Income – Wages, Interest, Etc.

Introduction

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

Objectives

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

- Compute taxable and nontaxable income
- Distinguish between earned and unearned income
- Report income correctly on Form 1040

The following chart will help you select the appropriate topic for your certification course.

What do I need?

- ☐ Form 13614-C
- ☐ Publication 4012
- ☐ Publication 17

Optional:

- ☐ Form 1040 Instructions
- ☐ Form 1099-PATR
- ☐ Schedule B
- ☐ Publication 531
- ☐ Publication 550
- ☐ Publication 926
- ☐ Publication 970

	Certification Course			
	Basic	Advanced	Military	International
Wages & Reported Tips	■	■		
Unreported Tip Income		■		
Scholarship and Fellowship Income	■	■		
Interest Income	■	■		
Dividend Income	■	■		
Taxable Refunds	■	■		
Alimony Received	■	■		
Business Income		■		
Capital Gain/Loss		■		
Other Gains/Losses	N/A	N/A	N/A	N/A
IRA Distributions*	■	■		
Pensions/Annuities*	■	■		
Rental Income			■	
Schedule K-1 Distributions		■		
Farm Income	N/A	N/A	N/A	N/A
Unemployment Compensation	■	■		
Social Security Benefits	■	■		
Other Income	■	■		
Foreign Earned Income				■
Military Income			■	
*Basic only if the taxable amount is already determined.				

How do I determine taxable and nontaxable income?

The Income Quick Reference Guide in the Volunteer Resource Guide, Tab D, Income, includes examples of taxable and nontaxable income.

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

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

What are types of taxable income?

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

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

What are examples of nontaxable or exempt income?

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

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

Under the Victims of Terrorism Tax Relief Act of 2001, the following amounts are not included in income:

- Certain disability payments received in tax years ending after September 10, 2001, for injuries sustained in a terrorist attack
- Payments from the September 11th Victim Compensation Fund of 2001
- Qualified disaster relief payments made after September 10, 2001, to cover personal, family, living, or funeral expenses incurred because of a terrorist attack
- Death benefits paid by an employer to the survivor of an employee if the benefits are paid because the employee died as a result of a terrorist attack

The Act also provides that the federal income tax liability of those who died as a result of the following attacks is forgiven for certain tax years:

- The September 11, 2001 attacks on the World Trade Center, the Pentagon, and United Airlines Flight 93 in Somerset County, Pennsylvania
- Terrorist attacks involving anthrax occurring after September 10, 2001, and before January 1, 2002
- The April 19, 1995 attack on the Alfred P. Murrah Federal Building

For additional details, see Publication 3920, Tax Relief for Victims of Terrorist Attacks.

How do I get started?

To determine a taxpayer's income, discuss and review the Income section of the intake and interview sheet with the taxpayer.

Income is reported on a variety of forms depending on its source. Ask taxpayers to show you all Forms W-2, Forms 1099, and other statements reporting income. Also ask taxpayers if they received income that was not reported on a tax form, such as odd jobs or tips from customers. (Do not confuse Form 1099 with Form 1098. Generally, Form 1098 reports expenses the taxpayers have paid, not income they have received.)

Tax Software Hint: After you have collected all the income statements, review the pages on Income Documents and How/Where to Enter Income in the Volunteer Resource Guide, Tab D, Income. These pages will show you where to correctly report income items.

CAUTION Taxpayers who transact in or trade any virtual currency should be referred to a professional tax preparer. Identify these situations as early in the interview as possible.

How do I report wages, salaries, tips, etc.?

What is Form W-2?

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

TIP Additional Medicare Tax applies to an individual's wages, Railroad Retirement Tax Act compensation, and self-employment income that exceeds a threshold amount based on the individual's filing status. This topic is out of scope for the VITA/TCE programs. Taxpayers affected by the Additional Medicare Tax should be referred to a professional tax preparer. Additional information can be found on **https://www.irs.gov**

TIP A Form W-2 with code Q in Box 12, indicating combat pay, requires Military certification to complete the return.

Tax Software Hint: Refer to the Volunteer Resource Guide, Tab D, Income, for instructions on entering income. Once you enter all Forms W-2 into the software, it carries the total to Form 1040 and transfers necessary information for credits, deductions, withholding, etc., to other sections of the tax return.

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

Taxpayers who do not receive Form W-2 by January 31 should first contact the employer and find out if, or when, the form was mailed, or if it can be picked up or accessed online.

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

If taxpayers do not receive Form W-2 before the filing deadline, they should file their tax return with Form 4852, Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. Taxpayers will need to provide the information required to complete Form 4852, such as the last paycheck stub. Taxpayers should keep a copy of Form 4852 for their records. Usually, Form 4852 can be filed with a state return as well.

TIP If the taxpayer eventually receives the employer's Form W-2, and the numbers differ from those on Form 4852, the taxpayer will need to amend the return to report the correct amounts.

If the earnings reported on Form 4852 are not reflected on the taxpayer's Social Security Statement, the taxpayer should contact the Social Security Administration at the number shown on the statement. See Publication 5396-A: Job Aid for VITA/TCE Volunteers: Using Form 4852 when Missing the Form W-2 or 1099-R (PDF) for help completing the form.

example

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

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

Use the taxpayer's ITIN when starting the return. Enter the Social Security number as shown on the Form W-2 when prompted by the tax software. Refer to the Volunteer Resource Guide, Tab D, Income, for instructions.

What is Box 10, Dependent Care Benefits?

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

What do Box 12 codes mean?

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

The tax software will automatically transfer qualified voluntary retirement contributions to Form 8880, Credit for Qualified Retirement Savings Contributions, for the retirement savings credit. Refer to the Volunteer Resource Guide, Tab G, Nonrefundable Credits, for instructions on how to enter these amounts. Also see the Miscellaneous Credits lesson.

CAUTION Code FF in Box 12 of a Form W-2 indicates a Qualified Small Employer Health Reimbursement Arrangement (QSEHRA) and is out of scope for the VITA/TCE programs.

Other W-2 Income

Can a disability pension be treated as wages?

An individual who has not reached their employer's minimum retirement age and is receiving a disability pension may report the disability pension as wages for tax purposes, such as the earned income credit. This is discussed in the Retirement Income lesson.

What about income received by household employees?

The term "household employee" refers to an individual who works in someone's home performing household duties such as caring for children, cleaning, or cooking. Generally, an employer is not required to provide Form W-2 to a household employee who earns less than the threshold amount for that year. In this situation, neither the employer nor the employee will owe Social Security or Medicare tax on those wages. However, employers who withhold federal income taxes from their employee's wages must issue Form W-2. Regardless of whether Form W-2 is issued, the income must be included on Form 1040.

TIP For further information and a definition of who is a household employee, see Publication 926, Household Employers Tax Guide.

What about Qualified Medicaid Waiver Payments?

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

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

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

Taxpayers who excluded qualified Medicaid waiver payments from gross income in prior tax years may amend a return for any open tax years to include Medicaid waiver payments in earned income for the EIC and ACTC.

For more information, refer to the Volunteer Resource Guide, Tab D, Income, Entering Medicaid Waiver Payments.

Tip Income

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

If taxpayers have jobs in which tips are normally received (e.g., waiter/waitress, bellhop, or motel/hotel housekeeper), be sure to ask about any tips they may have received. All tip income is taxable, whether or not it is reported to the employer.

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

What are allocated tips?

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

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

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

What about unreported tips?

An individual is not required to report tip income to their employer if it is $20 or less per month. Since these tips are subject to federal income tax, ask taxpayers if they have any tip income that was not reported to their employer.

Other Tips

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

Tax Software Hint: If the taxpayer has unreported tip income, enter the income on Form W-2, unreported tip income box. This will initiate Form 4137. Refer to the Volunteer Resource Guide, Tab D, Income, for instructions on how to enter tip income.

TIP For more information about tip income, see Publication 531, Reporting Tip Income.

What is penal income (or prisoner income)?

An individual may be compensated while in a penal institution, a work-release program, or in a halfway house. The compensation will be reported on Form W-2 but it is not treated as earned income for most tax benefits, such as the earned income credit. The amount is reported as wages on Form 1040 and is shown as "PRI" on the dotted line next to the wages line. Refer to the Volunteer Resource Guide, Tab D, Income, for instructions on how to identify and enter penal income, also known as prisoner income.

Scholarship and Fellowship Income (Form W-2 and Form 1098-T)

Are scholarships and fellowships taxable income?

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

- Payment for services
- Money used for personal living expenses, such as room and board

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

Form 1098-T lists qualified tuition and related expenses paid to the school. Verify that these amounts have been paid by reviewing the student's detailed financial account transcript which lists scholarship and grant money the student received. If scholarships or grants exceed the qualified educational costs, some of the grant or scholarship may be taxable.

In certain situations, the student may choose to include all or part of certain scholarships or grants in income in order to increase an education credit. This is explained in the education credits lesson, and examples can be found in the Form 8863 Instructions and Publication 970, Tax Benefits for Education.

Tax Software Hint: Taxable scholarships are entered into the software in the Income>Less Common Income>Other compensation> Scholarships and Grants section, but are shown as part of Wages on the tax return with "SCH" printed on the line. Refer to the Volunteer Resource Guide for specific entries.

What about higher education emergency financial aid grants?

Emergency financial aid grants under the CARES Act for unexpected expenses, unmet financial need, or expenses related to the disruption of campus operations due to the COVID-19 pandemic, such as unexpected expenses for food, housing, course materials, technology, health care, or childcare, are qualified disaster relief payments under section 139 of the Internal Revenue Code. This grant is not includible in gross income.

Because the emergency financial aid grant is not includible in gross income, taxpayers cannot claim any deduction or credit for expenses paid with the grant including the tuition and fees deduction, the American opportunity credit, or the lifetime learning credit.

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

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

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

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

What about ministers or other members of the clergy?

The ministry profession presents unique issues, such as the parsonage/housing allowance, whether earnings are covered under FICA or SECA (self employment tax), and the rules for being exempt. Publication 517, Social Security and Other Information for Members of the Clergy and Religious Workers, covers this topic. This information is provided for awareness only and is out of scope for the VITA/TCE programs. Taxpayers who have these issues should be referred to a professional tax preparer.

What interest is taxable?

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

TIP If a taxpayer received less than $10 in interest, the financial institution might not issue Form 1099-INT. Even if the taxpayer did not receive Form 1099-INT, they must still report all of their taxable interest income. The interest amount for the year will typically be shown on the December statement.

CAUTION If the FATCA (Foreign Account Tax Compliance Act) filing requirement box is checked on Forms 1099-INT, 1099-DIV, or any other income reporting document, the taxpayer may have a FATCA filing requirement. Refer these taxpayers to a professional tax preparer.

Where do I get interest income information?

There are many sources of information about interest income. Ask the taxpayer to supply all Form(s) 1099-INT from institutions that pay interest. Some institutions issue a year-end summary statement with the title "In lieu of Form 1099-INT or Form 1099-DIV" rather than preparing multiple documents for each account.

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

TIP Entries in Boxes 10,11,12 and 13 of Form 1099-INT, and Boxes 5 and 10 of Form 1099-OID are in scope. Enter the information just as it appears on the information reporting documents (type what you see) and TaxSlayer software will complete the calculations.

If the amount reported in Box 11 exceeds the amount reported in Box 1, the return is out of scope.

If the amount reported in Box 12 exceeds the amount reported in Box 3, or if the amount reported in Box 13 exceeds the amount reported in Box 8, the return is also out of scope.

If the taxpayers cashed in Series EE or Series I bonds, they should have received a Form 1099-INT. Most taxpayers report the total interest when they cash in the bonds. Few taxpayers elect to report savings bond interest as it accrues each year. This method is out of scope for the volunteer program and taxpayers should be referred to a professional tax preparer.

TIP Interest on qualified U.S. Series EE and Series I savings bonds that are used to pay for higher education expenses may be eligible for exclusion from income using Form 8815, Exclusion of Interest From Series EE and Series I U.S. Savings Bonds Issued After 1989. Form 8815 is out of scope for the VITA/TCE programs.

TIP A Net Investment Income Tax applies to individuals, estates and trusts that have certain investment income above certain threshold amounts. This topic is out of scope for the VITA/TCE programs. Taxpayers affected by the Net Investment Income Tax should be referred to a professional tax preparer. Additional information can be found in Publication 17 or on **https://www.irs.gov**

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

Publication 17, Interest Income.

- Taxpayers with Series HH bonds receive interest twice a year.
- Ask the taxpayer for all tax statements reporting the interest received.
- Ask if the taxpayer holds any loans or seller-financed mortgages.

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

example

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

example

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

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

TIP Interest from U.S. government obligations is not taxable by any state. Refer to the Volunteer Resource Guide, Tab D, Income, for the entries needed to identify the interest that is not taxable for state purposes.

What interest income is tax-exempt?

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

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

- State and political subdivisions (county or city)
- District of Columbia
- U.S. possessions and political subdivisions
- Port authorities
- Toll-road commissions
- Utility service authorities
- Community redevelopment agencies
- Qualified volunteer fire departments
- Amounts indicated on broker statements as tax-exempt interest or tax-exempt dividends

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

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

Interest from Private Activity Bonds (PAB) may be shown on the interest statement. It is a subset of tax-exempt interest and may affect the Alternative Minimum Tax. Taxpayers who are subject to the Alternative Minimum Tax should be referred to a professional tax preparer. Although tax-exempt interest is not taxable, it must be reported on Form 1040. Tax-exempt interest is used in calculating the taxability of some income items, such as Social Security benefits.

What if a bond is sold between interest payment dates?

If a bond is sold between interest payment dates, part of the sales price represents interest accrued to the date of the sale. This amount is taxable to the seller and must be reported as interest income for that tax year, even if the seller does not receive a Form 1099-INT. The buyers of the bond may receive a 1099-INT reflecting the accrued interest and will treat this amount as a return of capital investment, reducing their basis in the bond. Payers and brokers will report the correct amount of interest on the Form 1099-INT/OID for all covered securities. Taxpayers who sell noncovered bonds between interest payment dates should be referred to a professional tax preparer. If taxpayers would like additional information, refer them to Publication 550, Investment Income and Expenses.

Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide, Tab D, Income, Interest Income entries.

What about the interest on an IRA?

Generally, interest on a Roth IRA is not taxable. However, if the criteria for distribution are not followed, the interest is taxable.

Interest on a traditional IRA is tax-deferred. Do not include that interest in taxable income until the taxpayer receives distributions from the IRA, which will be reported on Form 1099-R. See the Retirement Income lesson, Publication 17, and Publication 590 for more information on IRAs.

example

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

How do I report interest income?

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

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

On Form 1099-INT, if the box labeled Specified private activity bond interest contains an amount, the alternative minimum tax (AMT) may apply, and the taxpayer should be referred to a professional tax preparer. If taxpayers indicate there are adjustments needed for any of the amounts listed on Form 1099-OID, or if they have income from original issue discount but did not receive a Form 1099-OID, refer them to a professional tax preparer to ensure the correct amount is reported.

Tax Software Hint: Refer to the Volunteer Resource Guide, Tab D, Income, for instructions on entering interest income. The software will file Schedule B if required.

Taxpayer Interview and Tax Law Application

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

SAMPLE INTERVIEW

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

How do I handle dividends?

The corporate distributions that volunteer tax preparers may handle are:

- Ordinary dividends

- Section 199A dividends
- Qualified dividends
- Capital gain distributions
- Nondividend distributions

These are all reported on Form 1099-DIV.

What are ordinary dividends?

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

example

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

What are Section 199A dividends?

A subset of ordinary dividends is called Section 199A dividends, which are eligible for the qualified business income deduction. See the Standard Deduction lesson for this deduction and the Volunteer Resource Guide, Tab D, Income, for software entries.

What are qualified dividends?

Qualified dividends are ordinary dividends that qualify for lower, long-term capital gains tax rates. See Publication 17, Dividends and Other Distributions chapter, for a detailed definition of qualified dividends.

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

What are capital gain distributions?

Capital gain distributions are also called capital gain dividends. They come from mutual funds and real estate investment trusts (REITs). They are taxed at the lower long-term capital gains rate, regardless of how long the taxpayer holds the shares. Capital gain distributions are reported to the taxpayer on Form 1099-DIV. While you may enter these distributions in the dividend section of the software, these distributions will appear as long-term capital gains on Form 1040 and on Schedule D if required.

TIP Capital gains are not the same as capital gain distributions. A capital gain *distribution* is the owner's portion of the capital gains that were realized when the mutual fund or REIT sold assets. A volunteer with a Basic certification can prepare a return with this type of income.

A capital gain occurs when the owner of a mutual fund or other capital asset sells the asset for more than its cost. A volunteer must have Advanced certification to prepare a return for taxpayers who actually sold mutual fund shares, or other shares of stock.

What are nondividend distributions?

Form 1099-DIV also shows nondividend distributions, which is the part of a distribution that is nontaxable because it is a return of the taxpayer's cost or other basis in a stock or security. Brokers will keep track of these and other basis adjustments for covered securities. Otherwise, taxpayers should keep this information with their tax records in order to calculate the adjusted basis of the stock when it is sold.

example

During the tax year, Olivia owned shares in a mutual fund and in a real estate investment trust. Both made capital gain distributions that year. The following January she received Forms 1099-DIV listing these capital gain distributions.

Where do I get dividend information?

Taxpayers that hold their securities in a brokerage account will receive Form 1099-DIV from their broker. For stocks held directly, corporations use Form 1099-DIV to report dividend distributions to each shareholder. Ask the taxpayer for any Form(s) 1099-DIV. If the taxpayers did not receive a Form 1099-DIV for a dividend, they should contact the payer or their broker to get the needed forms.

What about Patronage dividends on Form 1099-PATR?

Form 1099-PATR, Box 1, shows patronage dividends paid to the taxpayer during the year in cash, qualified written notices of allocation (at stated dollar value), or other property (not including nonqualified allocations). Any dividends paid on property bought for personal use are not taxable. Ask the taxpayer if the patronage dividends are only for personal consumption of goods. Only when the dividends are not taxable are they in scope. In this case, it is not necessary to enter the dividend into the software.

How do I report dividend information?

Generally, all dividend income is reported on Form 1040. Schedule B may be needed if the taxpayer's ordinary dividends exceed a specified amount, or if the taxpayer was the nominee for dividends that actually belong to someone else. On Form 1099-DIV, amounts included in boxes labeled Unrecap. Sec. 1250 gain, Section 1202 gain, Cash liquidation distributions, and Noncash liquidation distributions are out of scope for the VITA/TCE programs. Refer taxpayers with amounts in these boxes to a professional tax preparer.

Any federal income tax withheld shown on a Form 1099-DIV is reported on the federal income tax withheld line of the return. Foreign tax paid will be covered in the Foreign Tax Credit lesson.

Tax Software Hint: Review the Volunteer Resource Guide, Tab D, Income, for guidance for entering dividend income. If the taxpayer has multiple accounts, the software will add all the dividends for you, preventing math errors.

Taxpayer Interview and Tax Law Application

Leonard and Gloria are filing a joint return. Leonard and the volunteer are discussing dividend income.

SAMPLE INTERVIEW

VOLUNTEER SAYS...	LEONARD RESPONDS...
Do you and your wife own shares of stock, mutual funds, or bond funds?	Yes, I have an IRA and I own shares in several mutual funds and a bond fund. My wife has an IRA. Here are the statements.
The earnings on the IRAs are tax deferred until you take a distribution. These 1099-DIVs are what we want right now. Are these the only Forms 1099-DIV that you received?	Yes
We will enter the information from each of these in the tax software. It will add everything up and display it properly on your tax return.	

How do I report a refund of state or local income taxes?

Taxpayers who receive a refund of state or local income taxes may receive Form 1099-G reporting their refund amount(s). Only taxpayers who itemized and received a federal income tax benefit for deducting their state or local income taxes have to include their state/local tax refunds in income. Not everyone must include the refund in their taxable income.

- Taxpayers who claimed the standard deduction on the tax return for the year they received a refund of state or local income taxes do not have to include the refund in their taxable income.
- Taxpayers who itemized and deducted the state sales tax instead of the state income tax withheld or paid do not have to include the refund in their taxable income.
- Some taxpayers could not deduct all their state income taxes because of the annual cap on state and local taxes deduction. Refer to the Volunteer Resource Guide, Tab D, Income, for the State and Local Refund Worksheet in the software to determine the amount, if any, of the refund that is taxable.

example

Nancy itemized her deductions on last year's federal return. She included the income taxes paid to her state on Schedule A. During the current tax year, she received a state refund on the overpaid portion of those taxes. When filing her current year tax return, she must use the state tax refund worksheet to see how much of the refund to include in her federal taxable income.

CAUTION Refer taxpayers who received a state or local income tax refund for a year other than the previous tax year to a professional tax preparer.

What is alimony?

Alimony is a payment to or for a spouse or former spouse under a separation or divorce instrument. It may include payments on behalf of the spouse or former spouse, such as medical bills, housing costs, and other expenses. It does not include child support or voluntary payments outside the instrument.

Post-1984 and Pre-2019 Divorces

The person receiving alimony must include it as income. The person paying alimony can subtract it as an adjustment to income. Both items are reported on Form 1040, Schedule 1. The date of divorce or separation agreement must also be provided.

TIP If the taxpayer is unsure whether a payment is alimony or child support, ask if the payments will stop once the child is grown.

TIP Alimony income received under a pre-2019 divorce or separation instrument is unearned income. However, it is considered compensation, which may allow the taxpayer receiving alimony income to make a deductible traditional IRA or nondeductible Roth IRA contribution.

TIP If the agreement was executed before 1985, refer the taxpayer to a professional tax preparer.

Where do I get alimony information?

Ask if the taxpayer received alimony under a divorce or separation instrument. If so, explain that you need the exact amount, since it may also be reported as a deduction by the payor, and the two amounts must agree.

How do I report alimony income?

Tax Software Hint: Enter any alimony income on the alimony received screen. The Social Security number of the person paying the alimony is not needed.

Post-2018 Divorces

The Tax Cuts and Jobs Act provides that alimony and separate maintenance payments are not deductible by the payor spouse and repeals the code provisions that specify that alimony and separate maintenance payments are included in income by the recipient of the payments.

This treatment is effective for any divorce or separation instrument executed after December 31, 2018, or for any divorce or separation instrument executed on or before December 31, 2018, and modified after that date, if the modification expressly provides that the amendments made by the Tax Cuts and Jobs Act, Section 11051, apply to such modification.

Summary

This lesson covered income reported on Form 1040, including how to differentiate taxable and nontaxable income, and earned or unearned income.

- Earned income is any income received for work, such as wages or business/self-employment income.
- Unearned income is any income produced by investments, such as interest on savings, dividends on stocks, or rental income.
- The Form 1040 wages, salaries, tips, etc. line includes wages, salaries, tips, and scholarships usually reported to the taxpayer on Form W-2. Taxable scholarships or household employee income are shown on the same line even when not shown on a Form W-2.
- Common sources of taxable interest income are checking and savings accounts, certificates of deposit

(CDs), savings certificates, or U.S. government bonds. This interest is reported by the payer on Form 1099-INT and included in the taxpayer's income on Form 1040.

- Interest on certain bonds, such as from state political subdivisions, District of Columbia, or port authorities, are exempt from federal income tax but must be reported on Form 1040.
- Dividends are reported to the taxpayer on Form 1099-DIV. Ordinary dividends are corporate distributions paid out of the earnings and profits of a corporation. Qualified dividends are ordinary dividends that qualify for lower, long-term capital gains tax rates. Capital gain distributions are reported on Form 1040 and Schedule D, if required.
- Taxpayers who itemized deductions in the previous year and received a tax benefit from deducting state or local income taxes may have to report part or all of their refund as income. Taxpayers generally receive Form 1099-G reporting their state or local tax refund.
- Alimony is income received from a spouse or former spouse under a separation or divorce instrument. If the alimony was paid pursuant to a divorce or separation instrument executed on or before December 31, 2018, it is taxable income and included on Form 1040, Schedule 1.

What situations are out of scope for the VITA/TCE programs?

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

- Taxpayers with income from the following sources:
  - Other gains/losses
  - Farm income
- Taxpayers affected by the Additional Medicare Tax
- Taxpayers who use the accrual method for reporting income
- Taxpayers who buy or sell noncovered bonds between interest payment dates
- Form 1099-INT amounts reported in the box labeled Specified private activity bond interest if AMT applies
- Adjustments needed for any of the amounts reported on Form 1099-OID, or if the taxpayer should have received Form 1099-OID but did not receive one
- Form 1099-DIV amounts reported in the boxes labeled Unrecap. Sec. 1250 gain, Section 1202 gain, Cash liquidation distributions, and Noncash liquidation distributions
- State or local income tax refunds received during the current tax year for a year other than the previous tax year
- Alimony/divorce agreements executed before 1985
- Tax returns for ministers and members of the clergy because of unique tax issues

TAX LAW APPLICATION

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.