12,900	12,950	0	1,731	2,187
2,000	2,050	155	533	608	5,000	5,050	304	1,322	1,508	8,000	8,050	75	2,038	2,408	12,950	13,000	0	1,723	2,178
2,050	2,100	159	546	623	5,050	5,100	300	1,335	1,523	8,050	8,100	71	2,038	2,423	13,000	13,050	0	1,715	2,169
2,100	2,150	163	559	638	5,100	5,150	296	1,348	1,538	8,100	8,150	67	2,038	2,438	13,050	13,100	0	1,707	2,161
2,150	2,200	166	572	653	5,150	5,200	293	1,361	1,553	8,150	8,200	63	2,038	2,453	13,100	13,150	0	1,699	2,152
2,200	2,250	170	585	668	5,200	5,250	289	1,374	1,568	8,200	8,250	59	2,038	2,468	13,150	13,200	0	1,691	2,143
2,250	2,300	174	598	683	5,250	5,300	285	1,387	1,583	8,250	8,300	55	2,038	2,483	13,200	13,250	0	1,683	2,134
2,300	2,350	178	611	698	5,300	5,350	281	1,400	1,598	8,300	8,350	52	2,038	2,498	13,250	13,300	0	1,675	2,125
2,350	2,400	182	625	713	5,350	5,400	277	1,414	1,613	8,350	8,400	48	2,038	2,513	13,300	13,350	0	1,667	2,116
2,400	2,450	186	638	728	5,400	5,450	273	1,427	1,628	8,400	8,450	44	2,038	2,528	13,350	13,400	0	1,659	2,108
2,450	2,500	189	651	743	5,450	5,500	270	1,440	1,643	8,450	8,500	40	2,038	2,528	13,400	13,450	0	1,651	2,099
2,500	2,550	193	664	758	5,500	5,550	266	1,453	1,658	8,500	8,550	36	2,038	2,528	13,450	13,500	0	1,643	2,090
2,550	2,600	197	677	773	5,550	5,600	262	1,466	1,673	8,550	8,600	33	2,038	2,528	13,500	13,550	0	1,635	2,081
2,600	2,650	201	690	788	5,600	5,650	258	1,479	1,688	8,600	8,650	29	2,038	2,528	13,550	13,600	0	1,627	2,072
2,650	2,700	205	704	803	5,650	5,700	254	1,493	1,703	8,650	8,700	25	2,038	2,528	13,600	13,650	0	1,619	2,063
2,700	2,750	208	717	818	5,700	5,750	251	1,506	1,718	8,700	8,750	21	2,038	2,528	13,650	13,700	0	1,611	2,055
2,750	2,800	212	730	833	5,750	5,800	247	1,519	1,733	8,750	8,800	17	2,038	2,528	13,700	13,750	0	1,603	2,046
2,800	2,850	216	743	848	5,800	5,850	243	1,532	1,748	8,800	8,850	13	2,038	2,528	13,750	13,800	0	1,595	2,037
2,850	2,900	220	756	863	5,850	5,900	239	1,545	1,763	8,850	8,900	10	2,038	2,528	13,800	13,850	0	1,587	2,028
2,900	2,950	224	769	878	5,900	5,950	235	1,558	1,778	8,900	8,950	6	2,038	2,528	13,850	13,900	0	1,579	2,019
2,950	3,000	228	782	893	5,950	6,000	231	1,571	1,793	8,950	9,000	2	2,038	2,528	13,900	13,950	0	1,571	2,010

1994 Earned Income Credit (EIC) Table *Continued*

INCOME FROM EIC WORKSHEET— see "To find your credit" above		And you have—			INCOME FROM EIC WORKSHEET— see "To find your credit" above		And you have—			INCOME FROM EIC WORKSHEET— see "To find your credit" above		And you have—			INCOME FROM EIC WORKSHEET— see "To find your credit" above		And you have—		
		No children	One child	Two children			No children	One child	Two children			No children	One child	Two children			No children	One child	Two children
At least	But less than	Your credit is—			At least	But less than	Your credit is—			At least	But less than	Your credit is—			At least	But less than	Your credit is—		
13,950	14,000	0	1,563	2,002	17,150	17,200	0	1,051	1,436	20,350	20,400	0	540	870	23,550	23,600	0	29	304
14,000	14,050	0	1,555	1,993	17,200	17,250	0	1,043	1,427	20,400	20,450	0	532	861	23,600	23,650	0	21	295
14,050	14,100	0	1,547	1,984	17,250	17,300	0	1,036	1,418	20,450	20,500	0	524	852	23,650	23,700	0	13	287
14,100	14,150	0	1,539	1,975	17,300	17,350	0	1,028	1,409	20,500	20,550	0	516	843	23,700	23,750	0	5	278
14,150	14,200	0	1,531	1,966	17,350	17,400	0	1,020	1,400	20,550	20,600	0	508	835	23,750	23,800	0	*	269
14,200	14,250	0	1,523	1,957	17,400	17,450	0	1,012	1,392	20,600	20,650	0	500	826	23,800	23,850	0	0	260
14,250	14,300	0	1,515	1,948	17,450	17,500	0	1,004	1,383	20,650	20,700	0	492	817	23,850	23,900	0	0	251
14,300	14,350	0	1,507	1,940	17,500	17,550	0	996	1,374	20,700	20,750	0	484	808	23,900	23,950	0	0	242
14,350	14,400	0	1,499	1,931	17,550	17,600	0	988	1,365	20,750	20,800	0	476	799	23,950	24,000	0	0	234
14,400	14,450	0	1,491	1,922	17,600	17,650	0	980	1,356	20,800	20,850	0	468	790	24,000	24,050	0	0	225
14,450	14,500	0	1,483	1,913	17,650	17,700	0	972	1,347	20,850	20,900	0	460	782	24,050	24,100	0	0	216
14,500	14,550	0	1,475	1,904	17,700	17,750	0	964	1,339	20,900	20,950	0	452	773	24,100	24,150	0	0	207
14,550	14,600	0	1,467	1,895	17,750	17,800	0	956	1,330	20,950	21,000	0	444	764	24,150	24,200	0	0	198
14,600	14,650	0	1,459	1,887	17,800	17,850	0	948	1,321	21,000	21,050	0	436	755	24,200	24,250	0	0	189
14,650	14,700	0	1,451	1,878	17,850	17,900	0	940	1,312	21,050	21,100	0	428	746	24,250	24,300	0	0	180
14,700	14,750	0	1,443	1,869	17,900	17,950	0	932	1,303	21,100	21,150	0	420	737	24,300	24,350	0	0	172
14,750	14,800	0	1,435	1,860	17,950	18,000	0	924	1,294	21,150	21,200	0	412	729	24,350	24,400	0	0	163
14,800	14,850	0	1,427	1,851	18,000	18,050	0	916	1,285	21,200	21,250	0	404	720	24,400	24,450	0	0	154
14,850	14,900	0	1,419	1,842	18,050	18,100	0	908	1,277	21,250	21,300	0	396	711	24,450	24,500	0	0	145
14,900	14,950	0	1,411	1,834	18,100	18,150	0	900	1,268	21,300	21,350	0	388	702	24,500	24,550	0	0	136
14,950	15,000	0	1,403	1,825	18,150	18,200	0	892	1,259	21,350	21,400	0	380	693	24,550	24,600	0	0	127
15,000	15,050	0	1,395	1,816	18,200	18,250	0	884	1,250	21,400	21,450	0	372	684	24,600	24,650	0	0	119
15,050	15,100	0	1,387	1,807	18,250	18,300	0	876	1,241	21,450	21,500	0	364	676	24,650	24,700	0	0	110
15,100	15,150	0	1,379	1,798	18,300	18,350	0	868	1,232	21,500	21,550	0	356	667	24,700	24,750	0	0	101
15,150	15,200	0	1,371	1,789	18,350	18,400	0	860	1,224	21,550	21,600	0	348	658	24,750	24,800	0	0	92
15,200	15,250	0	1,363	1,781	18,400	18,450	0	852	1,215	21,600	21,650	0	340	649	24,800	24,850	0	0	83
15,250	15,300	0	1,355	1,772	18,450	18,500	0	844	1,206	21,650	21,700	0	332	640	24,850	24,900	0	0	74
15,300	15,350	0	1,347	1,763	18,500	18,550	0	836	1,197	21,700	21,750	0	324	631	24,900	24,950	0	0	66
15,350	15,400	0	1,339	1,754	18,550	18,600	0	828	1,188	21,750	21,800	0	316	622	24,950	25,000	0	0	57
15,400	15,450	0	1,331	1,745	18,600	18,650	0	820	1,179	21,800	21,850	0	308	614	25,000	25,050	0	0	48
15,450	15,500	0	1,323	1,736	18,650	18,700	0	812	1,171	21,850	21,900	0	300	605	25,050	25,100	0	0	39
15,500	15,550	0	1,315	1,727	18,700	18,750	0	804	1,162	21,900	21,950	0	292	596	25,100	25,150	0	0	30
15,550	15,600	0	1,307	1,719	18,750	18,800	0	796	1,153	21,950	22,000	0	284	587	25,150	25,200	0	0	21
15,600	15,650	0	1,299	1,710	18,800	18,850	0	788	1,144	22,000	22,050	0	276	578	25,200	25,250	0	0	13
15,650	15,700	0	1,291	1,701	18,850	18,900	0	780	1,135	22,050	22,100	0	268	569	25,250	25,296	0	0	4
15,700	15,750	0	1,283	1,692	18,900	18,950	0	772	1,126	22,100	22,150	0	260	561	25,296 or more		0	0	0
15,750	15,800	0	1,275	1,683	18,950	19,000	0	764	1,118	22,150	22,200	0	252	552					
15,800	15,850	0	1,267	1,674	19,000	19,050	0	756	1,109	22,200	22,250	0	244	543					
15,850	15,900	0	1,259	1,666	19,050	19,100	0	748	1,100	22,250	22,300	0	237	534					
15,900	15,950	0	1,251	1,657	19,100	19,150	0	740	1,091	22,300	22,350	0	229	525					
15,950	16,000	0	1,243	1,648	19,150	19,200	0	732	1,082	22,350	22,400	0	221	516					
16,000	16,050	0	1,235	1,639	19,200	19,250	0	724	1,073	22,400	22,450	0	213	508					
16,050	16,100	0	1,227	1,630	19,250	19,300	0	716	1,064	22,450	22,500	0	205	499					
16,100	16,150	0	1,219	1,621	19,300	19,350	0	708	1,056	22,500	22,550	0	197	490					
16,150	16,200	0	1,211	1,613	19,350	19,400	0	700	1,047	22,550	22,600	0	189	481					
16,200	16,250	0	1,203	1,604	19,400	19,450	0	692	1,038	22,600	22,650	0	181	472					
16,250	16,300	0	1,195	1,595	19,450	19,500	0	684	1,029	22,650	22,700	0	173	463					
16,300	16,350	0	1,187	1,586	19,500	19,550	0	676	1,020	22,700	22,750	0	165	455					
16,350	16,400	0	1,179	1,577	19,550	19,600	0	668	1,011	22,750	22,800	0	157	446					
16,400	16,450	0	1,171	1,568	19,600	19,650	0	660	1,003	22,800	22,850	0	149	437					
16,450	16,500	0	1,163	1,560	19,650	19,700	0	652	994	22,850	22,900	0	141	428					
16,500	16,550	0	1,155	1,551	19,700	19,750	0	644	985	22,900	22,950	0	133	419					
16,550	16,600	0	1,147	1,542	19,750	19,800	0	636	976	22,950	23,000	0	125	410					
16,600	16,650	0	1,139	1,533	19,800	19,850	0	628	967	23,000	23,050	0	117	401					
16,650	16,700	0	1,131	1,524	19,850	19,900	0	620	958	23,050	23,100	0	109	393					
16,700	16,750	0	1,123	1,515	19,900	19,950	0	612	950	23,100	23,150	0	101	384					
16,750	16,800	0	1,115	1,506	19,950	20,000	0	604	941	23,150	23,200	0	93	375					
16,800	16,850	0	1,107	1,498	20,000	20,050	0	596	932	23,200	23,250	0	85	366					
16,850	16,900	0	1,099	1,489	20,050	20,100	0	588	923	23,250	23,300	0	77	357					
16,900	16,950	0	1,091	1,480	20,100	20,150	0	580	914	23,300	23,350	0	69	348					
16,950	17,000	0	1,083	1,471	20,150	20,200	0	572	905	23,350	23,400	0	61	340					
17,000	17,050	0	1,075	1,462	20,200	20,250	0	564	897	23,400	23,450	0	53	331					
17,050	17,100	0	1,067	1,453	20,250	20,300	0	556	888	23,450	23,500	0	45	322					
17,100	17,150	0	1,059	1,445	20,300	20,350	0	548	879	23,500	23,550	0	37	313					

36.

Other Credits

Important Change for 1994

Excess withholding of social security tax and tier 1 railroad retirement tax. Social security and railroad retirement tax (RRTA) were both withheld at a rate of 6.2% on the first $60,600 of wages in 1994. If you had two or more employers and they withheld too much social security or RRTA tax during 1994, you may be entitled to a credit of the excess withholding. For more information about the credit and how to get it, see *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld.*

Important Reminder

Credit for electric vehicles. You may be allowed a tax credit if you placed an electric vehicle in service after June 30, 1993. The credit is limited to $4,000 for each vehicle. For more information, see *Credit for Electric Vehicles.*

Introduction

In addition to the child and dependent care credit (Chapter 33), the credit for the elderly or the disabled (Chapter 34), and the earned income credit (Chapter 35) you may be able to claim other tax credits. This chapter is divided into two parts and discusses seven credits in the following order.

- Part 1, Nonrefundable Credits:
  - Credit for prior year minimum tax,
  - Mortgage interest credit,
  - Credit for electric vehicles, and
  - Foreign tax credit.
- Part 2, Refundable Credits:
  - Credit for excess social security tax or railroad retirement tax withheld,
  - Credit from a regulated investment company, and
  - Credit on diesel-powered highway vehicles.

Nonrefundable credits. The first part of the chapter, *Nonrefundable Credits,* covers four credits that you subtract directly from your tax. These credits may reduce your tax to zero. If these credits are more than your tax, the excess is not refunded to you.

Refundable credits. The second part of this chapter, *Refundable Credits,* covers three credits that are refundable to you and treated as payments. These credits are added to the federal income tax withheld and any estimated tax payments you made. If this total is more than your total tax, the excess will be refunded to you.

Useful Items

You may want to see:

Publication

- ❑ **378** Fuel Tax Credits and Refunds
- ❑ **514** Foreign Tax Credit for Individuals
- ❑ **564** Mutual Fund Distributions
- ❑ **936** Home Mortgage Interest Deduction

Form (and Instructions)

- ❑ **1040** U.S. Individual Income Tax Return
- ❑ **1116** Foreign Tax Credit
- ❑ **2439** Notice to Shareholder of Undistributed Long-Term Capital Gains
- ❑ **4136** Credit for Federal Tax Paid on Fuels
- ❑ **8396** Mortgage Interest Credit
- ❑ **8801** Credit For Prior Year Minimum Tax—Individuals, Estates, and Trusts
- ❑ **8828** Recapture of Federal Mortgage Subsidy
- ❑ **8834** Qualified Electric Vehicle Credit

Nonrefundable Credits

The following credits are discussed in this part:

- Credit for prior year minimum tax
- Mortgage interest credit
- Credit for electric vehicles
- Foreign tax credit.

Credit for Prior Year Minimum Tax

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. If you benefit from these laws, you may have to pay at least a minimum amount of tax. This is called the alternative minimum tax.

The special treatment of some items of income and expenses only allows you to postpone paying tax until a later year. It does not allow you to completely avoid the tax. In these situations, you may be able to claim a credit for prior year minimum tax against your current year's tax. The amount of the credit cannot reduce your current year's tax below your current year's tentative alternative minimum tax.

You may be able to take a credit against your regular tax if you:

1) Paid alternative minimum tax in 1993,
2) Had an unused minimum tax credit that you are carrying forward from 1993 to 1994, or
3) Had certain unallowed nonconventional-source fuel, orphan drug, or electric vehicle credits in 1993.

Credit amount. The credit is generally the amount of alternative minimum tax you actually paid in 1993 reduced by the part of it generated by exclusion items. Add to this any:

1) Credit carried forward,
2) Unallowed nonconventional-source fuel credit,
3) Unallowed orphan drug credit, and
4) Unallowed electric vehicle credit.

Exclusion items. These are adjustments and preference items that result in the permanent exclusion of income for regular tax purposes. The exclusion items are:

- The standard deduction,
- Medical and dental expenses,
- Miscellaneous itemized deductions,
- Taxes,
- Interest expense,
- Exclusion for gains on sale of certain small business stock,
- Tax-exempt interest from certain private activity bonds, and
- Depletion.

How to claim the credit. Figure your 1994 credit and any carryforward to 1995 on **Form 8801,** and attach it to your Form 1040. Include the credit in your total for line 44, Form 1040, and check box c. You can carry forward any unused credit for prior year minimum tax to later years until it is completely used.

For additional information about the credit, see the instructions for Form 8801.

Mortgage Interest Credit

Mortgage credit certificates issued by state and local governments may entitle a certificate holder to a mortgage interest credit. The certificate must be used in connection with the purchase, qualified rehabilitation, or qualified home improvement of the certificate holder's main home.

Who qualifies. You may be able to claim a mortgage interest credit if you were issued a mortgage credit certificate (MCC) under a qualified MCC program. The MCC must relate to your main home.

Amount of credit. You figure the credit by multiplying the certificate credit rate by the lesser of the interest you paid during the year on your actual loan amount (mortgage) or the interest you paid on the loan amount shown on your MCC. The certificate credit

rate and the maximum loan amount are shown on the MCC.

Limit. If the certificate credit rate is more than 20%, the credit cannot be more than $2,000.

Dividing the credit. If two or more persons (other than a married couple filing a joint return) hold an interest in the home to which the MCC relates, the credit must be divided based on the interest held by each person.

Example. John and his brother, George, were issued a MCC. They used the certificate to obtain a mortgage on a home that is their main home. John has a 60% interest and George has a 40% interest. John paid $5,400 mortgage interest and George paid $3,600.

The MCC shows a credit rate of 25% and a maximum loan amount of $65,000. Their actual mortgage loan is $60,000, which is less than the $65,000 maximum. However, their combined credit is limited to $2,000 because the credit rate is more than 20%.

John's credit is limited to $1,200 ($2,000 × 60%). He figures the credit by multiplying the interest he paid ($5,400) by the certificate credit rate (25%) for a total of $1,350. However, his credit is limited to the $1,200 above.

George's credit is limited to $800 ($2,000 × 40%). He figures the credit by multiplying the interest he paid ($3,600) by the certificate credit rate (25%) for a total of $900. His credit is limited to the $800 above.

Carryforward. If your allowable credit is more than your tax liability reduced by certain credits, you can carry forward the unused portion of the credit to your next 3 tax years or until used, whichever comes first.

If you are subject to the $2,000 limit because your certificate credit rate is more than 20%, no amount over the $2,000 (or your prorated share of the $2,000 if you must allocate the credit) may be carried forward.

How to claim the credit. Figure the credit and any carryforward to next year on **Form 8396,** and attach it to your Form 1040. Be sure to include any carryforward from 1991, 1992, and 1993. You cannot use a carryforward from 1991 on your tax return for any year after 1994.

Include the credit in your total for line 44 (Form 1040), and check box b.

Reduced home mortgage interest deduction. If you itemize your deductions on Schedule A (Form 1040), reduce your home mortgage interest deduction by the amount on line 3 of Form 8396, even if part of that amount is to be carried forward to 1995. For more information about the home mortgage interest deduction, see Chapter 25.

Recapture of Federal mortgage subsidy. If you closed on a mortgage from a qualified mortgage bond program and received a mortgage credit certificate after December 31, 1990, you may be subject to a recapture rule. The recapture would generally occur if you sold or disposed of your home during the first 9 years following the date of closing. See Publication 523, *Selling Your Home,* for more information.

Credit for Electric Vehicles

You may be allowed a 10% tax credit if you placed a qualified electric vehicle in service after June 30, 1993.

Qualified electric vehicle. This is a motor vehicle that:

1) Has at least four wheels and is manufactured for use on public streets, roads, and highways.
2) Is powered ***primarily*** by an electric motor that draws its power from rechargeable batteries, fuel cells, or other portable sources of electrical current.
3) Is originally used by you.
4) Is acquired for your own use, not for resale.

Amount of credit. The credit is equal to 10% of the cost of the vehicle. However, if the vehicle is a depreciable business asset, you must reduce the cost by any section 179 deduction before figuring the credit. Get Publication 917, *Business Use of a Car,* for information on the section 179 deduction.

The credit is limited to $4,000 for each vehicle.

Special rules. You cannot take the credit if you use the vehicle predominately outside the United States.

The credit will be subject to recapture if, within 3 years after the date you place the vehicle in service, the vehicle is modified so that it is no longer eligible for the credit or is used predominately outside the United States.

How to claim the credit. To claim the credit, complete **Form 8834,** and attach it to your Form 1040. Include the credit in your total for line 44, check box d, and write ''8834'' on the line next to box d.

Foreign Tax Credit

You generally can choose to claim income taxes you paid or accrued during the year to a foreign country or U.S. possession as a credit against your U.S. income tax. Or, you can deduct them as an itemized deduction.

To take the foreign tax credit, complete **Form 1116** and attach it to your Form 1040. Enter the credit on line 43, Form 1040. For more information, get Publication 514.

Refundable Credits

The following credits are refundable and are treated as payments of tax:

- Credit for excess social security tax or railroad retirement tax withheld,
- Credit from a regulated investment company, and
- Credit on diesel-powered highway vehicles.

Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld

There are limits on the amount of wages subject to social security and railroad retirement tax (RRTA). If you worked for two or more employers in 1994, and together they paid you wages that exceeded these limits, you may be entitled to a credit for any excess amount of tax withheld on those wages. This is a credit against your income tax. The limits are:

1) **$60,600** in wages subject to social security and tier 1 RRTA withholding tax of not more than $3,757.20, or
2) **$45,000** in wages subject to tier 2 RRTA withholding tax of not more than $2,205.00.

Note. Beginning in 1994, ***all*** wages are subject to Medicare tax withholding.

One employer. If any one employer withheld social security or RRTA tax that exceeded the limits in the preceding list, you cannot claim the extra amount withheld by that employer as a credit against your income tax. Your employer must adjust this for you.

Joint return. If you are filing a joint return, you cannot add the social security or RRTA tax withheld from your spouse's wages to the amount withheld from your wages. Figure the credit separately for both you and your spouse to determine if either of you has excess withholding.

How to claim the credit. If you file Form 1040, enter the credit on line 58. If you file Form 1040A, include the credit in the total on line 28d. Write ''Excess SST'' and show the amount of the credit in the space to the left of the line.

Note. You cannot claim the credit for excess social security or railroad retirement tax on Form 1040EZ.

How to figure the credit if you did not work for a railroad. If you did not work for a railroad during 1994, figure the credit as follows:

1. Add all social security tax withheld (but not more than $3,757.20 for each employer). Enter the total here ..... _____
2. Enter any uncollected social security tax on tips or group-term life insurance included in the total on Form 1040, line 53 ..... _____

3. Add lines 1 and 2. If $3,757.20 or less, stop here. You cannot claim the credit	
4. Social security tax limit	3,757.20
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 58 (or Form 1040A, line 28d)	

Example. You are married and file a joint return with your spouse who had no gross income in 1994. During 1994 you worked for the Brown Shoe Company and earned $45,000 in wages. Social security tax of $2,790 was withheld. You also worked for another employer in 1994 and earned $35,000 in wages. $2,170 of social security tax was withheld from these wages. Because you worked for more than one employer and your total wages were more than $60,600, you can claim a credit of $1,202.80 for the excess social security tax withheld.

1. Add all social security tax withheld (but not more than $3,757.20 for each employer). Enter the total here	$ 4,960.00
2. Enter any uncollected social security tax on tips or group-term life insurance included in the total on Form 1040, line 53	–0–
3. Add lines 1 and 2. If $3,757.20 or less, stop here. You cannot claim the credit	4,960.00
4. Social security tax limit	3,757.20
5. Credit. Subtract line 4 from line 3. Enter the result here and on Form 1040, line 58 (or Form 1040A, line 28d)	1,202.80

How to figure the credit if you worked for a railroad. If you were a railroad employee during 1994, figure the credit as follows:

1. Add all social security and tier 1 RRTA tax withheld (but not more than $3,757.20 for each employer). Enter the total here	
2. Enter any uncollected social security and tier 1 RRTA tax on tips or group-term life insurance included in the total on Form 1040, line 53	
3. Add lines 1 and 2. If $3,757.20 or less, enter –0– on line 5 and go to line 6	
4. Social security and tier 1 RRTA tax limit	3,757.20
5. Subtract line 4 from line 3	
6. Add all tier 2 RRTA tax withheld (but not more than $2,205.00 for each employer). Enter the total here	
7. Enter any uncollected tier 2 railroad retirement tax on tips or group-term life insurance included in the total on Form 1040, line 53	
8. Add lines 6 and 7. If $2,205.00 or less, enter –0– on line 10 and go to line 11	
9. RRTA tier 2 limit	2,205.00
10. Subtract line 9 from line 8	
11. Credit. Add lines 5 and 10. Enter the result here and on Form 1040, line 58 (or Form 1040A, line 28d)	

Credit from a Regulated Investment Company

You must include in your income any amounts that an investment company (for example, a mutual fund) allocated to you as capital gain distributions, even if you did not actually receive them. If the investment company paid a tax on the capital gain, you are allowed a credit for the tax since it is considered paid by you. The company will send you **Form 2439** showing the undistributed capital gains amount and the tax paid, if any. Claim the credit by entering the amount on line 59, Form 1040, and checking box a. Also attach Copy B of Form 2439 to your return. See *Capital Gain Distributions* in Chapter 9 for more information on undistributed capital gains.

Credit on Diesel-Powered Highway Vehicles

If you purchased a diesel-powered highway vehicle, you may be entitled to a ***one-time*** credit if:

1) You are the first owner of the vehicle, and

2) You did not purchase the vehicle for the purpose of reselling it.

Amount of credit. The credit is $102 if you purchased a diesel-powered automobile or $198 if you purchased a diesel-powered light van or truck.

How to claim the credit. To claim the credit, complete **Form 4136** and attach it to Form 1040. Enter the credit on line 59, Form 1040, and check box b.

For more information, see the discussion of *Diesel-Powered Highway Vehicles* in Publication 378.

Part Eight.

Sample Returns

The three chapters in this part give examples of filled-in tax returns. Chapter 37 illustrates Form 1040EZ. Chapter 38 illustrates Form 1040A with some of the schedules that may need to be filled out and filed with it. Chapter 39 illustrates Form 1040 with many of the schedules and forms that may need to be filled out and filed with it.

37.

Form 1040EZ

Pat Brown is single and does not have any children or dependents. She is 26 years old and has been a full-time student at State University since January 1994. She has a scholarship that covers her tuition and $1,000 of her room and board. Her parents cannot claim her as a dependent; nor can anyone else do so. In January of this year, she received two Forms W–2. One W–2 shows her taxable scholarship of $1,000. The other W–2 shows she earned $5,500 in wages and had $150 in federal tax withheld. She also received a 1994 Form 1099–INT showing she had $270 in interest income.

Pat filed Form 1040EZ for 1993, so the IRS sent her the Form 1040EZ tax package. Because she meets all the requirements for using Form 1040EZ (see *Which Form Should I Use?* in Chapter 1), she decides to use it again for 1994. Also, Pat may qualify for the earned income credit and, if so, can claim it on Form 1040EZ.

To make processing her return quicker and to speed her refund, Pat prints (does not type) her numbers and keeps them inside the boxes on her Form 1040EZ. She does not use dollar signs.

Use the IRS Label (Name, Address, and Social Security Number)

Pat uses the mailing label that came with her forms package. The label has her name, address, and social security number. She does not put the label on her tax return until the return is completed and she is sure the return and label are accurate.

Pat could use the label even if some of the information on it was incorrect. She would make the necessary changes directly on the label and then place it on her completed return.

Presidential Election Campaign Fund. Pat wants $3 of her taxes to go to this fund, so she checks the ''Yes'' box. Checking ''Yes'' will not change her tax or reduce her refund.

Income

Pat has two items of income which must be combined and entered on line 1 of Form 1040EZ. The part of her scholarship that is for room and board ($1,000) is taxable. She adds this amount to her wages ($5,500), which are shown in box 1 of her Forms W–2. Pat enters the total ($6,500) on line 1. On line 2, she enters her interest income of $270. Pat has no tax-exempt interest, so she does not have to write ''TEI'' and show any amount in the space to the right of the words ''Form 1040EZ.'' She adds her wages, taxable scholarship, and interest together to figure her adjusted gross income of $6,770. She enters $6,770 on line 3.

Standard deduction and personal exemption. Because Pat cannot be claimed as a dependent by her parents or anyone else, her standard deduction is $3,800 and her personal exemption is $2,450. She checks the ''No'' box and enters $6,250 ($3,800 + $2,450) on line 4.

If Pat could have been claimed as a dependent by her parents or anyone else (even if they chose not to claim her as a dependent), she would check the ''Yes'' box on line 4. She would use the worksheet on the back of Form 1040EZ to figure her standard deduction.

Note. Because Pat checked the ''No'' box on line 4, and because neither her parents nor anyone else can claim her as a dependent on their own tax return, she can claim an exemption for herself. If she had checked the ''Yes'' box on line 4, she could not claim an exemption for herself.

Pat subtracts line 4 ($6,250) from line 3 ($6,770) and enters the result of $520 on line 5. This amount is Pat's taxable income which is used to figure her income tax.

Payments and Tax (Figure Your Tax and Credit)

Pat had $150 of federal income tax withheld from her wages by her employer. She found this amount in box 2 of her 1994 Forms W–2. She enters this amount on line 6 of Form 1040EZ.

Pat reads the instructions for line 7 to see if she can take the earned income credit, and finds that she can. Because she does not have any nontaxable earned income to enter in the spaces marked **Type** and **$** on line 7, she leaves those spaces blank.

Note. If Pat wanted the IRS to compute her tax and credit for her, she would stop at this point. She would make sure lines 1 through 6 were accurately completed. Then she would print ''EIC'' in the space to the right of the words ''earned income below,'' skip lines 8 through 11, sign and date the return, and enter her occupation. Finally, she would attach the first copy or Copy B of her W–2 forms to her return and mail it by April 17, 1995.

Pat decides to figure the tax and credit herself. After completing line 6 and leaving the **Type** and **$** spaces blank on line 7, she figures the amount of her credit by completing the *Earned Income Credit Worksheet* that is in the Form 1040EZ instructions under *Line 7 Earned income credit (EIC).* A copy of her completed worksheet is shown at the end of this chapter. The amount of her credit is $170. She enters $170 on line 7, Form 1040EZ. Next, she adds line 6 (federal tax withheld) to line 7 (earned income credit) and enters the total ($320) on line 8.

To complete line 9, she takes the amount on line 5, her taxable income of $520, and goes to the Tax Table. She reads down the income column of the Tax Table until she finds the line that includes her taxable income shown on line 5 of her Form 1040EZ.

She reads across the line to find the Single column. The amount shown at the point where the income line and the filing status column meet is her tax ($77).

She enters this amount on line 9 of her Form 1040EZ.

Refund or Amount You Owe

Pat compares line 8 and line 9. Because line 8 is larger, she subtracts line 9 ($77) from line 8 ($320) to arrive at her refund of $243. She enters this amount on line 10. Pat will receive a tax refund of $243.

If Pat did not qualify for the earned income credit and her employer had not withheld any federal income tax from her wages, Pat would have owed $77 in income tax. She would have been instructed to enter that amount on line 11. She would then include a check or money order for the full amount of $77, payable to ''Internal Revenue Service.'' She would write on the front of her check or money order:

Her name,

Her address,

Her social security number,

Her daytime telephone number, and

''1994 Form 1040EZ.''

Sign Your Return

Pat goes back over her return to make sure that she entered the numbers clearly and correctly and that the math is accurate.

Pat signs and dates her return and enters her occupation in the spaces provided at the bottom of the form. Now that she has filled in her Form 1040EZ, she takes her pre-printed mailing label from the front of her forms package and, after checking it for accuracy (and making any corrections), places it in the address portion at the top of her return. She attaches Copy B of her Forms W–2 to the location indicated on the front of Form 1040EZ.

She makes a copy of her filled-in tax return for her records. Then she mails her return to the Service Center in the envelope that came with her forms package.

A filled-in copy of Pat's Earned Income Credit Worksheet and tax return follows.

Filled-in Form 1040EZ
If you need more information, turn to the page shown in the circle.

Department of the Treasury—Internal Revenue Service

Form **1040EZ** **Income Tax Return for Single and Joint Filers With No Dependents** **1994** (15)

OMB No. 1545-0675

Use the IRS label (See page 12.) Otherwise, please print.

(14)

Print your name (first, initial, last)

CAR-RT SORT**CRO1
PB 571-00-4684 S29 21
PAT A BROWN
3408 UNION ST
HOMETOWN MD 21214

IRS

City, town or post office, state and ZIP code. If you have a foreign address, see page 12.

Your social security number

Spouse's social security number

See instructions on back and in Form 1040EZ booklet.

Presidential Election Campaign (See page 12.)

Note: *Checking "Yes" will not change your tax or reduce your refund.*

	Yes	No
Do you want $3 to go to this fund? ▶	☑	☐
If a joint return, does your spouse want $3 to go to this fund? ▶	☐	☐

Income

Attach Copy B of Form(s) W-2 here. Enclose, but do not attach, any payment with your return.

Note: *You **must** check Yes or No.*

	Dollars	Cents
1 Total wages, salaries, and tips. This should be shown in box 1 of your W-2 form(s). Attach your W-2 form(s). (56) (64) 1	6,500	00
2 Taxable interest income of $400 or less. If the total is over $400, you cannot use Form 1040EZ. (67) 2	270	00
3 Add lines 1 and 2. This is your **adjusted gross income.** If less than $9,000, see page 15 to find out if you can claim the earned income credit on line 7. 3	6,770	00
4 Can your parents (or someone else) claim you on their return? (28) (23) (166) ☐ **Yes.** Do worksheet on back; enter amount from line G here. ☑ **No.** If **single,** enter 6,250.00. If **married,** enter 11,250.00. For an explanation of these amounts, see back of form. 4	6,250	00
(236) **5** Subtract line 4 from line 3. If line 4 is larger than line 3, enter 0. This is your **taxable income.** ▶ 5	520	00

Payments and tax

6 Enter your Federal income tax withheld from box 2 of your W-2 form(s). 6	150	00
(265) **7** **Earned income credit** (see page 15). Enter type and amount of nontaxable earned income below. 7	170	00
(236) **8** Add lines 6 and 7 (don't include nontaxable earned income). These are your **total payments.** 8	320	00
9 **Tax.** Use the amount on **line 5** to find your tax in the tax table on pages 28–32 of the booklet. Then, enter the tax from the table on this line. 9	77	00

Refund or amount you owe

10 If line 8 is larger than line 9, subtract line 9 from line 8. This is your **refund.** 10	243	00
11 If line 9 is larger than line 8, subtract line 8 from line 9. This is the **amount you owe.** See page 20 for details on how to pay and what to write on your payment. 11		

Sign your return (16)

Keep a copy of this form for your records.

I have read this return. Under penalties of perjury, I declare that to the best of my knowledge and belief, the return is true, correct, and accurately lists all amounts and sources of income I received during the tax year.

Your signature		Spouse's signature if joint return	
Pat Brown			
Date 2/14/95	Your occupation Student	Date	Spouse's occupation

For IRS Use Only — Please do not write in boxes below.

For Privacy Act and Paperwork Reduction Act Notice, see page 4. Cat. No. 11329W Form 1040EZ (1994)

Filled-in Form 1040EZ — EIC Worksheet

If you need more information, turn to the page shown in the circle.

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Earned income credit worksheet—Line 7 (keep for your records)

1. Enter the amount from Form 1040EZ, line 1. — 1. 6,500
2. If you received a taxable scholarship or fellowship grant that wasn't reported on a W-2 form, enter that amount here. — 2. _____
3. Subtract line 2 from line 1. 269 — 3. 6,500
4. Enter any **nontaxable earned income** (see page 18). Types of nontaxable earned income include contributions to a 401(k) plan, which should be shown in box 13 of your W-2 form, and military housing and subsistence. — 4. _____
5. Add lines 3 and 4. — 5. 6,500

   Caution: *If line 5 is $9,000 or more, you **cannot take** the credit. Print "NO" next to line 7 of Form 1040EZ.*
6. Look up the amount on **line 5** above in the **EIC Table** on page 19 to find your credit. Enter the credit here. 280 — 6. 189
7. Enter the amount from Form 1040EZ, line 3. — 7. 6,770
8. **Is line 7 $5,000 or more?**

   ☑ **YES.** Look up the amount on **line 7** above in the **EIC Table** on page 19 to find your credit. Enter the credit here. — 8. 170

   ☐ **NO.** Go to line 9.
9. **Earned income credit.**
   - If you checked "YES" on line 8, enter the **smaller** of line 6 or line 8.
   - If you checked "NO" on line 8, enter the amount from line 6. — 9. 170

Next: Take the amount from line 9 above and enter it on Form 1040EZ, line 7.

AND

If you had any nontaxable earned income (see line 4 above), enter the type and amount of that income in the spaces marked "Type" and "$" on line 7.

38.

Form 1040A

Don and Jean Smith are a married couple with two young children. Don worked full time as a carpenter during 1994. Jean worked full time as a secretary until September when she was laid off. She received a distribution from her company's profit-sharing plan and also received unemployment compensation. Their 10-month-old son, Todd, went to a day-care center while both were working. Their 7-year-old daughter, Lynn, stayed with a neighbor before and after school.

The Smiths filed Form 1040A for 1993 so the IRS sent them the Form 1040A tax package this year. Since they meet all the requirements for using Form 1040A (see *Which Form Should I Use?* in Chapter 1), they decide to use it again for 1994.

Their filled-in Form 1040A is shown at the end of this chapter.

Name, Address, and Social Security Number

Don and Jean use the label that came with their forms package. The label has their names, address, and social security numbers. They check the label to make sure it is correct, but they do not put it on the return until they have completed and checked the return to make sure it is accurate. Because they use the label, their tax return can be processed faster.

The Smiths should use the label even if some of the information on it is incorrect. They would make any necessary changes directly on the label.

Presidential Election Campaign Fund. Don and Jean each want $3 of their tax to go to this fund. They check both *Yes* boxes. Checking *Yes* does not increase their tax or reduce their refund.

Filing Status

Don and Jean must choose their filing status before they figure their tax liability.

Filing status (lines 1–5). Don and Jean check the box on line 2 to file a joint return. Because they are married and living together, they must file a joint return in order to claim the child care credit.

Exemptions

Don and Jean must indicate the number of exemptions they can claim.

Exemptions (lines 6a–e). Don and Jean can take two personal exemptions, one for each of them. They check these exemptions in the boxes on lines 6a and 6b and enter the total, ''2,'' on the line at the right. On line 6c, column 1, they write their children's names and enter ''2'' on the line ''lived with you'' at the right.

They have to enter the social security number for any dependent who is at least 1 year old. They write Lynn's social security number in column 3. Because Todd was not yet 1 at the end of 1994, they put a checkmark in column 2 by his name. They write their children's relationship to them (daughter and son) in column 4. They enter ''12'' in column 5 for each child since their daughter lived with them all year and their son was born during the year. They do not have any other dependents, so in the box on line 6e they enter ''4'' as the total number of exemptions.

Total Income

Don and Jean report their income on **lines 7–13b** and total it on **line 14.**

Wages (line 7). Don's Form W–2, *Wage and Tax Statement,* shows he earned $22,250 in 1994. Jean's Form W–2 shows she earned $12,155. They find these amounts in box 1 of their Forms W–2. They add the amounts and put the total, $34,405, on line 7.

Interest income (lines 8a–b and Part I of Schedule 1). Don and Jean received a statement (Form 1099–INT) from their bank showing they earned $410 of taxable interest income last year. Because their interest income is over $400, they must list the name of the bank and the amount received in Part I of Schedule 1. They also enter this amount on line 8a of Form 1040A. They also received $35 of tax-exempt interest from a municipal bond. They enter $35 on line 8b. This amount does not increase their taxable income.

Dividends (line 9). Don and Jean opened an account in a mutual fund last year. They received a statement (Form 1099–DIV) from the fund showing they earned dividends of $20. They also received a Form 1099–DIV from the XYZ Corporation showing they earned dividends of $80 last year. Because the total amount of their dividends is not over $400, they do not have to list them in Part II of Schedule 1. They enter the total amount of their dividends, $100, on line 9 of Form 1040A.

Pensions (lines 11a–b). Jean received Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* from her employer's profit-sharing plan showing a distribution of $2,250 in box 1. Box 2a shows -0- and box 7 shows Code **G.**

Before the distribution was made, Jean received an explanation from the plan administrator that advised her that the distribution would be tax free with no withholding if she elected a direct rollover into an IRA. Jean, age 40, made the election, and the plan administrator directly transferred the entire amount of the distribution into her IRA account. This transfer qualifies as a tax-free rollover under the rules described in Chapter 11.

Jean reports $2,250 on line 11a and $0 on line 11b. Because she rolled over the entire distribution into her IRA, Jean does not have to file Form 5329 or pay the 10% tax on early distributions.

Unemployment compensation (line 12). Jean received Form 1099–G, *Certain Government Payments,* from her state, showing $1,010 in unemployment compensation. She enters this amount on line 12.

Nontaxable income. Don and Jean also received a Form 1099–G showing a $100 1993 state tax refund they received in 1994. Because they did not itemize deductions on their 1993 federal return, they do not report the refund as income in 1994. If they had itemized, part or all of the refund may have had to be included in income.

Total (line 14). Their total income is the sum of the amounts shown on lines 7, 8a, 9, and 12. Don and Jean add these amounts and enter the total, $35,925, on line 14.

Adjusted Gross Income

Don and Jean figure their **adjusted gross income** on **lines 15 and 16.**

IRA deduction (lines 15a–c). In 1994, Don contributed $750 to his IRA and Jean contributed $650 to hers. Jean also contributed an additional $100 to her IRA in January 1995 and asked that it be counted for 1994. They complete lines 1–3 of *IRA worksheet 1* (as shown later) in their forms instruction package to figure how much of their contributions they can deduct. The entire amount of their contributions to both IRAs is deductible. They enter $750 for Don on line 15a and $750 for Jean on line 15b. The sum of their IRA contributions to both IRAs, $1,500, is entered on line 15c.

Adjusted gross income (line 16). Don and Jean subtract their total IRA deduction on line 15c from their total income on line 14. They enter the result, $34,425, on line 16 and on line 17. This amount is their adjusted gross income. Since it is $34,425, they do not qualify for the earned income credit.

IRA worksheet 1—Lines 15a and 15b (keep for your records)

		(a) Your IRA	(b) Your working spouse's IRA
1. Enter IRA contributions you made, or will make by April 17, 1995, for 1994. But **do not** enter more than $2,000 in either column.	1.	750	750
2. Enter wages, salaries, and tips for each person from Form 1040A, line 7.	2.	22,250	12,155
3. Enter the **smaller** of line 1 or line 2. Enter on Form 1040A, line 15a, the amount from line 3, column (a). Enter on Form 1040A, line 15b, the amount, if any, from line 3, column (b). If filing a joint return and contributions were made to your nonworking spouse's IRA, go to line 4.	3.	750	750

Taxable Income

Don and Jean figure their **taxable income** on **lines 17–22.**

Standard deduction (lines 18a–c and 19). Lines 18a–c do not apply to either Don or Jean. They enter their standard deduction amount of $6,350 (see Chapter 21) on line 19. They subtract their standard deduction on line 19 from their adjusted gross income on line 17 and enter the result, $28,075, on line 20.

Exemptions (line 21). Then, Don and Jean deduct $2,450 for each exemption shown on line 6e. They multiply $2,450 by 4 (the number of exemptions shown on line 6e) and enter the result, $9,800, on line 21. They subtract the amount on line 21 ($9,800) from the amount on line 20 ($28,075) and put the difference, $18,275, on line 22. This amount is their taxable income.

Tax, Credits, and Payments

Next, Don and Jean figure their tax liability.

Tax (line 23). Don and Jean use the Tax Table in the 1040A instructions to find their tax. The Smiths' taxable income from line 22 is $18,275. Don and Jean first look for the large print "**18,000**" in the table. Under this, they look down to the line for taxable income of at least 18,250 but less than 18,300. Their taxable income is between these two amounts. They then find their tax, $2,741, in the column for married filing jointly. They put this amount on line 23 and check the box for "Tax Table."

Credit for child and dependent care expenses (line 24a and Schedule 2). Don and Jean paid $3,325 of qualified expenses for the time both of them worked in 1994. Their son, Todd, went full time to a day-care center. The cost for his care was $2,325. Their daughter, Lynn, was cared for by a neighbor before and after school. The neighbor also cared for the children when school and the day-care center were not in session. They paid the neighbor $1,000. Their employers did not provide any dependent care benefits.

Don and Jean prepare Parts I and II of Schedule 2. They enter the names, addresses, and taxpayer identification numbers (employer identification number and social security number) of the day-care center and the neighbor who provided the care on line 1, columns a, b, and c.

The Smiths enter the amounts they paid to the child-care providers on line 1, column d, and enter the total of these amounts, $3,325, on line 2. Because they had qualified expenses for two children, they enter "2" in the box for line 3. On line 4, they enter the amount of qualified expenses, $3,325, they paid when both parents were working. On line 5, Don enters his earned income; on line 6, Jean enters her earned income. Because their child-care expenses were less than Jean's earned income and less than Don's earned income, all the expenses can be used to figure the credit. So they enter $3,325 on line 7. They enter their adjusted gross income from Form 1040A, line 17 ($34,425) on line 8. Then they check the table for line 9 to see what percentage of their child-care expenses they can take as a credit.

Since the Smiths' adjusted gross income on line 17 of Form 1040A is $34,425, they can take 20% of $3,325, or $665, as their credit. They put .20 on line 9 and $665 on line 10. They have no tax-exempt interest from private activity bonds, so their credit is not limited and they do not complete the credit limit worksheet. They enter $665 on line 24a of Form 1040A. Because their credit is less than their tax, they can use all of it to reduce their income tax liability.

Total tax (line 27). Don and Jean leave line 24b blank because they do not claim a credit for the elderly or the disabled. They subtract their total credits on line 24c ($665) from the tax on line 23 ($2,741) and enter the difference, $2,076, on lines 25 and 27. The amount on line 27 is their total tax liability.

The Smiths do not complete the alternative minimum tax worksheet because:

1) Their adjusted gross income plus their tax-exempt interest income is not more than $45,000, and
2) They do not claim more than four exemptions.

Total payments (lines 28a–d). Don and Jean then check box 2 of their Forms W–2 and box 4 of Form 1099–R for the amount of federal income tax withheld from their income. Don's Form W–2 shows $1,612 tax withheld and Jean's Form W–2 shows $666 tax withheld. Jean's Form 1099–R shows no withholding since she elected a direct rollover into her IRA. Tax was not withheld from Jean's unemployment compensation. The Smiths did not make any estimated tax payments for 1994. They are not entitled to the earned income credit on line 28c. Their total payments are $2,278. They enter this amount on lines 28a and 28d.

Refund or Amount You Owe

The tax withheld from the Smiths' wages is more than their total tax. They subtract their tax on line 27, $2,076, from their total payments shown on line 28d, $2,278, and enter the difference, $202, on lines 29 and 30. This is the amount that will be refunded to them.

If Don and Jean had not had at least $2,076 withheld for federal income tax, they would have owed tax. They would have entered the difference between their tax (line 27) and their payments (line 28d) on line 32. They would then enclose a check or money order for the full amount owed (line 32), payable to "Internal Revenue Service." They would also make sure the following information is on the check:

Their names,

Their address,

Don's social security number (since his name and social security number are listed on the return first),

A daytime telephone number, and

"1994 Form 1040A."

Sign Your Return

Don and Jean sign and date their return and list their occupations. Then they check their return to make sure it is accurate and complete. They remove the mailing label from the forms package and put it in the address portion on the top of the form. Then they attach Copy B of their Forms W–2 to the location indicated on the front of their return.

They use the envelope that came with their forms package to mail their return to the service center. Don and Jean save a copy of the return for their records.

Filled-in Form 1040A
If you need more information, turn to the page shown in the circle.

Form **1040A** — Department of the Treasury—Internal Revenue Service — **U.S. Individual Income Tax Return** (1) **1994** — IRS Use Only—Do not write or staple in this space.

OMB No. 1545-0085

Label (See page 16.)

Use the IRS label. Otherwise, please print or type. (14)

LABEL HERE

Your first name and initial: BN 329-00-1000 — Last name: DON J. & JEAN P. SMITH

CART-RT SORT*SCR01 410-00-1111 S29 30

90 BEAVER CT.

HOMETOWN MI 48001

Apt. no.

(15) Your social security number

Spouse's social security number

For Privacy Act and Paperwork Reduction Act Notice, see page 4.

Presidential Election Campaign Fund (See page 17.)

	Yes	No
Do you want $3 to go to this fund?	✓	
If a joint return, does your spouse want $3 to go to this fund?	✓	

Note: *Checking "Yes" will not change your tax or reduce your refund.*

Check the box for your filing status (23) (See page 17.) Check only one box.

1 ☐ Single
2 ☑ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. Enter spouse's social security number above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 18.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶ 19). (See page 19.)

Figure your exemptions (28) (See page 20.)

6a ☑ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a. But be sure to check the box on line 18b on page 2.
b ☑ **Spouse**

No. of boxes checked on 6a and 6b: 2

c **Dependents:**

(1) Name (first, initial, and last name)	(2) Check if under age 1	(3) If age 1 or older, dependent's social security number	(4) Dependent's relationship to you	(5) No. of months lived in your home in 1994
Lynn R. Smith		410 00 7070	daughter	12
Todd B. Smith	✓		son	12

If more than seven dependents, see page 23.

No. of your children on 6c who:
• lived with you: 2
• didn't live with you due to divorce or separation (see page 23):

Dependents on 6c not entered above:

(84) d If your child didn't live with you but is claimed as your dependent under a pre-1985 agreement, check here ▶ ☐

Add numbers entered on lines above: 4

(56) e Total number of exemptions claimed.

Figure your total income

(67) 7 Wages, salaries, tips, etc. This should be shown in box 1 of your W-2 form(s). Attach Form(s) W-2. — 7: 34,405

(76) 8a **Taxable** interest income (see page 25). If over $400, attach Schedule 1. — 8a: 410

(79) b **Tax-exempt** interest. DO NOT include on line 8a. — 8b: 35

9 Dividends. If over $400, attach Schedule 1. — 9: 100

Attach Copy B of your Forms W-2 and 1099-R here. (152) 10a Total IRA distributions. — 10a: ; 10b Taxable amount (see page 26). — 10b:

If you didn't get a W-2, see page 25. (96) 11a Total pensions and annuities. — 11a: 2,250 ; 11b Taxable amount (see page 27). — 11b: -0-

Enclose, but do not attach, any payment with your return. (57) 12 Unemployment compensation (see page 30). — 12: 1,010

(103) 13a Social security benefits. — 13a: ; 13b Taxable amount (see page 31). — 13b:

14 Add lines 7 through 13b (far right column). This is your **total income.** ▶ 14: 35,925

Figure your adjusted gross income

(145) 15a Your IRA deduction (see page 34). — 15a: 750

b Spouse's IRA deduction (see page 34). — 15b: 750

c Add lines 15a and 15b. These are your **total adjustments.** — 15c: 1,500

16 Subtract line 15c from line 14. This is your **adjusted gross income.** If less than $25,296 and a child lived with you (less than $9,000 if a child didn't live with you), see "Earned income credit" on page 44. ▶ 16: 34,425

Cat. No. 11327A — **1994 Form 1040A page 1**

Filled-in Form 1040A
If you need more information, turn to the page shown in the circle.

Figure your standard deduction, exemption amount, and taxable income

	17	Enter the amount from line 16.	17 34,425
	18a	Check if: ☐ You were 65 or older ☐ Blind ☐ Spouse was 65 or older ☐ Blind — Enter number of boxes checked ▶ 18a	
166	b	If your parent (or someone else) can claim you as a dependent, check here ▶ 18b ☐	
168	c	If you are married filing separately and your spouse files Form 1040 and itemizes deductions, see page 38 and check here. ▶ 18c ☐	
	19	Enter the **standard deduction** shown below for your filing status. **But if you checked any box on line 18a or b,** go to page 38 to find your standard deduction. **If you checked box 18c,** enter -0-. • Single—$3,800 • Married filing jointly or Qualifying widow(er)—$6,350 • Head of household—$5,600 • Married filing separately—$3,175	19 6,350
	20	Subtract line 19 from line 17. If line 19 is more than line 17, enter -0-.	20 28,075
	21	Multiply $2,450 by the total number of exemptions claimed on line 6e.	21 9,800
237	22	Subtract line 21 from line 20. If line 21 is more than line 20, enter -0-. This is your **taxable income.** ▶	22 18,275

Figure your tax, credits, and payments

If you want the IRS to figure your tax, see the instructions for line 22 on page 39.

248	23	Find the tax on the amount on line 22. Check if from: ☑ Tax Table (pages 62–67) or ☐ Form 8615 (see page 40). 243		23 2,741
258	24a	Credit for child and dependent care expenses. Attach Schedule 2.	24a 665	
	b	Credit for the elderly or the disabled. Attach Schedule 3.	24b	
278	c	Add lines 24a and 24b. These are your **total credits.**		24c 665
	25	Subtract line 24c from line 23. If line 24c is more than line 23, enter -0-.		25 2,076
	26	Advance earned income credit payments from Form W-2.		26
	27	Add lines 25 and 26. This is your **total tax.**		▶ 27 2,076
52	28a	Total Federal income tax withheld. If any tax is from Form(s) 1099, check here. ▶ ☐	28a 2,278	
	b	1994 estimated tax payments and amount applied from 1993 return.	28b	
265	c	**Earned income credit.** If required, attach Schedule EIC (see page 44).	28c	
		Nontaxable earned income: amount ▶ and type ▶		
	d	Add lines 28a, 28b, and 28c (don't include nontaxable earned income). These are your **total payments.**		▶ 28d 2,278

Figure your refund or amount you owe

16	29	If line 28d is more than line 27, subtract line 27 from line 28d. This is the amount you **overpaid.**	29 202
	30	Amount of line 29 you want **refunded to you.**	30 202
51	31	Amount of line 29 you want **applied to your 1995 estimated tax.** 31	
16	32	If line 27 is more than line 28d, subtract line 28d from line 27. This is the **amount you owe.** For details on how to pay, including what to write on your payment, see page 52.	32
53	33	Estimated tax penalty (see page 52). Also, include on line 32. 33	

Sign your return

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.

Keep a copy of this return for your records.

Your signature: Don S. Smith	Date: 4-8-95	Your occupation: Carpenter
Spouse's signature. If joint return, BOTH must sign.: Jean S. Smith	Date: 4-8-95	Spouse's occupation: Secretary

Paid preparer's use only

Preparer's signature 16	Date	Check if self-employed ☐ / Preparer's social security no.
Firm's name (or yours if self-employed) and address		E.I. No. / ZIP code

Printed on recycled paper

Filled-in Schedule 1
If you need more information, turn to the page shown in the circle.

Schedule 1 (Form 1040A)

Department of the Treasury—Internal Revenue Service

Interest and Dividend Income for Form 1040A Filers (T) **1994**

OMB No. 1545-0085

Name(s) shown on Form 1040A: Don J. and Jean P. Smith

Your social security number: 329:00: 1000

Part I

Interest income

(See pages 25 and 68.) 67

Note: *If you received a Form 1099–INT, Form 1099–OID, or substitute statement from a brokerage firm, enter the firm's name and the total interest shown on that form.*

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page 68 and list this interest first. Also, show that buyer's social security number and address.		
	Hometown Savings Bank	1	410
2	Add the amounts on line 1.	2	410
3	Excludable interest on series EE U.S. savings bonds issued after 1989 from Form 8815, line 14. You MUST attach Form 8815 to Form 1040A.	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040A, line 8a.	4	410

Part II

Dividend income

(See pages 26 and 69.) 79

Note: *If you received a Form 1099–DIV or substitute statement from a brokerage firm, enter the firm's name and the total dividends shown on that form.*

			Amount
5	List name of payer	5	
6	Add the amounts on line 5. Enter the total here and on Form 1040A, line 9.	6	

For Paperwork Reduction Act Notice, see Form 1040A instructions. Cat. No. 12075R **1994 Schedule 1 (Form 1040A) page 1**

Filled-In Schedule 2
If you need more information, turn to the page shown in the circle.

Schedule 2 (Form 1040A)

Department of the Treasury—Internal Revenue Service (248)

Child and Dependent Care Expenses for Form 1040A Filers (!) **1994**

OMB No. 1545-0085

Name(s) shown on Form 1040A: Don J. and Jean P. Smith

Your social security number: 329:00:1000

You need to understand the following terms to complete this schedule: **Qualifying person(s), Dependent care benefits, Qualified expenses,** and **Earned income.** See **important terms** on page 70.

Part I

Persons or organizations who provided the care

You MUST complete this part.

1 (a) Care provider's name	(b) Address (number, street, apt. no., city, state, and ZIP code)	(c) Identifying number (SSN or EIN)	(d) Amount paid (see page 72)
Anytime Childcare Center	612 Castle Street Hometown, MI 48001	10-0077000	2,325
Marie Thomas	38 Minton Lane Hometown, MI 48001	326-00-4000	1,000

(If you need more space, use the bottom of page 2.)

2 Add the amounts in column (d) of line 1. 2 3,325

3 Enter the number of **qualifying persons** cared for in 1994 . . . . ▶ 2

Did you receive **dependent care benefits?**
- NO ▶ Complete only Part II below.
- YES ▶ Complete Part III on the back now.

Part II

Credit for child and dependent care expenses

4 Enter the amount of **qualified expenses** you incurred and paid in 1994. DO NOT enter more than $2,400 for one qualifying person or $4,800 for two or more persons. If you completed Part III, enter the amount from line 25. 4 3,325

5 Enter YOUR **earned income.** 5 22,250

6 If married filing a joint return, enter YOUR SPOUSE'S earned income (if student or disabled, see page 73); **all others,** enter the amount from line 5. 6 12,155

7 Enter the **smallest** of line 4, 5, or 6. 7 3,325

8 Enter the amount from Form 1040A, line 17. 8 34,425

9 Enter on line 9 the decimal amount shown below that applies to the amount on line 8.

If line 8 is— Over	But not over	Decimal amount is	If line 8 is— Over	But not over	Decimal amount is
$0	10,000	.30	$20,000	22,000	.24
10,000	12,000	.29	22,000	24,000	.23
12,000	14,000	.28	24,000	26,000	.22
14,000	16,000	.27	26,000	28,000	.21
16,000	18,000	.26	28,000	No limit	.20
18,000	20,000	.25			

9 × .20

10 Multiply **line 7** by the decimal amount on line 9. Enter the result. Then, see page 73 for the amount of credit to enter on Form 1040A, line 24a. 10 = 665

Caution: *If you paid $50 or more in a calendar quarter to a person who worked in your home, you must file an employment tax return. Get* ***Form 942*** *for details.*

For Paperwork Reduction Act Notice, see Form 1040A Instructions. Cat. No. 10749I **1994 Schedule 2 (Form 1040A) page 1**

39.

Form 1040

Frank and Evelyn Jones are a married couple with two children. The sample tax return at the end of this chapter is based on their situation. It shows the proper reporting of items on the tax forms.

Frank works full time as an electrician. He is also a partner in the Jones Brothers Partnership. Evelyn, a retired state government employee, is a partner in the Gateway Travel Agency. Frank and Evelyn own some stocks and bonds, and Frank owns rental property.

In May 1994, Frank and Evelyn sold their home and moved to a new home in a nearby city. Soon after their move, they called the IRS and asked for Form 8822, *Change of Address.* They completed the form and mailed it to the Internal Revenue Service Center where they filed their last return.

Because the IRS received Frank and Evelyn's Form 8822 before the address labels for the 1994 tax forms packages were prepared, their new address appears on the address label that came on their Form 1040 package for 1994. They do not put the label on their return until they have completed and checked the return to make sure it is accurate.

The forms they received in their Form 1040 package were based on the return and schedules they filed for 1993. They used the order blank in their Form 1040 package to order any other forms they needed.

Presidential Election Campaign Fund. Frank and Evelyn each want $3 of their tax to go to the Presidential Election Campaign Fund. They check both *Yes* boxes. Checking "Yes" will not increase their tax or reduce their refund.

Filing Status and Exemptions

Frank and Evelyn show their filing status and personal exemptions on lines 1–6e.

Filing status (lines 1–5). Because Frank and Evelyn decide to file a joint return, they check the filing status box on line 2, *Married filing joint return.*

Exemptions (lines 6a–6e). Frank and Evelyn show the exemption for Frank on line 6a and the exemption for Evelyn on line 6b. They enter "2" on the line to the right of lines 6a and b.

Their daughter, Marie, who is 18, earned $2,500 last year. Frank and Evelyn provided more than half her support. The gross income test does not apply because she is under 19 and the other dependency tests were met. They claim Marie as a dependent on line 6c. (See *Exemptions for Dependents* in Chapter 3.)

Their son, James, who is 22, goes to a local college full time. During the summer, James earned $2,600, which he spent for his support. The gross income test does not apply because he is a full-time student under age 24. Frank and Evelyn provided more than $2,600 toward their son's support and the other dependency tests were met. On line 6c of the return, they claim James as a dependent. Frank and Evelyn write the information asked about Marie and James on line 6c, columns (1), (3), (4), and (5). They do not check column (2) because neither Marie nor James is under age 1. They enter "2" on the first line to the right of line 6c because both Marie and James lived at home.

Grace Smith, Evelyn's mother, lives with Frank and Evelyn and their two children. Grace got a pension of $2,100 and social security of $2,900 during the year. She spent this money for clothing and other personal things. Only $1,500 of her pension is gross income for her and taxable. The rest of the pension is not taxable because it is a return of her cost.

Frank and Evelyn must figure Grace's total support to know if they can claim her exemption. Because five persons live in the household, Grace's total support includes one-fifth of the family's food costs and one-fifth of the rental value of the house. Frank and Evelyn paid a total of $8,000 for food for the family. The fair rental value of their house was $13,000 for the year. They also bought Grace a $200 television set for her bedroom, paid $700 for a trip she took, and paid her unreimbursed medical and drug expenses of $300. Grace's total support is:

Expenses paid by Grace		$ 5,000
Expenses paid by Frank and Evelyn:		
TV set	$ 200	
Trip	700	
Medical	300	
Food—Grace's share (⅕ of $8,000)	1,600	
Lodging—Grace's share (⅕ of $13,000)	2,600	
Total		$ 5,400
Total support		$10,400

The support Frank and Evelyn provided is more than half of Grace's total support, so they meet the support test to claim her as a dependent. Since Grace had less than $2,450 gross income, Frank and Evelyn also meet the gross income test to claim her as a dependent. The other dependency tests are also met, so Frank and Evelyn can claim Grace as a dependent. They write the information asked about Grace on line 6c of their return.

Frank Jones and his two brothers provided $3,500 for the total support of their sister, Clara Jones. Frank provided 35%, one brother provided 35%, and the other brother provided the remaining 30%. Any one of them may claim the exemption for Clara if a written statement from each of the others is attached to the income tax return of the brother claiming the exemption. The brothers agree to let Frank claim Clara as his dependent this year. They each give Frank a signed Form 2120, *Multiple Support Declaration,* for Frank to attach to his return. (Forms 2120 are not shown here.) Frank and Evelyn write the information asked about Clara on line 6c. They enter "2" on the third line to the right of line 6c for Grace and Clara.

They then enter "6" in the box to the right of line 6e to show the total exemptions they claim.

Income

Frank and Evelyn report the kinds of income they received for the year on lines 7–21.

Wages (line 7). Frank's Form W–2, *Wage and Tax Statement,* shows he earned $22,940. (Form W–2 is not shown here.) Frank and Evelyn enter $22,940 on line 7.

Interest income (lines 8a and 8b and Part I of Schedule B). Frank and Evelyn have a statement savings account, a certificate of deposit (CD) in which Frank's brother, Chuck Jones, also has a one-third investment, and a tax-exempt municipal bond. The Forms 1099–INT that they received show that they had interest income of $330 on their statement savings account with National Bank and $150 on their CD with First Savings and Loan. They must report their interest income on Schedule B because they received part of the interest as nominees for Chuck. (Even if they did not receive interest as nominees, they would still have to report their interest on Schedule B because it is more than $400.) In addition, they received $500 interest from a municipal bond. They did not receive a Form 1099–INT for this tax-exempt interest and do not report it on Schedule B.

On line 1, Part 1 of Schedule B, they enter the names of the financial institutions and the interest received from each, including the interest they received as nominees for Chuck. They show Chuck's share of the interest, $50 ($150 × one-third), separately below a $480 subtotal of all interest income listed. They identify the $50 as "Nominee Distribution" and subtract it from the $480 subtotal. They report the remainder, $430, on line 2. They file a Form 1099–INT and Form 1096, *Annual Summary and Transmittal of U.S. Information Returns,* with their Internal Revenue Service Center showing the $50 distribution to Chuck. They give Chuck Copy B of the Form 1099–INT. (Form 1099–INT and Form 1096 are not shown here.)

They did not have excludable savings bond interest (explained in *Education Savings Bond Program* in Chapter 8), so they leave line 3 blank and enter $430 on line 4, Schedule B, and on line 8a, Form 1040. They show the $500 tax-exempt interest on line 8b, Form 1040. The tax-exempt interest will not be included in their total income on line 22.

Dividends (line 9 and Part II of Schedule B). During 1994, Frank and Evelyn received or had credited to their accounts the following dividends and other corporate distributions:

Forms 1099–DIV

Acme Publishing Company	
Gross dividends, etc. (Box 1a)	$210
Ordinary dividends (Box 1b)	210
Zepco, Inc.	
Gross dividends, etc. (Box 1a)	$310
Ordinary dividends (Box 1b)	300
Nontaxable distributions (Box 1d)	10
Equity Mutual Fund	
Gross dividends, etc. (Box 1a)	$ 50
Ordinary dividends (Box 1b)	50
Tiger Mutual Fund	
Gross dividends, etc. (Box 1a)	$ 60
Capital gain distributions (Box 1c)	60
Equity Brokers	
Gross dividends, etc. (Box 1a)	$ 40
Ordinary dividends (Box 1b)	40

Schedule K–1 (Form 1065)

Frank's share of dividends on stock owned by his partnership	$ 80

Frank and Evelyn received more than $400 in dividends, so they must report them on Schedule B.

They list all payers and the total amount received from each payer on line 5, Part II of Schedule B. This includes capital gain distributions and nontaxable distributions. They show the total on line 6. Frank and Evelyn put their capital gain distributions of $60 from the Tiger Mutual Fund on line 7. They also enter this amount on line 14, Part II of Schedule D. The $10 nontaxable distribution from Zepco, Inc., is entered on line 8. They reduce their basis in the stock by this amount.

Frank and Evelyn add the amounts on lines 7 and 8 and enter the total, $70, on line 9. They subtract this amount from the $750 on line 6 and enter the result, $680, on line 10, Part II of Schedule B, and on line 9, Form 1040.

Foreign accounts and foreign trusts (Part III of Schedule B). Evelyn has a foreign checking account that she uses for her travel agency. Because she had less than $10,000 in the account during 1994, she answers *No* to the question on line 11a in Part III of Schedule B. Neither Frank nor Evelyn was a grantor of, or transferor to, a foreign trust, so they answer *No* to the question on line 12 in Part III of Schedule B.

State and local income tax refunds (line 10). Frank and Evelyn received a 1993 state tax refund of $110 in 1994. This amount is shown on the Form 1099–G, *Certain Government Payments,* sent to them by their state. Because they itemized their deductions on Schedule A for 1993, they must use the worksheet in their Form 1040 instructions package to figure the taxable part of their refund. They use their copy of their 1993 tax return to fill out lines 2, 3, and 4 of the worksheet. Their filled-in worksheet is shown here.

State and Local Income Tax Refund Worksheet — Line 10

1.	Enter the income tax refund from Form(s) 1099–G (or similar statement)	$ 110
2.	Enter the amount from your 1993 Schedule A, line 26	$6,461
3.	Enter on line 3 the amount shown below for the filing status claimed on your 1993 Form 1040: Single, enter $3,700 Married filing jointly or Qualifying widow(er), enter $6,200 Married filing separately, enter $3,100 Head of household, enter $5,450	$6,200
4.	If you didn't complete line 33a on your 1993 Form 1040, enter –0–	–0–
5.	Add lines 3 and 4	$6,200
6.	Subtract line 5 from line 2. If zero or less, enter –0–	$ 261
7.	Taxable part of your refund. Enter the smaller of line 1 or line 6 here and on Form 1040, line 10	$ 110

They report $110 as income on line 10 of their Form 1040.

Capital gain or loss (line 13 and Schedule D). On line 13, Frank and Evelyn show their income from the sale or exchange of capital assets from Schedule D.

Short-term capital gains and losses (Part I of Schedule D). In Part I of Schedule D, they show their short-term capital gains and losses from assets they held one year or less. This year they had a short-term loss of $300 on the sale of stock they bought in 1993 and held for 5 months, and a short-term gain of $100 on the sale of stock they bought in January 1994 and held for 2 months. They list these transactions on line 1.

In 1990, Frank lent $200 to a former coworker. The debt became worthless in May 1994. Because it is a nonbusiness bad debt, he reports it as a short-term capital loss on line 1.

Frank and Evelyn also had a short-term capital loss carryover of $500 from 1993. They show this on line 6.

They add the amounts in column (f) of lines 1 through 6 and enter ($1,000), the total short-term loss, on line 7, column (f). They add the amounts in column (g) of lines 1 through 5 and enter $100, the total short-term gain, on line 7, column (g). They combine the amounts in columns (f) and (g), line 7, and enter their $900 net short-term loss on line 8.

Long-term capital gains and losses (Part II of Schedule D). In Part II of Schedule D, Frank and Evelyn show their long-term capital gains and losses from assets they held more than one year. On line 9, they show a $3,000 gain from the sale of stock and a $560 loss from a worthless bond. They also enter $300, Frank's share of long-term capital gain from his partnership, on line 13 and their $60 capital gain distributions on line 14. They do not report the sale of their home on Schedule D. (See *Sale of Home,* later.)

They add the amounts in column (f) of lines 9 through 15 and enter ($560) on line 16, column (f). They add the amounts in column (g) of lines 9 through 14 and enter $3,360 on line 16, column (g). They combine the amounts in columns (f) and (g), line 16, and enter their $2,800 net long-term gain on line 17.

Summary (Part III of Schedule D). In Part III of Schedule D they must summarize Parts I and II. They combine their $900 net short-term capital loss with their $2,800 net long-term capital gain and enter the result, $1,900, on line 18, Schedule D, and on line 13, Form 1040. Their taxable income is not over $91,850, so they will not use the *Capital Gain Tax Worksheet.*

Pensions (lines 16a and 16b). Evelyn retired in 1993 on her 63rd birthday. She received pension income of $850 in 1993 and $2,550 in 1994. $150 of her $9,000 pension cost was recovered tax free in 1993. Evelyn uses the worksheet in her Form 1040 instructions package to figure the taxable part of her pension for 1994. Her filled-in worksheet is shown here.

Worksheet for Simplified General Rule

1.	Enter the total pension or annuity payments received this year. Also enter this amount on Form 1040, line 16a		$2,550
2.	Enter your cost in the plan at the annuity starting date plus any death benefit exclusion		$9,000
3.	Age at annuity starting date:	Enter:	
	55 and under	300	
	56 – 60	260	
	61 – 65	240	
	66 – 70	170	
	71 and older	120	240
4.	Divide line 2 by the number on line 3.		$37.50
5.	Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was **before** 1987, also enter this amount on line 8; skip lines 6 and 7. Otherwise, go to line 6.		$ 450
6.	Enter the amount, if any, recovered tax free in years after 1986		$ 150
7.	Subtract line 6 from line 2.		$8,850
8.	Enter the smaller of line 5 or line 7		$ 450
9.	**Taxable amount.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also enter this amount on Form 1040, line 16b. If your Form 1099–R shows a larger amount, use the amount on this line instead of the amount from Form 1099–R		$2,100

Evelyn shows the total amount of her pension on line 16a, Form 1040. She shows the taxable amount, $2,100, on line 16b.

Rental and partnership income (line 17 and Schedule E). Frank and Evelyn show their total income from these sources on Schedule E and on line 17, Form 1040.

Rental income (Part I of Schedule E). Frank received rental income from two properties he owns, a store building and an unimproved piece of land. On line 1, Schedule E, he lists the building and its location in the space marked ''A,'' and the land and its location in the space marked ''B.'' On line 2, he checks the *No* box for both properties because neither was used for personal purposes.

On line 3, Frank enters his $8,400 rental income from the building in column A, his $720 rental income from the land in column B, and the total, $9,120, in the ''Totals'' column. Then he lists expenses, such as insurance, interest, general repairs, and real estate taxes, on the appropriate lines in each column. On line 6, column A, he shows his auto expenses connected with the rental of the building, figured at 29 cents a mile. Because he is claiming auto expenses, he completes Part V of Form 4562, *Depreciation and Amortization.*

In Part I of Schedule E, he adds the expenses for each property and on line 19 enters $5,420 in column A, $100 in column B, and the total, $5,520, in the ''Totals'' column.

Frank's records show that he purchased the store building in 1976. His basis for the building is $40,000, and he is using the straight line method of depreciation with a 40–year life. Frank shows depreciation of $1,000 for 1994 on line 20 in column A and the ''Totals'' column. Because the building was placed in service before 1994, he can figure the depreciation on the building on a separate worksheet and does not need to enter it on Form 4562 or attach his worksheet.

Frank enters the total expenses for each property on line 21, columns A and B. In each column he subtracts the amount on line 21 from the amount on line 3 and enters the result on line 22. He adds the amounts on line 22 and enters his total rental income, $2,600, on lines 24 and 26.

Partnership income (Part II of Schedule E). Frank is an active partner in the Jones Brothers Partnership. The following amounts are shown as his share of income and deductions on the Schedule K–1 (Form 1065) given to him by the partnership.

Ordinary income from trade or business	$4,600
Net long-term capital gain	300
Dividends	80
Charitable contributions	50
Net earnings from self-employment	4,600

Evelyn is an active partner in the Gateway Travel Agency. The following amounts are shown as her share of items on Schedule K–1 (Form 1065).

Ordinary income from trade or business	$1,900
Net earnings from self-employment	1,900

Frank and Evelyn list their partnerships in column (a) of line 27, in the spaces marked ''A'' and ''B,'' and complete columns (b) and (d) for each. Because they are at risk for the amounts invested in each of their partnerships, they check column (e) and do not complete Form 6198, *At-Risk Limitations.*

Because Frank and Evelyn actively participate in their partnerships' business activities, they report the ordinary business income from both of the partnerships as nonpassive income in column (k), line 27. They enter the total partnership nonpassive income of $6,500 on line 28a in column (k), and also on lines 29 and 31.

Frank and Evelyn report their other partnership items as follows:

Dividends—line 5 of Schedule B. Also, see *Dividends (line 9 and Part II of Schedule B),* earlier.

Net long-term capital gain—line 13, column (g) of Schedule D. Also, see *Capital gain or loss (line 13 and Schedule D),* earlier.

Contributions—line 15 of Schedule A. Also, see *Itemized Deductions (Schedule A),* later.

Net earnings from self-employment—line 2, Section A of Schedule SE. Also, see *Other Taxes,* later. Frank and Evelyn report their net earnings on separate Schedules SE.

Summary (Part V of Schedule E). In Part V of Schedule E, Frank and Evelyn combine the amounts on lines 26 and 31. They enter the total, $9,100, on line 40, Schedule E, and on line 17, Form 1040.

Other income (line 21). Frank won a $50 prize in a photography contest. Frank and Evelyn show this income on line 21, Form 1040.

Total income (line 22). Frank and Evelyn add the amounts on lines 7 through 21 to figure their total income, $37,310. They enter this amount on line 22.

Sale of Home (Form 2119)

Frank and Evelyn bought and moved into their new home May 5, 1994, and sold their old home May 6, 1994.

They do not have a taxable gain on the sale of their home. However, they must report it on Form 2119, *Sale of Your Home.*

They received a Form 1099–S, *Proceeds From Real Estate Transactions,* showing gross proceeds of $165,000 from the sale. Their records also show the following items:

Old home		
Original basis (purchased 1968)	$ 18,000	
Improvements	7,000	
Adjusted basis	$ 25,000	
Fixing-up expenses for sale	$ 1,000	
Selling price		$ 165,000
Settlement charges at closing (old home):		
Realtor's commission	$ 8,000	
Balance of mortgage	4,500	
Penalty for prepayment of mortgage	50	
Mortgage interest (4/1/94–5/5/94)	20	
Points—paid by seller for buyer (loan origination fee, 1% of loan amount)	1,000	
Real estate taxes (1/1/94–5/5/94)	630	14,200
Net received		$ 150,800
New home		
Purchase price		$ 90,000
Settlement charges at closing (new home):		
Title search, attorney fees, other settlement fees	$ 1,300	
Points charged to buyer (1% of loan amount)	400	
Mortgage assumed	(40,000)	
Down payment	(5,000)	
Real estate taxes (1/1/94–5/4/94—for period seller owned the home; credit from seller to buyer)	(300)	(43,600)
Balance at settlement		$ 46,400

They deduct certain of the amounts paid at settlement when they sold their old home and purchased their new home as itemized deductions on Schedule A. Their itemized deduction for interest includes the $50 penalty for prepayment of the mortgage on their old home, the $20 interest on the old house from April 1, 1994, through May 5, 1994, and the $400 points paid for the mortgage on their new home. The points qualify to be deducted in full in 1994. See *Interest paid (lines 10–14, Schedule A)* under *Itemized Deductions,* later.

Frank and Evelyn figure the amount realized and the gain realized on the sale of their old home as follows:

Selling price		$165,000
Less:		
Commission	$8,000	
Points	$1,000	$ 9,000
Amount realized		$156,000
Less: Adjusted basis of home sold		25,000
Gain realized		$131,000

They use these figures to fill out Part I of Form 2119.

They are over 55 and meet all the tests for the once-in-a-lifetime exclusion of up to $125,000. They choose to take the exclusion. To do this, they fill out Part II of Form 2119. On line 14, they enter the amount they can exclude, $125,000.

They then complete Part III of Form 2119. On line 15, they enter $6,000 ($131,000 gain

– $125,000 exclusion). This is the part of their gain they cannot exclude. On line 19b, they enter the cost of their new home, $91,300 ($90,000 purchase price + $1,300 settlement fees). By filling in the rest of Part III, they find their taxable gain is zero and the adjusted basis of their new home is $85,300.

Frank and Evelyn do not have to sign Form 2119 since they are attaching it to their tax return.

Adjustments to Income

Frank and Evelyn report their adjustments to income on lines 23a–30.

IRA deduction (lines 23a and 23b). Frank and Evelyn each made contributions to an individual retirement arrangement (IRA). Frank contributed $2,000 to his 1994 IRA. In February 1995, Evelyn contributed $900 to her IRA for 1994.

Because neither Frank nor Evelyn was covered by an employer retirement plan during 1994, they each figure their deduction using lines 1 through 3 of *IRA Worksheet 1* in their Form 1040 instructions package. Before completing their worksheets, they must each figure their earned income by completing a Schedule SE (see *Other Taxes,* later) and figuring their deductions for self-employment tax (explained later). Frank's earned income is $27,215. This is his $22,940 wages plus $4,600 (the amount on his Schedule SE, Section A, line 3) minus $325 (the deduction for self-employment tax shown on his Schedule SE, Section A, line 6, and carried to line 25, Form 1040). Evelyn's earned income is $1,765. This is $1,900 (the amount on her Schedule SE, Section A, line 3) minus $135 (the deduction for self-employment tax shown on her Schedule SE, Section A, line 6, and carried to line 25, Form 1040).

Only Frank's column of the worksheet is shown here.

IRA Worksheet 1

1. Enter IRA contributions you made, or will make by April 17, 1995, for 1994. But **do not** enter more than $2,000	$ 2,000
2. Enter wages and other earned income from Form 1040, minus any deductions on Form 1040, lines 25 and 27. Do not reduce wages by any loss from self-employment	27,215
3. Enter the **smaller** of line 1 or line 2. Enter on Form 1040, line 23a the amount from line 3 you choose to deduct	$ 2,000

Both Frank and Evelyn can deduct their total contribution. They show Frank's $2,000 contribution on line 23a and Evelyn's $900 contribution on line 23b.

Moving expenses (line 24 and Form 3903). Frank was transferred by his employer to a new job in another city. Frank and Evelyn decided to sell their home and buy a townhouse closer to Frank's new job. They kept their partnership interests at the old location because they can still carry out their duties by mail and telephone from their new home and do not have to commute. Frank's employer did not reimburse him for any of the moving expenses.

Frank and Evelyn make sure that the move meets the distance and time tests explained under *Requirements* in Chapter 19. The distance from their old home to Frank's new job is 91 miles farther than the distance from their old home to Frank's old job. Therefore, they meet the 50-mile distance test. Also, Frank expects to meet the 39-week full-time work test.

Their records show the following expenses for the move.

Paid to van company for moving furniture and household goods	$ 530
Car mileage to drive from old to new home—100 miles at 9¢ a mile	9
Motel room rent for one night on the day of arrival	61
Meals on the day of arrival	50
Pre-move mileage and motel expenses while looking for new home	500
Pre-move meals while looking for new home	200
Expenses of selling old home (realtor's commission and points)	9,000
Expenses of buying new home (settlement fees)	1,300

They figure their moving expense deduction on Form 3903, *Moving Expenses,* which they attach to their return.

They show the total cost to move furniture and other household goods, $530, on line 4, Form 3903.

They show $70 on line 5. This is the total of the car mileage and the motel room rent.

They cannot deduct the amounts they spent for meals on the day of arrival, pre-move househunting expenses, the expenses of selling their old home, or the expenses of buying their new home. They use the expenses of selling their old home and buying their new home on Form 2119. (See *Sale of Home,* earlier.)

Frank and Evelyn add lines 4 and 5 and enter the result, $600, on lines 6 and 8 of Form 3903 and on line 24 of Form 1040. They did not incur any of their moving expenses before 1994, so they do not need to complete Parts II and III of Form 3903.

Deduction for self-employment tax (line 25). Both Frank and Evelyn owe self-employment tax for 1994. To figure the amount they can deduct, they each complete a Schedule SE. (See *Other Taxes,* later.) They add the amounts from line 6, Section A, of each Schedule SE and enter the total, $460, on line 25.

Adjusted gross income (line 31). Frank and Evelyn add the amounts from lines 23a, 23b, 24, and 25, and enter $3,960 on line 30. Then they subtract line 30 from line 22. This amount, $33,350, is their adjusted gross income. They enter it on lines 31 and 32. This is the amount they use to figure the limit on their medical deduction and the limit on their miscellaneous deductions. They will also use this amount to figure whether certain of their itemized deductions and their deduction for exemptions are limited.

Standard Deduction

Frank and Evelyn must decide whether to take the standard deduction or itemize their actual deductions. They find the standard deduction for their filing status next to line 34. Their standard deduction is $6,350. They will use this amount to compare with their itemized deductions when they complete Schedule A.

Itemized Deductions (Schedule A)

Frank and Evelyn figure their total itemized deductions by completing Schedule A.

Medical and dental expenses (lines 1–4, Schedule A). Frank and Evelyn paid $2,564 for medical and dental expenses that were not reimbursed by insurance. This includes $300 for Grace Smith (Evelyn's dependent mother) and $700 for Clara Jones (Frank's dependent sister). It also includes $800 for health insurance premiums that Frank paid.

They enter $2,564 on line 1 and their adjusted gross income, $33,350, on line 2. On line 3, they enter $2,501, which is 7.5% of their adjusted gross income. They subtract line 3 from line 1 and enter the result, $63, on line 4.

Taxes paid (lines 5–9, Schedule A). Frank and Evelyn next itemize the deductible taxes they paid during the year.

Frank had $751 state income tax withheld from his salary during 1994. He and Evelyn also made estimated state income tax payments of $550 for 1994 during 1994. They enter the total, $1,301, on line 5.

Frank and Evelyn's tax year for real estate taxes on both their old and new homes is the calendar year, with payment due August 1. Their share of the tax on their old home, sold on May 6, was $630. Frank and Evelyn are considered to have paid their share of the real estate taxes on their old home even though they did not actually pay them to the tax authority.

They can claim only their share of the real estate taxes paid on their new home, $610.

Frank and Evelyn also paid $200 real estate taxes on a lakeside cottage they own and use only for personal purposes.

Frank and Evelyn's real estate tax deduction is $1,440 ($630 + $610 + $200). They write this amount on line 6.

Frank and Evelyn show their total taxes paid, $2,741, on line 9.

Interest paid (lines 10–14, Schedule A). Frank and Evelyn made mortgage interest payments on both their old and new homes in 1994.

They received a Form 1098, *Mortgage Interest Statement,* from the financial institution that holds the mortgage on their new home. Box 1 shows they paid $2,300 interest in 1994. Box 2 shows they paid $400 deductible points at closing. They add these amounts and enter the total, $2,700, on line 10 of Schedule A.

They did not receive a Form 1098 from the financial institution that held the mortgage on their old home. From January to April they paid $140 interest on the mortgage on their old home. The settlement sheet for the sale of their old home showed a $50 penalty for prepayment of the mortgage and $20 interest for the period April 1 through May 5. They enter the total of these amounts, $210, on line 11.

They add the amounts on lines 10 and 11 and show their total deductible interest, $2,910, on line 14. Frank and Evelyn also paid $260 interest expense on their credit card and revolving charge accounts. They cannot deduct this interest expense.

Gifts to charity (lines 15–18, Schedule A). Frank and Evelyn made cash charitable contributions of $778. They made no one gift of $250 or more. They have receipts for all their contributions. Frank's share of the charitable contributions made by the Jones Brothers Partnership, as shown on his Schedule K–1 (Form 1065), is $50. Frank and Evelyn enter the total, $828, on line 15. They also enter this amount on line 18.

Casualty and theft losses (line 19, Schedule A). Frank and Evelyn did not have any casualty or theft losses, so they enter –0– on line 19.

Job expenses and miscellaneous deductions (lines 20–26, Schedule A). Frank and Evelyn list union dues of $350, subscriptions to trade magazines of $75, and small tools needed for Frank's job costing $335, and enter the total of these deductions, $760, on line 20. They do not have any expenses on lines 21 or 22, so they also enter $760 on line 23.

They enter their adjusted gross income, $33,350, on line 24 and $667 ($33,350 × .02) on line 25. They subtract line 25 from line 23 and enter the result, $93, on line 26.

Other miscellaneous deductions (lines 27–28). Frank and Evelyn do not have any moving expenses incurred before 1994 or any other miscellaneous deductions not subject to the 2% of adjusted gross income limit, so they enter –0– on lines 27 and 28.

Total itemized deductions (line 29, Schedule A). Because the amount Frank and Evelyn entered on line 32 was not more than $111,800, they now add lines 4, 9, 14, 18, and 26, and write the total of their itemized deductions, $6,635, on line 29. Since this total is larger than their standard deduction ($6,350), they enter $6,635 on line 34, Form 1040.

Tax Computation

Frank and Evelyn are now ready to figure their tax on lines 32–40. None of the situations described on lines 33a, 33b, or 33c apply to them, so they leave the boxes on those lines blank. They subtract their itemized deductions on line 34 from their adjusted gross income on line 32 and enter $26,715 on line 35. They multiply $2,450 by the six exemptions they claimed on line 6e, and they enter the result, $14,700, on line 36. They subtract this from line 35. The result, $12,015, is their taxable income. They enter it on line 37.

Frank and Evelyn must use the Tax Table to figure their tax because their taxable income is less than $100,000. They read down the income column until they find the line that includes their $12,015 taxable income. Next, they find the column heading that describes their filing status—married filing jointly—and read down the column. The amount shown where the income line and filing status column meet, $1,804, is their tax. They write it on line 38 and check the box marked *Tax Table.* Because Frank and Evelyn do not owe any additional taxes (line 39), they also write $1,804 on line 40.

Credits

Because Frank and Evelyn do not have any credits, they leave lines 41–45 blank and enter $1,804 on line 46.

Other Taxes

Frank and Evelyn each have self-employment income over $400 and their total self-employment tax is the only ''Other'' tax they show on lines 47–52.

Self-employment tax (line 47 and Schedules SE). Frank and Evelyn each figure their self-employment tax on a separate Schedule SE. They can each use the short Schedule SE (Section A).

Evelyn enters her self-employment income of $1,900 on line 2 of Section A. She also enters $1,900 on line 3 and multiplies that amount by .9235. She enters the result, $1,755, on line 4. She multiplies the amount on line 4 by .153 to figure her self-employment tax of $269, which she enters on line 5. She enters one-half of this amount ($135) on line 6.

On a separate Schedule SE, Frank enters his self-employment income, $4,600, on lines 2 and 3 of Section A. He multiplies that amount by .9235 and enters the result, $4,248, on line 4. Frank's self-employment tax is $650 ($4,248 × .153), which he enters on line 5. He enters one-half of this amount ($325) on line 6.

They add Frank's self-employment tax and Evelyn's self-employment tax and enter the total, $919, on line 47, Form 1040. They add the amounts from line 6 of each Schedule SE and enter the total ($460) on line 25. (See *Deduction for self-employment tax,* under *Adjustments to Income,* earlier.) They attach both Schedules SE to their Form 1040.

Because they are not liable for any other taxes, they add the amount on line 47 to the amount on line 46. This total, $2,723, is Frank and Evelyn's total tax. They enter it on line 53.

Payments

Frank and Evelyn enter $2,158 on line 54. This is the amount of federal income tax withheld from Frank's salary, as shown on his Form W–2. On line 55, they write $800—the amount of estimated tax payments they made for 1994.

Frank and Evelyn enter on line 60, Form 1040, the total of these payments, $2,958.

Refund or Amount Owed

Because line 60 is more than line 53, Frank and Evelyn have overpaid their taxes. They write the amount of the overpayment, $235, on line 61. Because they do not want the amount credited to their 1995 estimated tax, they also enter $235 on line 62. This is the amount of their refund.

They check their return to make sure they have completed all the items and the schedules called for and that the schedules and forms are attached in attachment sequence number order. The attachment sequence number is just below the year in the upper right corner of each schedule or form. They remove the mailing label from their Form 1040 package and put it in the address portion on the top of Form 1040. Both Frank and Evelyn sign the return and date it, because it is a joint return. Also, they enter their occupations in the space provided next to the signature lines.

Frank and Evelyn make a copy of the return to keep for their records. Then they use the envelope that came with their Form 1040 package to mail the return to the Service Center for their area.

Filled-in Form 1040
If you need more information, turn to the page shown in the circle.

Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** (1) **1994** IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 1994, or other tax year beginning , 1994, ending , 19 OMB No. 1545-0074

Label (See instructions on page 12.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

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

CAR-RT SORT**CRO1
JT 516-00-1492 575-00-1776 S29 30
FRANK R & EVELYN D JONES
3807 MILLWAY 203
LAKECITY NY 14010

Spouse's social security number

Apt. no.

For Privacy Act and Paperwork Reduction Act Notice, see page 4.

Presidential Election Campaign (See page 12.)

	Yes	No	Note: Checking "Yes" will not change your tax or reduce your refund.
Do you want $3 to go to this fund?	✓		
If a joint return, does your spouse want $3 to go to this fund?	✓		

Filing Status (See page 12.) Check only one box.

1 ☐ Single
2 ☑ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. Enter spouse's social security no. above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 13.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶ 19). (See page 13.)

Exemptions (See page 13.)

6a ☑ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a. But be sure to check the box on line 33b on page 2
b ☑ **Spouse**

No. of boxes checked on 6a and 6b: 2

c **Dependents:**

(1) Name (first, initial, and last name)	(2) Check if under age 1	(3) If age 1 or older, dependent's social security number	(4) Dependent's relationship to you	(5) No. of months lived in your home in 1994
Marie Jones		123 00 4567	Daughter	12
James R. Jones		234 00 5678	Son	12
Grace L. Smith		345 00 6789	Mother	12
Clara D. Jones		456 00 7890	Sister	0*

If more than six dependents, see page 14.

No. of your children on 6c who:
- lived with you: 2
- didn't live with you due to divorce or separation (see page 14):

Dependents on 6c not entered above: 2

d If your child didn't live with you but is claimed as your dependent under a pre-1985 agreement, check here ▶ ☐
e Total number of exemptions claimed — Add numbers entered on lines above ▶ 6

Income

Attach Copy B of your Forms W-2, W-2G, and 1099-R here.

If you did not get a W-2, see page 15.

Enclose, but do not attach, any payment with your return.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	22,940
8a	**Taxable** interest income (see page 15). Attach Schedule B if over $400		8a	430
b	**Tax-exempt** interest (see page 16). DON'T include on line 8a	8b 500		
9	Dividend income. Attach Schedule B if over $400		9	680
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 16)		10	110
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). If required, attach Schedule D (see page 16)		13	1,900
14	Other gains or (losses). Attach Form 4797		14	
15a	Total IRA distributions	15a	b Taxable amount (see page 17)	15b
16a	Total pensions and annuities	16a 2,550	b Taxable amount (see page 17)	16b 2,100
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	9,100
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation (see page 18)		19	
20a	Social security benefits	20a	b Taxable amount (see page 18)	20b
21	Other income. List type and amount—see page 18 Photo contest prize		21	50
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	37,310

Adjustments to Income

Caution: See instructions ▶

23a	Your IRA deduction (see page 19)	23a 2,000		
b	Spouse's IRA deduction (see page 19)	23b 900		
24	Moving expenses. Attach Form 3903 or 3903-F	24 600		
25	One-half of self-employment tax	25 460		
26	Self-employed health insurance deduction (see page 21)	26		
27	Keogh retirement plan and self-employed SEP deduction	27		
28	Penalty on early withdrawal of savings	28		
29	Alimony paid. Recipient's SSN ▶	29		
30	Add lines 23a through 29. These are your **total adjustments** ▶		30	3,960

Adjusted Gross Income

31	Subtract line 30 from line 22. This is your **adjusted gross income.** If less than $25,296 and a child lived with you (less than $9,000 if a child didn't live with you), see "Earned Income Credit" on page 27 ▶	31	33,350

*Forms 2120 attached (not shown)

Cat. No. 11320B Form **1040** (1994)

Filled-in Form 1040
If you need more information, turn to the page shown in the circle.

Form 1040 (1994) Page 2

Tax Computation (See page 23.)	32	Amount from line 31 (adjusted gross income)	32	33,350
	33a	Check if: ☐ You were 65 or older, ☐ Blind; ☐ Spouse was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 33a		
(166)	b	If your parent (or someone else) can claim you as a dependent, check here ▶ 33b ☐		
(167)	c	If you are married filing separately and your spouse itemizes deductions or you are a dual-status alien, see page 23 and check here ▶ 33c ☐		
(168)	34	Enter the larger of your: **Itemized deductions** from Schedule A, line 29, **OR** **Standard deduction** shown below for your filing status. **But if you checked any box on line 33a or b,** go to page 23 to find your standard deduction. If you checked **box 33c,** your standard deduction is zero. • Single—$3,800 • Head of household—$5,600 • Married filing jointly or Qualifying widow(er)—$6,350 • Married filing separately—$3,175	34	6,635
(238)	35	Subtract line 34 from line 32	35	26,715
(239)	36	If line 32 is $83,850 or less, multiply $2,450 by the total number of exemptions claimed on line 6e. If line 32 is over $83,850, see the worksheet on page 24 for the amount to enter	36	14,700
	37	**Taxable income.** Subtract line 36 from line 35. If line 36 is more than line 35, enter -0-	37	12,015
If you want the IRS to figure your tax, see page 24.	38	Tax. Check if from a ☑ Tax Table, b ☐ Tax Rate Schedules, c ☐ Capital Gain Tax Worksheet, or d ☐ Form 8615 (see page 24). Amount from Form(s) 8814 ▶ e	38	1,804
	39	Additional taxes. Check if from a ☐ Form 4970 b ☐ Form 4972	39	
(248)	40	Add lines 38 and 39 ▶	40	1,804
Credits (See page 24.)	41	Credit for child and dependent care expenses. Attach Form 2441 — 41		
(258)	42	Credit for the elderly or the disabled. Attach Schedule R — 42		
	43	Foreign tax credit. Attach Form 1116 — 43		
	44	Other credits (see page 25). Check if from a ☐ Form 3800 b ☐ Form 8396 c ☐ Form 8801 d ☐ Form (specify) — 44		
(8) (282)	45	Add lines 41 through 44	45	
	46	Subtract line 45 from line 40. If line 45 is more than line 40, enter -0- ▶	46	1,804
Other Taxes (See page 25.) (241)	47	Self-employment tax. Attach Schedule SE	47	919
	48	Alternative minimum tax. Attach Form 6251	48	
(85)	49	Recapture taxes. Check if from a ☐ Form 4255 b ☐ Form 8611 c ☐ Form 8828	49	
	50	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	50	
(153)	51	Tax on qualified retirement plans, including IRAs. If required, attach Form 5329	51	
(278)	52	Advance earned income credit payments from Form W-2	52	
(52)	53	Add lines 46 through 52. This is your **total tax** ▶	53	2,723
Payments	54	Federal income tax withheld. If any is from Form(s) 1099, check ▶ ☐ — 54: 2,158		
	55	1994 estimated tax payments and amount applied from 1993 return — 55: 800		
(265)	56	**Earned income credit.** If required, attach Schedule EIC (see page 27). Nontaxable earned income: amount ▶ and type ▶ — 56		
Attach Forms W-2, W-2G, and 1099-R on the front. (12)	57	Amount paid with Form 4868 (extension request) (284) — 57		
(283)	58	Excess social security and RRTA tax withheld (see page 32) — 58		
	59	Other payments. Check if from a ☐ Form 2439 b ☐ Form 4136 — 59		
(16)	60	Add lines 54 through 59. These are your **total payments** ▶	60	2,958
Refund or Amount You Owe	61	If line 60 is more than line 53, subtract line 53 from line 60. This is the amount you **OVERPAID** ▶	61	235
	62	Amount of line 61 you want **REFUNDED TO YOU** ▶	62	235
	63	Amount of line 61 you want **APPLIED TO YOUR 1995 ESTIMATED TAX** ▶ — 63		
(51) (16)	64	If line 53 is more than line 60, subtract line 60 from line 53. This is the **AMOUNT YOU OWE.** For details on how to pay, including what to write on your payment, see page 32	64	
	65	Estimated tax penalty (see page 33). Also include on line 64 — 65		

Sign Here (53)

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.

Keep a copy of this return for your records. (16)

Your signature	Date	Your occupation
Frank R. Jones	4-4-95	Electrician
Spouse's signature. If a joint return, BOTH must sign.	**Date**	**Spouse's occupation**
Evelyn B. Jones	4-4-95	Travel agent

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed ☐	Preparer's social security no.
Firm's name (or yours if self-employed) and address		E.I. No.	
		ZIP code	

Printed on recycled paper

Filled-in Schedule A
If you need more information, turn to the page shown in the circle.

SCHEDULES A&B (Form 1040)
Department of the Treasury Internal Revenue Service (1)

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074
1994
Attachment Sequence No. 07

Name(s) shown on Form 1040: Frank R. and Evelyn D. Jones
Your social security number: 516 00 1492

Medical and Dental Expenses (170)		**Caution:** *Do not include expenses reimbursed or paid by others.*			
	1	Medical and dental expenses (see page A-1)	1	2,564	
	2	Enter amount from Form 1040, line 32. 2 33,350			
	3	Multiply line 2 above by 7.5% (.075)	3	2,501	
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4: 63
Taxes You Paid (175) (See page A-1.)	5	State and local income taxes	5	1,301	
	6	Real estate taxes (see page A-2)	6	1,440	
	7	Personal property taxes	7		
	8	Other taxes. List type and amount ▶	8		
	9	Add lines 5 through 8			9: 2,741
Interest You Paid (180) (See page A-2.)	10	Home mortgage interest and points reported to you on Form 1098	10	2,700	
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶	11	210	
Note: Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-3 for special rules	12		
	13	Investment interest. If required, attach Form 4952. (See page A-3.)	13		
	14	Add lines 10 through 13			14: 2,910
Gifts to Charity (187)	15	Gifts by cash or check. If any gift of $250 or more, see page A-3	15	828	
If you made a gift and got a benefit for it, see page A-3.	16	Other than by cash or check. If any gift of $250 or more, see page A-3. If over $500, you **MUST** attach Form 8283	16		
	17	Carryover from prior year	17		
	18	Add lines 15 through 17			18: 828
Casualty and Theft Losses (195)	19	Casualty or theft loss(es). Attach Form 4684. (See page A-4.) (202)			19: -0-
Job Expenses and Most Other Miscellaneous Deductions (224) (229) (See page A-5 for expenses to deduct here.)	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. If required, you **MUST** attach Form 2106 or 2106-EZ. (See page A-5.) ▶ union dues - $350; subscriptions - $75; tools - $335	20	760	
	21	Tax preparation fees	21		
	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22		
	23	Add lines 20 through 22	23	760	
	24	Enter amount from Form 1040, line 32. 24 33,350			
	25	Multiply line 24 above by 2% (.02)	25	667	
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			26: 93
Other Miscellaneous Deductions	27	Moving expenses incurred before 1994. Attach Form 3903 or 3903-F. (See page A-5.)			27: -0-
	28	Other—from list on page A-5. List type and amount ▶			28: -0-
Total Itemized Deductions (238) (169)	29	Is Form 1040, line 32, over $111,800 (over $55,900 if married filing separately)? **NO.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter on Form 1040, line 34, the **larger** of this amount or your standard deduction. **YES.** Your deduction may be limited. See page A-5 for the amount to enter.			▶ 29: 6,635

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X **Schedule A (Form 1040) 1994**

Filled-in Schedule B
If you need more information, turn to the page shown in the circle.

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side. | Your social security number

Schedule B—Interest and Dividend Income

Attachment Sequence No. 08

Part I Interest Income (67)

(See pages 15 and B-1.)

Note: If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

Note: *If you had over $400 in taxable interest income, you must also complete Part III.*

		Amount
1 List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also show that buyer's social security number and address ▶		
National Bank		330
First Savings and Loan		150
Subtotal		480
Nominee Distribution		(50)
	1	
2 Add the amounts on line 1	2	430
3 Excludable interest on series EE U.S. savings bonds issued after 1989 from Form 8815, line 14. You MUST attach Form 8815 to Form 1040	3	
4 Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	4	430

Part II Dividend Income (79)

(See pages 16 and B-1.)

Note: If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total dividends shown on that form.

Note: *If you had over $400 in gross dividends and/or other distributions on stock, you must also complete Part III.*

		Amount
5 List name of payer. Include gross dividends and/or other distributions on stock here. Any capital gain distributions and nontaxable distributions will be deducted on lines 7 and 8 ▶		
Acme Publishing Co.		210
Zapco, Inc.		310
Equity Mutual Fund		50
Tiger Mutual Fund		60
Equity Brokers		40
Jones Brothers Partnership		80
	5	
6 Add the amounts on line 5	6	750
7 Capital gain distributions. Enter here and on Schedule D* . 7 60		
8 Nontaxable distributions. (See the inst. for Form 1040, line 9.) 8 10		
9 Add lines 7 and 8	9	70
10 Subtract line 9 from line 6. Enter the result here and on Form 1040, line 9 ▶	10	680

**If you do not need Schedule D to report any other gains or losses, enter your capital gain distributions on Form 1040, line 13. Write "CGD" on the dotted line next to line 13.*

Part III Foreign Accounts and Trusts (16)

(See page B-2.)

If you had over $400 of interest or dividends OR had a foreign account or were a grantor of, or a transferor to, a foreign trust, you must complete this part.

	Yes	No
11a At any time during 1994, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-2 for exceptions and filing requirements for Form TD F 90-22.1		✓
b If "Yes," enter the name of the foreign country ▶		
12 Were you the grantor of, or transferor to, a foreign trust that existed during 1994, whether or not you have any beneficial interest in it? If "Yes," you may have to file Form 3520, 3520-A, or 926		✓

For Paperwork Reduction Act Notice, see Form 1040 instructions. Printed on recycled paper **Schedule B (Form 1040) 1994**

Filled-in Schedule D
If you need more information, turn to the page shown in the circle.

SCHEDULE D (Form 1040)
Department of the Treasury Internal Revenue Service (T)

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).
▶ Use lines 20 and 22 for more space to list transactions for lines 1 and 9.

OMB No. 1545-0074
1994
Attachment Sequence No. **12**

Name(s) shown on Form 1040: Frank R. and Evelyn D. Jones
Your social security number: 516 00 1492

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

141

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-3)	(f) LOSS If (e) is more than (d), subtract (d) from (e)	(g) GAIN If (d) is more than (e), subtract (e) from (d)
1	100 sh. A Co.	12-7-93	5-9-94	800	1,100	300	
	50 sh. B Co.	1-4-94	3-4-94	600	500		100
	Bad debt — John Green (128)	Statement attached*				200	
2	Enter your short-term totals, if any, from line 21			2			
3	**Total short-term sales price amounts.** Add column (d) of lines 1 and 2 (131)			3	1,400		
4	Short-term gain from Forms 2119 and 6252, and short-term gain or (loss) from Forms 4684, 6781, and 8824				4		
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5		
6	Short-term capital loss carryover. Enter the amount, if any, from line 9 of your 1993 Capital Loss Carryover Worksheet				6	500	
7	Add lines 1, 2, and 4 through 6, in columns (f) and (g)				7	(1,000)	100
8	**Net short-term capital gain or (loss).** Combine columns (f) and (g) of line 7 ▶					8	(900)

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

9	300 sh. XYZ Co.	2-11-85	5-3-94	6,000	3,000		3,000
	Bond-D Co.	1-30-89	Worthless		560	560	
		(141)		(127)			
10	Enter your long-term totals, if any, from line 23			10			
11	**Total long-term sales price amounts.** Add column (d) of lines 9 and 10			11	6,000 (131)		
12	Gain from Form 4797; long-term gain from Forms 2119, 2439, and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				12		
13	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 (80)				13		300
14	Capital gain distributions				14		60
15	Long-term capital loss carryover. Enter the amount, if any, from line 14 of your 1993 Capital Loss Carryover Worksheet				15		
16	Add lines 9, 10, and 12 through 15, in columns (f) and (g)				16	(560)	3,360
17	**Net long-term capital gain or (loss).** Combine columns (f) and (g) of line 16 ▶					17	2,800

Part III Summary of Parts I and II

18	Combine lines 8 and 17. If a loss, go to line 19. If a gain, enter the gain on Form 1040, line 13. **Note:** *If both lines 17 and 18 are gains, see the* ***Capital Gain Tax Worksheet*** *on page 25*	18	1,900
19	If line 18 is a (loss), enter here and as a (loss) on Form 1040, line 13, the **smaller** of these losses: a The (loss) on line 18; **or** b ($3,000) or, if married filing separately, ($1,500)	19	( )

(141) **Note:** *See the* ***Capital Loss Carryover Worksheet*** *on page D-3 if the loss on line 18 exceeds the loss on line 19 or if Form 1040, line 35, is a loss.*

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 1994**

*Not shown

Filled-in Schedule E
If you need more information, turn to the page shown in the circle.

SCHEDULE E (Form 1040)

Department of the Treasury Internal Revenue Service (1)

Supplemental Income and Loss

(85) (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074

1994

Attachment Sequence No. **13**

Name(s) shown on return: Frank R. and Evelyn D. Jones

Your social security number: 516 00 1492

Part I **Income or Loss From Rental Real Estate and Royalties** **Note:** *Report income and expenses from your business of renting personal property on **Schedule C** or **C-EZ** (see page E-1). Report farm rental income or loss from **Form 4835** on page 2, line 39.*

1 Show the kind and location of each **rental real estate property:**

A Store building (113)
410 Main St., Hometown, NY

B Unimproved lot (87)
Hometown, NY

C

2 For each rental real estate property listed on line 1, did you or your family use it for personal purposes for more than the greater of 14 days or 10% of the total days rented at fair rental value during the tax year? (See page E-1.)

	Yes	No
A		✓
B		✓
C		

Income:		Properties A	Properties B	Properties C		Totals (Add columns A, B, and C.)
3 Rents received	3	8,400	720		3	9,120
4 Royalties received	4				4	
Expenses:						
5 Advertising	5					
6 Auto and travel (see page E-2)	6	78				
7 Cleaning and maintenance	7					
8 Commissions	8					
9 Insurance	9	300				
10 Legal and other professional fees	10					
11 Management fees	11					
12 Mortgage interest paid to banks, etc. (see page E-2)	12	3,100			12	3,100
13 Other interest	13					
14 Repairs	14	742				
15 Supplies	15					
16 Taxes	16	1,200	100			
17 Utilities	17					
18 Other (list) ▶	18					
19 Add lines 5 through 18	19	5,420	100		19	5,520
20 Depreciation expense or depletion (see page E-2)	20	1,000			20	1,000
21 Total expenses. Add lines 19 and 20	21	6,420	100			
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-2 to find out if you must file **Form 6198**	22	1,980	620			
23 Deductible rental real estate loss. **Caution:** *Your rental real estate loss on line 22 may be limited. See page E-3 to find out if you must file **Form 8582**. Real estate professionals must complete line 42 on page 2*	23	( )	( )	( )		
24 **Income.** Add positive amounts shown on line 22. **Do not** include any losses					24	2,600
25 **Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter the total losses here					25	( )
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 39 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 40 on page 2					26	2,600

For Paperwork Reduction Act Notice, see Form 1040 Instructions. Cat. No. 11344L **Schedule E (Form 1040) 1994**

Filled-in Schedule E
If you need more information, turn to the page shown in the circle.

Schedule E (Form 1040) 1994 — Attachment Sequence No. 13 — Page 2

Name(s) shown on return. Do not enter name and social security number if shown on other side. | Your social security number

Note: *If you report amounts from farming or fishing on Schedule E, you must enter your gross income from those activities on line 41 below. Real estate professionals must complete line 42 below.*

Part II **Income or Loss From Partnerships and S Corporations** **Note:** *If you report a loss from an at-risk activity, you MUST check either column (e) or (f) of line 27 to describe your investment in the activity. See page E-4. If you check column (f), you must attach* **Form 6198.**

111

27	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	Investment At Risk? (e) All is at risk	(f) Some is not at risk
A	Jones Brothers Partnership	P		10-1987654	✓	
B	Gateway Travel Agency	P		10-5431234	✓	
C						
D						
E						

	Passive Income and Loss		Nonpassive Income and Loss		
	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss from Schedule K-1	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
A					4,600
B					1,900
C					
D					
E					
28a Totals					6,500
b Totals					

29	Add columns (h) and (k) of line 28a	29	6,500
30	Add columns (g), (i), and (j) of line 28b	30	( )
31	Total partnership and S corporation income or (loss). Combine lines 29 and 30. Enter the result here and include in the total on line 40 below	31	6,500

Part III **Income or Loss From Estates and Trusts**

109

32	(a) Name	(b) Employer identification number
A		
B		

	Passive Income and Loss		Nonpassive Income and Loss	
	(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1
A				
B				
33a Totals				
b Totals				

34	Add columns (d) and (f) of line 33a	34	
35	Add columns (c) and (e) of line 33b	35	( )
36	Total estate and trust income or (loss). Combine lines 34 and 35. Enter the result here and include in the total on line 40 below	36	

Part IV **Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder**

37	(a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see page E-4)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b

38	Combine columns (d) and (e) only. Enter the result here and include in the total on line 40 below	38	

Part V **Summary**

39	Net farm rental income or (loss) from **Form 4835**. Also, complete line 41 below	39	
40	TOTAL income or (loss). Combine lines 26, 31, 36, 38, and 39. Enter the result here and on Form 1040, line 17 ▶	40	9,100
41	**Reconciliation of Farming and Fishing Income.** Enter your **gross** farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), line 15b; Schedule K-1 (Form 1120S), line 23; and Schedule K-1 (Form 1041), line 13 (see page E-4)	41	
42	**Reconciliation for Real Estate Professionals.** If you were a real estate professional (see page E-3), enter the net income or (loss) you reported anywhere on Form 1040 from all rental real estate activities in which you materially participated under the passive activity loss rules	42	

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Filled-in Schedule SE
If you need more information, turn to the page shown in the circle.

SCHEDULE SE (Form 1040)

Department of the Treasury Internal Revenue Service (T)

(8) Self-Employment Tax

▶ See Instructions for Schedule SE (Form 1040).

▶ Attach to Form 1040.

OMB No. 1545-0074

1994

Attachment Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040): Frank R. Jones

Social security number of person with **self-employment** income ▶ 516 00 1492

Who Must File Schedule SE

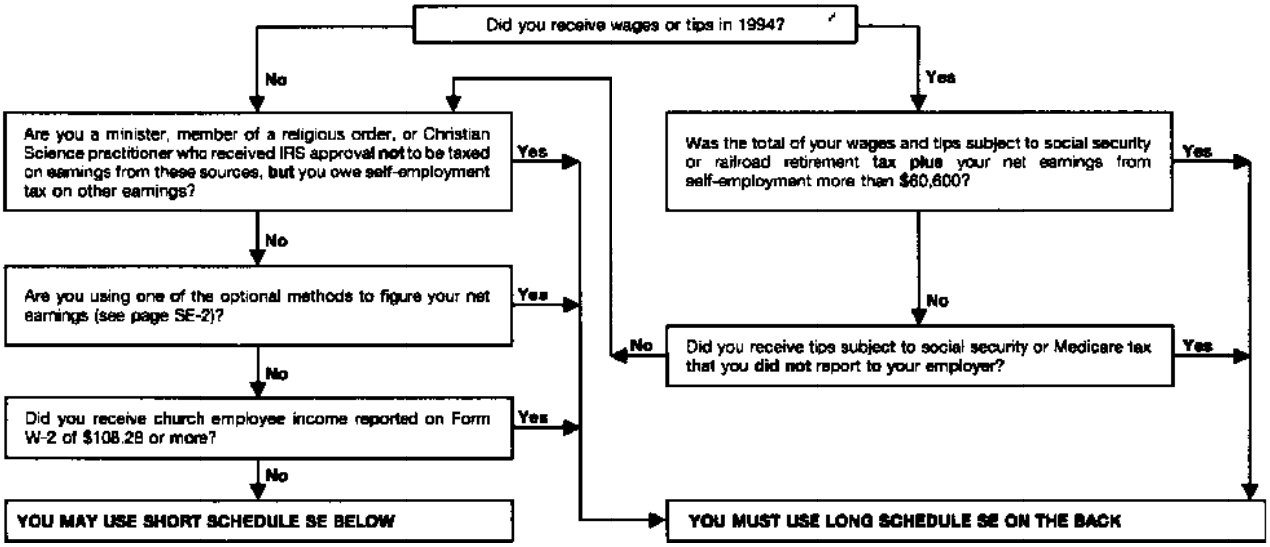
You must file Schedule SE if:

- You had net earnings from self-employment from other than church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more, **OR**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

Note: *Even if you have a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-2.*

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner, **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 47.

May I Use Short Schedule SE or MUST I Use Long Schedule SE?



Section A—Short Schedule SE. Caution: *Read above to see if you can use Short Schedule SE.*

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; and Schedule K-1 (Form 1065), line 15a (other than farming). Ministers and members of religious orders see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	4,600
3	Combine lines 1 and 2	3	4,600
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶	4	4,248
5	**Self-employment tax.** If the amount on line 4 is: • $60,600 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 47.** • More than $60,600, multiply line 4 by 2.9% (.029). Then, add $7,514.40 to the result. Enter the total here and on **Form 1040, line 47.**	5	650
(178) 6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 25**	6	325

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 1994**

Filled-in Schedule SE
If you need more information, turn to the page shown in the circle.

SCHEDULE SE (Form 1040)

Department of the Treasury
Internal Revenue Service (T)

(8) **Self-Employment Tax**

▶ **See Instructions for Schedule SE (Form 1040).**

▶ **Attach to Form 1040.**

OMB No. 1545-0074

1994

Attachment Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040): Evelyn D. Jones

Social security number of person with **self-employment** income ▶ 575 00 1776

Who Must File Schedule SE

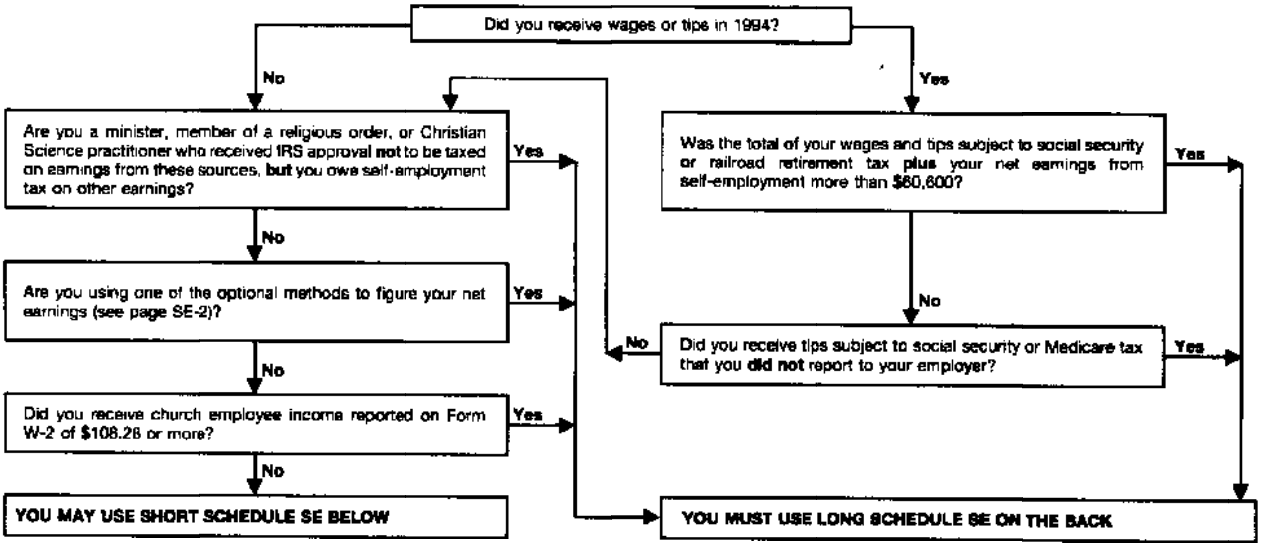
You must file Schedule SE if:

- You had net earnings from self-employment from other than church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more, **OR**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

Note: *Even if you have a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-2.*

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner, **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 47.

May I Use Short Schedule SE or MUST I Use Long Schedule SE?



Section A—Short Schedule SE. Caution: *Read above to see if you can use Short Schedule SE.*

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; and Schedule K-1 (Form 1065), line 15a (other than farming). Ministers and members of religious orders see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	1,900
3	Combine lines 1 and 2	3	1,900
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶	4	1,755
5	**Self-employment tax.** If the amount on line 4 is: • $60,600 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 47.** • More than $60,600, multiply line 4 by 2.9% (.029). Then, add $7,514.40 to the result. Enter the total here and on **Form 1040, line 47.**	5	269
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 25**	6	135

(178)

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 1994**

Filled-in Form 2119
If you need more information, turn to the page shown in the circle.

Form **2119**

Department of the Treasury
Internal Revenue Service

(131) **Sale of Your Home**

▶ **Attach to Form 1040 for year of sale.**

▶ **See separate instructions.** ▶ **Please print or type.**

OMB No. 1545-0072

1994

Attachment Sequence No. **20**

Your first name and initial, if a joint return, also give spouse's name and initial: Frank R. and Evelyn D.

Last name: Jones

Your social security number: 516:00:1492

Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return

Present address (no., street, and apt. no., rural route, or P.O. box no. if mail is not delivered to street address):

Spouse's social security number: 575:00:1776

City, town or post office, state, and ZIP code:

Part I Gain on Sale

1	Date your former main home was sold (month, day, year) ▶	1	5 / 6 / 94
2	Have you bought or built a new main home?		☑ Yes ☐ No
3	If any part of either main home was ever rented out or used for business, check here ▶ ☐ and see instructions.		
4	Selling price of home. Do not include personal property items you sold with your home	4	165,000
5	Expense of sale (see instructions)	5	9,000
6	Subtract line 5 from line 4	6	156,000
7	Adjusted basis of home sold (see instructions)	7	25,000
8	**Gain on sale.** Subtract line 7 from line 6	8	131,000

Is line 8 more than zero?

- **Yes** ▶ If line 2 is "Yes," you **must** go to Part II or Part III, whichever applies. If line 2 is "No," go to line 9.
- **No** ▶ **Stop** and attach this form to your return.

9 If you haven't replaced your home, do you plan to do so within the **replacement period** (see instructions)? ☐ Yes ☐ No
- If line 9 is "Yes," stop here, attach this form to your return, and see **Additional Filing Requirements** in the instructions.
- If line 9 is "No," you **must** go to Part II or Part III, whichever applies.

Part II One-Time Exclusion of Gain for People Age 55 or Older—By completing this part, you are electing to take the one-time exclusion (see instructions). If you are not electing to take the exclusion, go to Part III now.

10	Who was age 55 or older on the date of sale?		☐ You ☐ Your spouse ☑ Both of you
11	Did the person who was age 55 or older own and use the property as his or her main home for a total of at least 3 years (except for short absences) of the 5-year period before the sale? If "No," go to Part III now		☑ Yes ☐ No
12	At the time of sale, who owned the home?		☐ You ☐ Your spouse ☑ Both of you
13	Social security number of spouse at the time of sale if you had a different spouse from the one above. If you were not married at the time of sale, enter "None" ▶	13	: :
14	**Exclusion.** Enter the **smaller** of line 8 or $125,000 ($62,500 if married filing separate return). Then, go to line 15	14	125,000

Part III Adjusted Sales Price, Taxable Gain, and Adjusted Basis of New Home

15	If line 14 is blank, enter the amount from line 8. Otherwise, subtract line 14 from line 8	15	6,000
	• If line 15 is zero, stop and attach this form to your return.		
	• If line 15 is more than zero and line 2 is "Yes," go to line 16 now.		
	• If you are reporting this sale on the installment method, stop and see the instructions.		
	• All others, stop and **enter the amount from line 15 on Schedule D, col. (g), line 4 or line 12.**		
16	Fixing-up expenses (see instructions for time limits)	16	1,000
17	If line 14 is blank, enter amount from line 16. Otherwise, add lines 14 and 16	17	126,000
18	**Adjusted sales price.** Subtract line 17 from line 6	18	30,000
19a	Date you moved into new home ▶ 5 / 5 / 94 b Cost of new home (see instructions)	19b	91,300
20	Subtract line 19b from line 18. If zero or less, enter -0-	20	-0-
21	**Taxable gain.** Enter the **smaller** of line 15 or line 20	21	-0-
	• If line 21 is zero, go to line 22 and attach this form to your return.		
	• If you are reporting this sale on the installment method, see the line 15 instructions and go to line 22.		
	• All others, **enter the amount from line 21 on Schedule D, col. (g), line 4 or line 12,** and go to line 22.		
22	Postponed gain. Subtract line 21 from line 15	22	6,000
23	**Adjusted basis of new home.** Subtract line 22 from line 19b	23	85,300

Sign Here Only If You Are Filing This Form by Itself and Not With Your Tax Return

Under penalties of perjury, I declare that I have examined this form, including attachments, and to the best of my knowledge and belief, it is true, correct, and complete.

Your signature ▶ Date — Spouse's signature ▶ Date

If a joint return, both must sign.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11710J Form **2119** (1994)

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Filled-In Form 3903
If you need more information, turn to the page shown in the circle.

Form **3903** — Department of the Treasury, Internal Revenue Service

(157) **Moving Expenses**

▶ Attach to Form 1040.

▶ See separate instructions.

OMB No. 1545-0062

1994

Attachment Sequence No. **62**

Name(s) shown on Form 1040: Frank R. and Evelyn D. Jones

Your social security number: 516 : 00 : 1492

Part I **Moving Expenses Incurred in 1994**

Caution: *If you are a member of the armed forces, see the instructions before completing this part.*

1	Enter the number of miles from your **old home** to your **new workplace**	1	96 miles	
2	Enter the number of miles from your **old home** to your **old workplace**	2	5 miles	
3	Subtract line 2 from line 1. Enter the result but not less than zero	3	91 miles	

Is line 3 at least 50 miles?

Yes ▶ Go to line 4. Also, see **Time Test** in the instructions.

No ▶ You **cannot** deduct your moving expenses incurred in 1994. Do not complete the rest of this part. See the **Note** below if you also incurred moving expenses before 1994.

4	Transportation and storage of household goods and personal effects	4	530
5	Travel and lodging expenses of moving from your old home to your new home. **Do not** include meals	5	70
6	Add lines 4 and 5	6	600
7	Enter the total amount your employer paid for your move (including the value of services furnished in kind) that is **not** included in the wages box (box 1) of your W-2 form. This amount should be identified with code **P** in box 13 of your W-2 form	7	

Is line 6 more than line 7?

Yes ▶ Go to line 8.

No ▶ You **cannot** deduct your moving expenses incurred in 1994. If line 6 is less than line 7, subtract line 6 from line 7 and include the result in income on Form 1040, line 7.

8	Subtract line 7 from line 6. Enter the result here and on Form 1040, line 24. This is your **moving expense deduction for expenses incurred in 1994**	8	600

Note: *If you incurred moving expenses **before 1994** and you did not deduct those expenses on a prior year's tax return, complete Parts II and III on the back to figure the amount, if any, you may deduct on **Schedule A,** Itemized Deductions.*

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12490K Form **3903** (1994)

Filled-in Form 4562
If you need more information, turn to the page shown in the circle.

Form **4562**

Department of the Treasury
Internal Revenue Service (T)

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach this form to your return.

OMB No. 1545-0172

1994

Attachment Sequence No. **67**

Name(s) shown on return: Frank R. and Evelyn D. Jones

Identifying number: 516-00-1492

Business or activity to which this form relates: Rental of store building

Part I **Election To Expense Certain Tangible Property (Section 179)** (**Note:** *If you have any "Listed Property," complete Part V before you complete Part I.*)

1	Maximum dollar limitation (If an enterprise zone business, see instructions.)	1	$17,500
2	Total cost of section 179 property placed in service during the tax year (see instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation	3	$200,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. (If married filing separately, see instructions.)	5	

	(a) Description of property	(b) Cost	(c) Elected cost
6			

7	Listed property. Enter amount from line 26	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	
9	Tentative deduction. Enter the smaller of line 5 or line 8	9	
10	Carryover of disallowed deduction from 1993 (see instructions)	10	
11	Taxable income limitation. Enter the smaller of taxable income (not less than zero) or line 5 (see instructions)	11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	
13	Carryover of disallowed deduction to 1995. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property (automobiles, certain other vehicles, cellular telephones, certain computers, or property used for entertainment, recreation, or amusement). Instead, use Part V for listed property.*

Part II **MACRS Depreciation For Assets Placed in Service ONLY During Your 1994 Tax Year (Do Not Include Listed Property)**

	(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
	Section A—General Depreciation System (GDS) (see instructions)						
14a	3-year property						
b	5-year property						
c	7-year property						
d	10-year property						
e	15-year property						
f	20-year property						
g	Residential rental property			27.5 yrs.	MM	S/L	
				27.5 yrs.	MM	S/L	
h	Nonresidential real property			39 yrs.	MM	S/L	
					MM	S/L	
	Section B—Alternative Depreciation System (ADS) (see instructions)						
15a	Class life					S/L	
b	12-year			12 yrs.		S/L	
c	40-year			40 yrs.	MM	S/L	

Part III **Other Depreciation (Do Not Include Listed Property)**

16	GDS and ADS deductions for assets placed in service in tax years beginning before 1994 (see instructions)	16	
17	Property subject to section 168(f)(1) election (see instructions)	17	
18	ACRS and other depreciation (see instructions)	18	

Part IV **Summary**

19	Listed property. Enter amount from line 25	19	
20	**Total.** Add deductions on line 12, lines 14 and 15 in column (g), and lines 16 through 19. Enter here and on the appropriate lines of your return. (Partnerships and S corporations—see instructions)	20	
21	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs (see instructions)	21	

For Paperwork Reduction Act Notice, see page 1 of the separate instructions. Cat. No. 12906N Form **4562** (1994)

Filled-in Form 4562
If you need more information, turn to the page shown in the circle.

Part V **Listed Property—Automobiles, Certain Other Vehicles, Cellular Telephones, Certain Computers, and Property Used for Entertainment, Recreation, or Amusement**

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For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete **only** *22a, 22b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.*

Section A—Depreciation and Other Information (Caution: *See instructions for limitations for automobiles.)*

22a Do you have evidence to support the business/investment use claimed? ☑ Yes ☐ No **22b** If "Yes," is the evidence written? ☑ Yes ☐ No

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/ investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/ Convention	(h) Depreciation deduction	(i) Elected section 179 cost
23 Property used more than 50% in a qualified business use (see instructions):								
		%						
		%						
		%						
24 Property used 50% or less in a qualified business use (see instructions):								
USA coupe	9-3-91	3 %				S/L –		
		%				S/L –		
		%				S/L –		

25 Add amounts in column (h). Enter the total here and on line 19, page 1 . . . . . **25**

26 Add amounts in column (i). Enter the total here and on line 7, page 1 . . . . . **26**

Section B—Information on Use of Vehicles—*If you deduct expenses for vehicles:*

- *Always complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person.*
- *If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.*

	(a) Vehicle 1	(b) Vehicle 2	(c) Vehicle 3	(d) Vehicle 4	(e) Vehicle 5	(f) Vehicle 6
27 Total business/investment miles driven during the year (DO NOT include commuting miles)	270					
28 Total commuting miles driven during the year	2,200					
29 Total other personal (noncommuting) miles driven	7,830					
30 Total miles driven during the year. Add lines 27 through 29.	10,300					

	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
31 Was the vehicle available for personal use during off-duty hours?	✓											
32 Was the vehicle used primarily by a more than 5% owner or related person?	✓											
33 Is another vehicle available for personal use?	✓											

Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B. **Note:** *Section B must always be completed for vehicles used by sole proprietors, partners, or other more than 5% owners or related persons.*

	Yes	No
34 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
35 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? (See instructions for vehicles used by corporate officers, directors, or 1% or more owners.)		
36 Do you treat all use of vehicles by employees as personal use?		
37 Do you provide more than five vehicles to your employees and retain the information received from your employees concerning the use of the vehicles?		
38 Do you meet the requirements concerning qualified automobile demonstration use (see instructions)? . .		

Note: *If your answer to 34, 35, 36, 37, or 38 is "Yes," you need not complete Section B for the covered vehicles.*

Part VI **Amortization**

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
39 Amortization of costs that begins during your 1994 tax year:					

40 Amortization of costs that began before 1994 . . . . . **40**

41 **Total.** Enter here and on "Other Deductions" or "Other Expenses" line of your return . . . **41**

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We examine returns for correctness of income, exemptions, credits, and deductions.

Fairness if Your Return is Examined

Most taxpayers' returns are accepted as filed. But if your return is selected for examination, it does not suggest that you are dishonest. The examination may or may not result in more tax. Your case may be closed without change. Or, you may receive a refund.

Courtesy and consideration. You are entitled to courteous and considerate treatment from IRS employees at all times. If you ever feel that you are not being treated with fairness, courtesy, and consideration by an IRS employee, you should tell the employee's supervisor. Publication 1, *Your Rights as a Taxpayer,* explains the many rights you have as a taxpayer. You can get free publications by calling our toll-free number.

Pay only the required tax. You have the right to plan your business and personal finances in such a way that you will pay the least tax that is due under the law. You are liable only for the correct amount of tax. Our purpose is to apply the law consistently and fairly to all taxpayers.

Privacy and confidentiality. You have the right to have your tax case kept confidential. Under the law, the IRS must protect the privacy of your tax information. However, if a lien or a lawsuit is filed, certain aspects of your tax case will become public record. People who prepare your return or represent you must also keep your information confidential.

You also have the right to know why we are asking you for the information, exactly how we will use it, and what might happen if you do not give it.

Examination of Returns

An examination usually begins when we notify you that your return has been selected. We will tell you which records you will need. If you gather your records before the examination, it can be completed with the least amount of effort.

How returns are selected. We select returns for examination by several methods. A computer program called the Discriminant Function System (DIF) is used to select most returns. In this method, the computer uses historical data to give parts of the return a score. IRS personnel then screen the return.

Some returns are selected at random. We use the results of examining these returns to update and improve our selection process.

We also select returns by examining claims for credit or refund and by matching information documents, such as Forms W–2 and the 1099 series, with returns.

Arranging the examination. Many examinations are handled by mail. However, if we notify you that your examination is to be conducted through a personal interview, or if you request an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If the time or place we suggest is not convenient, the examiner will try to work out something more suitable. However, we will make the final determination on how, when, and where an examination takes place.

Transfers to another district. Generally, your individual return is examined in the IRS district office nearest your home. However, not all offices have examination facilities. Your business return is examined where your books and records are maintained. If the place of examination is not convenient, you may ask to have the examination done in another office or transferred to a different district.

Representation. Throughout the examination, you may represent yourself, have someone else accompany you, or, with proper written authorization, have someone represent you in your absence. If you want to consult an attorney, an enrolled agent, a C.P.A., or any other person permitted to represent a taxpayer during an examination, we will stop and reschedule the interview. We cannot suspend the interview if you are there because of an administrative summons.

Recordings. You can generally make an audio recording of an interview with an IRS Examination officer. Your request to record the interview should be made in writing. You must notify us at least 10 days before the meeting and bring your own recording equipment. We also can record an interview. If we initiate the recording, we will notify you 10 days before the meeting, and you can get a copy of the recording at your expense.

Repeat examinations. We try to avoid repeat examinations of the same items, but sometimes this happens. If we examined your tax return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so that we can see if we should discontinue the examination.

Explanation of changes. If we propose any changes to your return, we will explain the reasons for the changes. It is important that you understand the reasons for any proposed change. You should not hesitate to ask about anything that is unclear to you.

Agreement with changes. If you agree with the proposed changes, you may sign an agreement form and pay any additional tax you may owe. You must pay interest on any additional tax. If you pay when you sign the agreement, the interest is generally figured from the due date of your return to the date you paid.

If you do not pay the additional tax when you sign the agreement, you will receive a bill. The interest on the additional tax is generally figured from the due date of your return to the billing date. However, you will not be billed for more than 30 days additional interest, even if the bill is delayed.

If you are due a refund, we can refund your money more quickly if you sign the agreement form. You will be paid interest on the refund.

Appealing the Examination Findings

If you do not agree with the examiner's report, you may meet with the examiner's supervisor to discuss your case further. If you still do not agree after receiving the examiner's findings, you have the right to appeal them. The examiner will explain your appeal rights and give you a copy of Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases.* This free publication explains your appeal rights in detail and tells you exactly what to do if you want to appeal.

Appeals Office. You can appeal the findings of an examination within the IRS through our Appeals Office. The Appeals Office is independent of your examiner and IRS District Director or Service Center Director. Most differences can be settled through this appeals system without expensive and time-consuming court trials. If the matter cannot be settled to your satisfaction in Appeals, you can take your case to court.

Appeals to the courts. Depending on whether you first pay the disputed tax, you can take your case to the U.S. Tax Court, the U.S. Court of Federal Claims, or your U.S. District Court. These courts are entirely independent of the IRS. However, a U.S. Tax Court case is generally reviewed by our Appeals Office before it is heard by the Tax Court. As always, you can represent yourself or have someone admitted to practice before the court represent you.

If you did not yet pay the additional tax and you disagree about whether you owe it, you generally have the right to take your case to the Tax Court. We will mail you a formal notice (called a ''notice of deficiency'') telling you that you owe additional tax. You ordinarily have 90 days to file a petition with the Tax Court.

If you have already paid the disputed tax in full and filed a claim for refund (discussed later) for it that we disallowed (or on which we did not take action within 6 months), you may take your case to the U.S. District Court or U.S. Court of Federal Claims.

Court decisions. We follow Supreme Court decisions. However, we can lose cases in other courts involving taxpayers with the same issue and still apply our interpretation of the law to your situation. You have the right to appeal our decision to do so.

Recovering litigation expenses. If the court agrees with

you on most of the issues in your case, and finds the IRS's position to be largely unjustified, you may be able to recover some of your litigation expenses from us. But to do this, you must have used up all the administrative remedies available to you within the IRS, including going through our Appeals system. You may also be able to recover administrative expenses from the IRS. Free Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund,* explains your appeal rights.

Other remedies. If you believe that tax, penalty, or interest was unjustly charged, you have rights that can remedy the situation.

Claims for refund. Once you have paid your tax, you have the right to file a claim for a credit or refund if you believe the tax is too much. The procedure for filing a claim is explained in Chapter 1.

Cancellation of penalties. You have the right to ask that certain penalties (but not interest, as discussed later) be canceled (abated) if you can show reasonable cause for the failure that led to the penalty (or can show that you exercised due diligence, if that is the standard for the penalty).

If you relied on wrong advice given to you by IRS employees on the toll-free telephone system, we will cancel certain penalties that may result. But you have to show that your reliance on the advice was reasonable.

Reduction of interest. If our error caused a delay in your case, and this is grossly unfair, you may be entitled to a reduction of the interest that would otherwise be due. Only delays caused by procedural or mechanical acts that do not involve exercising judgment or discretion qualify. If you think we caused such a delay, please discuss it with the examiner and file a claim.