Introduction

This lesson will help you determine other forms of income and how to report other sources of income. Part of the lesson is for all course levels and part is only for the International level.

The International part of this lesson will help you report income earned from worldwide sources. To do this, you need to be able to identify the type of income and, if reportable, convert it to the equivalent U.S. dollar value of the foreign currency.

This lesson will cover the foreign earned income exclusion reported on Form 2555, Foreign Earned Income.

Objectives

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

• Other types of income and how to report other sources of income
• Determine the requirements for the cancellation of debt on nonbusiness credit card debt when preparing tax returns
• Determine when canceled credit card debt is included in gross income on Form 1040
• How to properly report income earned from worldwide sources
• Who is eligible for the foreign income exclusion and how to calculate the excludable amount using Form 2555, Foreign Earned Income

What is other income?

Income that does not have its own line on Form 1040 is generally reported on the Form 1040, Schedule 1. Here are some examples:

• Prizes and awards
• Gambling winnings, including lotteries and raffles
• Jury duty pay
• Alaska Permanent Fund dividends
• Recovery of a deduction claimed in a prior year
• Nonbusiness credit card debt cancellation

Even if the taxpayer does not receive an income document from the payer, the taxpayer is required to report the income.

What do I need?

□ Form 13614-C
□ Publication 4012
□ Publication 17
□ Publication 54
□ Form 1040 Instructions
□ Form 1099-NEC
□ Form 2555

Optional:

□ Publication 525
□ Publication 970
□ Form W-2G
□ Form 1099-MISC
□ Form 1099-Q

TIP

The Economic Impact Payment is not taxable and not includible in gross income. Also, a payment will not affect income for purposes of determining eligibility for federal government assistance or benefit programs.
If you are unsure about sources of other income, consult the Volunteer Resource Guide, Tab D, Income, and Publication 17, Other Income, or discuss the income item with your Site Coordinator.

Use the interview techniques and tools discussed in earlier lessons to ensure that all taxable income has been included.

**Health Savings Accounts (HSA)**

HSA distributions not used to pay or reimburse the taxpayer for qualified medical expenses are generally reported as additional income on Form 1040, Schedule 1. This topic is not covered in this lesson, it is covered in the Adjustments lesson.

**What are some examples of other income?**

**Gambling Winnings**

The taxpayer may receive one or more Forms W-2G reporting gambling winnings. Total gambling winnings must be reported as other income. If the taxpayer also had gambling losses, the losses can only be deducted on Schedule A. See the Itemized Deductions lesson for more details.

![Tax Software Hint: To review information related to reporting gambling income, go to the Volunteer Resource Guide, Tab D, Income, Income Quick Reference Guide.](image)

**Cash for Keys Program**

Cash for Keys Program income, which is taxable, is income from a financial institution, offered to taxpayers to expedite the foreclosure process. The taxpayers should receive Form 1099-MISC with the income in Box 3.

**Penal Income**

Amounts received for work performed while an inmate is in a penal institution aren’t earned income for the earned income credit. This includes amounts received for work performed while in a work release program or while in a halfway house. Any amount received for work done while an inmate in a penal institution is included in wages. See the Volunteer Resource Guide, Tab D, Income, for instructions on entering penal income in the software.

![CAUTION: Under the PATH Act, a wrongfully incarcerated individual does not include in income any civil damages, restitution, or other monetary award received that relates to his or her incarceration.](image)

**Qualified Medicaid Waiver Payments**

Qualified Medicaid waiver payments may be excluded from gross income. To be qualified Medicaid waiver payments, the care provider and the care recipient must reside in the same home. When the care provider and the care recipient do not live together in the same home, the Medicaid waiver payments are fully taxable.

A taxpayer may choose to include qualified Medicaid waiver payments in the calculation of earned income for the earned income credit (EIC) and the 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.
Are distributions from ABLE accounts taxable?

A qualified ABLE program is a program established and maintained by a state agency under which a person may make cash contributions to an ABLE account to pay for the qualified disability expenses of an eligible individual (the designated beneficiary). Qualified beneficiaries can have only one ABLE account. Contributions are made in after-tax dollars and can be made by any person. Contributions must be made in cash and are not deductible for federal income tax purposes.

Distributions from an ABLE account that do not exceed the qualified disability expenses of the beneficiary during the taxable year are excluded from gross income. A distribution from an ABLE account that exceeds the qualified disability expenses of the beneficiary is included in the beneficiary’s gross income and is subject to an additional tax of 10% imposed on the amount not used for qualified disability expenses. Taxable distributions from ABLE accounts are out of scope for the VITA/TCE programs.

Qualified disability expenses include: education, housing, transportation, employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, funeral and burial expenses.

Form 1099-QA, Distributions from ABLE Accounts, is used to report distributions from an ABLE Account.

Are distributions from an Educational Savings Account (ESA), such as a Coverdell ESA and a 529 plan, taxable?

Distributions from Coverdell ESAs and Qualified Tuition Plans (QTPs) are reported on Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530). Coverdell ESA distributions can be used to pay for qualified elementary, secondary, and postsecondary expenses. QTP distributions may also be used for qualified educational expenses for elementary and secondary public, private, and religious schools of up to $10,000 per year for each qualified beneficiary, certain expenses of an apprenticeship program, and the principal or interest on a qualified education loan up to a lifetime limit of $10,000 per beneficiary.

A portion of the distributions is generally taxable to the beneficiary if the total distributions are more than the beneficiary’s adjusted qualified education expenses for the year. Qualified education expenses are discussed in more detail in the Education Credits lesson.

The taxable portion is the amount of the excess distribution that represents earnings that have accumulated tax free in the account. The taxable amount must be reported as other income on the tax return. Taxable distributions from ESAs and QTPs are out of scope.

For additional information about educational savings accounts, distributions, and qualified education expenses, refer taxpayers to Publication 970, Tax Benefits for Education.

Is a recovery taxable?

Reimbursement in a later year for medical or other expenses deducted in an earlier year must be reported as income up to the amount previously deducted as medical or under another provision. However, do not report as income the amount of reimbursement received up to the amount of the prior year deductions that did not reduce the tax for the earlier year.
Cancellation of Debt – Nonbusiness Credit Card Debt

Cancellation of Debt – Basics

A debt includes any indebtedness for which a taxpayer is liable or which attaches to the taxpayer’s property, such as auto loans, credit card debt, medical care, professional services, mortgages, and home equity loans. Generally, if a debt for which a taxpayer is personally liable is canceled or forgiven, the taxpayer must include the canceled amount in income. There is no income from canceled debt if the cancellation or forgiveness of debt is a gift or bequest.

Use Form 13614-C, Intake/Interview & Quality Review Sheet, to determine if the taxpayer received one or both of Forms 1099-C, Cancellation of Debt, or 1099-A, Acquisition or Abandonment of Secured Property. Refer to the Legislative Extenders section for possible exclusion of cancellation of debt income on a main home.

Taxability of Canceled Debt

Taxpayers often question the taxability of canceled debt because they did not receive money in hand. In situations where property is surrendered, such as a foreclosure, taxpayers feel that by giving up the property they are relieved from any further obligation. Explain that the benefit to the taxpayer is the relief from personal liability to pay the debt. Information in Publication 17, Your Federal Income Tax for Individuals, can assist with the explanation. Refer to Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments.

Generally, when debt is canceled, the lender will issue Form 1099-C, Cancellation of Debt, which is then reported as income by the recipients on their tax return. There are exceptions and exclusions to the general rule that determines whether a canceled debt is included as income. This is covered in greater detail in the Legislative Extenders lesson and later in this lesson.

Form 1099-C

Generally, if a taxpayer receives Form 1099-C for canceled credit card debt and was solvent (assets greater than liabilities) immediately before the debt was canceled, all the canceled debt will be included on the tax return as other income.

Sometimes, Form 1099-C will show an interest amount in Box 3. Because only nonbusiness credit card debt income is in scope, any interest on the account would not have been deductible. The amount shown in Box 3 is included in Box 2; therefore, the full amount shown in Box 2 should be reported as other income.

**example**

John made a deal with his credit card company to pay $2,000 on his $7,000 balance, and the company agreed to take it as payment in full. In January of the current year, John received a Form 1099-C from his credit card company reporting $5,000 (the amount of debt canceled). John was solvent immediately before the debt was canceled. John must include the entire $5,000 as other income on his tax return.

Lenders and creditors are required to issue Form 1099-C if they cancel a debt of $600 or more. If the debt canceled is less than $600, some lenders or creditors may send a letter or some other form of notification to the taxpayer. Generally, taxpayers must include all canceled amounts (even if less than $600) in income.
Insolvency (Out of Scope for VITA/TCE)

Insolvency is a condition in which the fair market value (FMV) of all assets is less than one’s liabilities. The amount or level of insolvency is expressed as a negative net worth.

For purposes of determining insolvency, assets include the value of everything owned (including assets that serve as collateral for debt and exempt assets which are beyond the reach of creditors under the law, such as an interest in a pension plan and the value of a retirement account).

Liabilities are amounts owed and include:

- The entire amount of recourse debts
- The amount of nonrecourse debt that is not in excess of the FMV of the property and is security for the debt

Refer to the Insolvency Determination Worksheet in the Volunteer Resource Guide, Tab D, Income, as a resource. Taxpayers must determine if they are considered insolvent.

⚠️ If the taxpayer had nonbusiness credit card debt canceled, all or part of the debt may be excluded if the cancellation occurred in bankruptcy, or if the taxpayer was insolvent immediately before the cancellation. These situations are beyond the scope of VITA/TCE. If any of these situations apply, refer the taxpayer to a professional tax preparer. See IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments, for more information.

Publication 4731, Screening Sheet for Volunteers Assisting Taxpayers with Form 1099-C, located in the Volunteer Resource Guide, Tab D, Income, provides step-by-step guidance for the volunteer tax return preparer to determine if the cancellation of credit card debt is within scope.

Taxpayer Interview and Tax Law Application

Here is how a volunteer advised Michelle regarding her canceled credit card debt.

<table>
<thead>
<tr>
<th>SAMPLE INTERVIEW</th>
</tr>
</thead>
<tbody>
<tr>
<td>VOLUNTEER SAYS...</td>
</tr>
<tr>
<td>I notice you received a 1099-C from a credit card company.</td>
</tr>
<tr>
<td>Yes, Form 1099-C shows the amount of debt discharged.</td>
</tr>
<tr>
<td>Do you think your debts at the time exceeded your assets?</td>
</tr>
<tr>
<td>Let’s fill out the Insolvency Determination Worksheet to help us determine whether you were insolvent.</td>
</tr>
<tr>
<td>According to the worksheet, you are insolvent. I am afraid I am not able to help you. VITA/TCE volunteers are not trained to compute the nontaxable portion of canceled credit card debt.</td>
</tr>
<tr>
<td>I suggest you seek assistance from a professional tax preparer.</td>
</tr>
</tbody>
</table>
EXERCISES

Question 1: Greg was released from his obligation to pay $5,000 of personal credit card debt. The credit card company sent Form 1099-C showing canceled debt of $5,000. Greg is fairly certain he has more debt than he has assets.

Can the VITA/TCE site provide tax return preparation assistance to Greg?

A. Yes, since the entire $5,000 in canceled debt is considered income and reported on Form 1040.
B. No, because it appears Greg is insolvent, which might mean some of the canceled credit card debt would be nontaxable and beyond the scope of the VITA/TCE programs.

Question 2: Kay was released from her obligation to pay personal credit card debt. She owed $10,000 to her credit card company, which agreed to accept $2,500 as payment in full. Before paying the credit card company, it was determined Kay was solvent (assets greater than liabilities) and not in bankruptcy. The credit card company issued Kay a Form 1099-C, reporting $7,500 as the amount of debt discharged.

Based on the information above, can Kay be assisted at her local VITA/TCE site?  □ Yes  □ No

Question 3: Review the information in Question 2 about Kay’s canceled debt. If the VITA/TCE site is able to assist Kay, what amount would be reported on Kay’s Form 1040?

A. $0
B. $10,000
C. $2,500
D. $7,500
What is worldwide income?

U.S. citizens and U.S. resident aliens are required to report worldwide income on a U.S. tax return regardless of where they live and even if the income is taxed by the country in which it was earned. Filing requirements are the same as for U.S. citizens and U.S. resident aliens living in the United States and apply whether income is from within or outside the U.S.

U.S. citizens and U.S. resident aliens living abroad may be able to claim tax benefits such as the foreign earned income exclusion or the foreign tax credit. This part of the lesson covers the foreign earned income exclusion. The foreign tax credit will be covered in another lesson.

**example**

In the current year, Alfredo Kendall earned $40,000 while working in Dallas, Texas, for Dade Corporation. In September of this year, he transferred to their office in Stuttgart, Germany. While in Germany, he earned $30,000 (U.S. dollars). All of Alfredo’s wages, including the income he earned in Germany, is included in his gross income. His Form 1040 will show $70,000 in wages.

Income is treated the same on the return regardless of the country from which it is derived. Similar income earned inside or outside the U.S. is generally taxed in the same way on the return. Likewise, income earned in the U.S. and not taxed will be treated in the same way if earned outside the U.S. The lines on which income is reported on Form 1040 are the same whether the U.S. citizen or U.S. resident alien is living within or outside U.S. boundaries.

**TIP**

Foreign income might be reported to taxpayers on forms or in ways that are not used in the United States. Question taxpayers closely to ensure that they are reporting all worldwide income. Review the income records to ensure that includible amounts are accurate and complete.

**CAUTION**

Taxpayers with foreign income, bank accounts, or assets may have additional filing responsibilities, which are out of scope. See Schedule B and Form 8938 for additional information.

**Tax Software Hint:** To review information related to income from a foreign employer, go to the Volunteer Resource Guide, Tab D, Income.
**EXERCISES** (continued)

Answers are listed following the lesson summary.

**Question 4:** Marta Bremer, a U.S. citizen, lives in Mussbach, Germany. Her income included $22,000 in wages earned in Germany. She earned $300 in interest from her U.S. bank. What is Marta’s total income?

A. $0  
B. $22,300  
C. $300  
D. $22,000  

**Question 5:** Mary Carleton, a U.S. citizen, lives in Belgium. Her income included $10,000 in wages from her Belgian employer, $200 in interest from her U.S. bank, $8,000 in gambling winnings, and $7,000 in child support payments from her ex-spouse. What is Mary’s gross income?

A. $8,000  
B. $10,200  
C. $18,200  
D. $25,200

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**How do I convert foreign income to U.S. dollars?**

**Exchange rates**

All amounts on the U.S. tax return must be stated in U.S. dollars. Convert income that taxpayers received in foreign currency into U.S. dollars using the appropriate exchange rate. U.S. exchange rates are stated in two ways:

- Units of foreign currency to one U.S. dollar: 0.74855 Euro = 1 U.S. dollar
- U.S. dollars to one unit of the foreign currency: 1.33592 U.S. dollar = 1 Euro

⚠️ **Cautions:** Exchange rates shown here are for example only. Use the exchange rates in effect when the income was received.

To convert a sum of money into U.S. dollars, **divide** the amount of foreign currency by the exchange rate for the foreign currency to one U.S. dollar.

**example**

Ryan received 3,000 Euros (€3000) on a day that the exchange rate was 0.74855 Euros to one U.S. dollar. Based on this exchange rate, the value of Ryan’s €3000 is: €3000 ÷ 0.74855 = $4,007.75
In other words:

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

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

**EXERCISES (continued)**

**Question 6:** Caryn received 200 Euros on a day that the exchange rate was .75514 Euros to one U.S. dollar. In U.S. dollars, she would have ____.

A. $264.85  
B. $377.57  
C. $115.03  
D. $11.50

**Question 7:** Given an exchange rate of .7000, how much is 36,000 Euros worth in U.S. dollars?

A. $252.00  
B. $25,200.00  
C. $51,428.57  
D. $61,614.00

**Which exchange rate should I use?**

The exchange rate for a particular currency is likely to change every day. Use the exchange rate prevailing when the taxpayer receives the pay or accrues the item. The exchange rate is determined by the date of transaction, which is either the date on the check or the date the money is credited to the taxpayer’s account. If there is more than one exchange rate, use the one that most properly reflects the income.

However, the taxpayer can use the average annual exchange rate if:

- Foreign income was received evenly throughout the year, and
- The foreign exchange rate was relatively stable during the year

Taxpayers may use the monthly average exchange rates if they earned foreign income evenly for one or more months, but less than twelve months.

**example**

Edward Hall worked in Dallas for Lubbock Incorporated from January until September. On September 29, he was transferred to Lubbock’s Mexico City office, where he will be working for three more years. In Mexico, he is paid in Mexican pesos. Because he did not receive his salary in Mexican pesos evenly throughout the year, he cannot use the annual average exchange rate for Mexico source income. If he does not know the exchange rate at the time he received the funds, he can use the monthly average exchange rate for October, November, and December.
Where to obtain exchange rates

In mid-January, the IRS distributes exchange rates for various currencies to its worldwide offices, including the prior year’s average annual exchange rate information.

Exchange rates can be found at irs.gov by typing “foreign currency rates” in the search box. You may also contact banks that provide international currency exchange services.

Because taxpayers should use the rate that most closely reflects the value of the foreign currency at the time they receive the income, taxpayers may use an exchange rate that is different from the rates posted in IRS worldwide offices if they find it to be a true representation.

What is the foreign earned income exclusion?

Use Form 2555 to claim the foreign earned income exclusion. Certain taxpayers can exclude income earned in, and while living in, foreign countries. The maximum amount of the foreign earned income exclusion is indexed to inflation annually. For the current year amount go to irs.gov or Publication 17. The foreign earned income exclusion does not apply to wages and salaries of U.S. military members and civilian employees of the U.S. government.

If the taxpayer qualifies to exclude foreign earned income, the excludable amount will be reported as a negative amount on the other income line of Form 1040, Schedule 1. Since the foreign earned income would have been reported on Form 1040 as taxable wages or as self-employment income, the exclusion (negative amount) will reduce the total income calculated. The method of calculating the tax when the taxpayer elects the foreign earned income exclusion is based on the Foreign Earned Income Tax Worksheet. The tax software will do this calculation automatically.

If a taxpayer elects to exclude foreign earned income, he cannot claim the earned income credit and the refundable portion of the child tax credit. The child and dependent care credit does not include excluded foreign income as earned income when computing the credit.

Tax Software Hint: To review information related to the software for the foreign earned income exclusion, go to the Volunteer Resource Guide, Tab D, Income.

When do I choose the exclusion?

The foreign earned income exclusion is voluntary. It is not always an advantage to claim the exclusion. If taxpayers wish to claim the exclusion, they must file Form 2555 with a timely return (including extensions). If the taxpayer is not eligible for the foreign earned income exclusion, any taxes paid on this income to a foreign government may be eligible for the foreign tax credit. See the lesson Foreign Tax Credit for more information.

Once the taxpayer chooses to exclude foreign earned income, that choice remains in effect for that year and all later years until revoked. The taxpayer may revoke the exclusion for any tax year by attaching a statement to the return. When the exclusion is revoked, the taxpayer may not claim the exclusion again for the next five tax years without the approval of the IRS.

What are the eligibility requirements?

To claim the foreign earned income exclusion, taxpayers must:

• Demonstrate that their tax home is in a foreign country
• Meet either the bona fide residence test or the physical presence test
• Have income that qualifies as foreign earned income
The requirements are applied separately to each individual. If a married couple is working overseas, each spouse must meet all requirements to qualify for the exclusion. If they do qualify, each is entitled to an exclusion of up to the maximum amount for the current year.

**TIP**
The terms foreign, abroad, and overseas do not include Puerto Rico, U.S. Virgin Islands, American Samoa, Guam, the Commonwealth of the Northern Marianas, Wake Island, the Midway Islands, and Johnston Island.

**EXERCISES (continued)**

**Question 8:** Miranda has lived in Puerto Rico since 2003. Is she eligible for the foreign earned income exclusion?

- Yes
- No

**How do I determine the tax home?**

To claim the foreign earned income exclusion, the taxpayer’s tax home must be in a foreign country. The tax home is defined as the country in which the taxpayer is permanently or indefinitely engaged to work as an employee or a self-employed individual, regardless of where the family home is maintained.

For taxpayers who work abroad but do not have a regular place of business because of the nature of the work, their tax home is the place where they regularly live. The tax home for members of the U.S. Armed Forces is the permanent duty station, either land-based or on a ship.

**Example**

John and Mary are both in the Armed Forces and have been permanently stationed in Germany since August 2007. Their tax home for the current year is Germany.

**EXERCISES (continued)**

**Question 9:** Alan has lived and worked in China since August 16, 2005. China is his tax home.

- True
- False

**What is a regular place of abode?**

For purposes of the foreign earned income exclusion, if taxpayers work overseas for an indefinite period of time, and their regular place of abode is the U.S., the taxpayers cannot designate the foreign country as the tax home.

“Regular place of abode” is defined as one’s home, habitation, domicile, or place of dwelling. It does not necessarily include one’s principal place of business.

If the taxpayer maintains a place of business, or is assigned to overseas employment in a foreign country for an indefinite period, and does not maintain a regular place of abode in the U.S., the tax home is overseas and the taxpayer may be eligible for the foreign earned income exclusion.
How do I determine whether the U.S. is the taxpayer’s regular place of abode?

Ask three questions to determine whether a U.S. home is the taxpayer’s regular place of abode:

1. Did you use your home in the U.S. as a residence while you worked at your job in the U.S. just before going abroad to your new job, and did you continue to maintain work (e.g., contacts, job seeking, leave of absence, ongoing business) in that area in the U.S. during the time you worked abroad?

2. Are your living expenses duplicated at your U.S. and foreign homes because your work requires you to be away from your U.S. home?

3. Do you have a family member or members living at your U.S. home, or did you frequently use your U.S. home for lodging during the period you worked abroad?

If the answer to two of the questions is “no,” the taxpayer is considered to be indefinitely assigned to the new location abroad and is eligible for the foreign earned income exclusion.

If the answer to all three questions is “yes” and the job duration is for less than one year with the taxpayer returning to the U.S. home, the taxpayer is considered “temporarily away” from home. In this case, the taxpayer does not qualify for the foreign earned income exclusion, but may qualify to deduct away-from-home expenses.

If the answer to two of the three questions is “yes,” with the same expectation of job duration and return to the U.S. home, the location of the tax home depends on the facts and circumstances.

Example

Henry is a member of the Armed Forces. He was assigned to a post in Japan last year. This assignment was for an indefinite period that exceeds one year. Margaret, his wife, accompanied him to Japan and has foreign earned income. They have not used their home in the U.S. as a place of residence for over a year. Therefore, their tax home for this year is Japan.

EXERCISES (continued)

Question 10: Stan is employed on an offshore oil rig in the territorial waters of a foreign country and works a 28-day on/28-day off schedule. He returns to his family residence in the U.S. during his off periods. Does Stan’s employment satisfy the tax home test? □ Yes □ No

What is the period of stay requirement?

The period of stay is the amount of time the taxpayer stays in the foreign country. To meet the period of stay requirement, the taxpayer must be either:

- A U.S. citizen or U.S. resident alien from a tax treaty country who is a bona fide resident of a foreign country (or countries) for an uninterrupted period that includes an entire tax year, or

- A U.S. citizen or U.S. resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months

TIP

Revenue Procedure 2020-27 provides that the Secretary of the Treasury has determined that the global health emergency caused by the outbreak of COVID-19 is an adverse condition that precludes the normal conduct of business globally. Therefore, relief is being provided to any individual who reasonably expected to become a “qualified individual” for purposes of claiming the foreign earned income exclusion under section 911, but left the foreign jurisdiction during the period described in this revenue procedure.
What is the bona fide residence test?

To meet the bona fide residence test, taxpayers must show that they have set up permanent quarters in a foreign country for an entire, uninterrupted tax year (even though they intend to eventually return to the U.S.). Simply going to another country to work for a year or more is not enough to meet the bona fide residence test. A taxpayer must establish a residence in the foreign country.

A brief trip to the U.S. will not prevent the taxpayer from being a bona fide resident, as long as the intention to return to the foreign country is clear.

**example**

Charles is a military spouse who has lived and worked in England since 2006. His mother still lives in the U.S. Charles came to the U.S. for two weeks this year to be with his mother after she had surgery. Charles’ trip to the U.S. does not affect his status as a bona fide resident of a foreign country.

**EXERCISES (continued)**

**Question 11:** Zach, a U.S. citizen, has homes in the U.S. and in Spain, where he has worked for the last two years. Zach’s spouse, who is also a U.S. citizen, lives with him in Spain. Zach visits the U.S. occasionally. Does Zach meet the bona fide residence test in Spain? ☐ Yes ☐ No

What is the physical presence test?

If the taxpayers do not meet the bona fide residence test, then they may qualify under the physical presence test rules. To qualify, the taxpayers must be physically present in a foreign country 330 full days during a period of twelve consecutive months.

In order for a day to count for the test, it must be a full day in a foreign country. When arriving from the U.S., or returning to the U.S., any day in which part of the time is spent in the U.S. or over international waters does not count as a qualifying day in a foreign country.

The taxpayer may move about from one place to another in a foreign country or to another foreign country without losing full days. If any part of the taxpayer’s travel is not in any foreign country and takes less than 24 hours, you are considered to be in a foreign country during that part of travel. See Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad physical presence test section for additional information.

**example**

If a taxpayer left England by ship at 10:00 p.m. on July 6 and arrived in Lisbon at 6:00 a.m. on July 8, the taxpayer would lose July 6, 7, and 8 as full days because the trip took more than 24 hours. In this example, if the taxpayer remained in Lisbon, the first full day would be July 9.

**Figuring the 12-Month Period**

Any 12-month period may be used if the 330 full days in a foreign country fall within that period. If necessary, more than one period may be used, including periods that overlap. See Publication 54 for clarification on the physical presence rules.
What is qualifying income?

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

How does earned income qualify for the exclusion?

To qualify for the exclusion, the earned income must be for services performed in a foreign country. Amounts paid by the United States or its agencies to its employees do not qualify for the exclusion. This includes military pay and payment for such activities as post exchanges, commissaries, and officers clubs.

Earned income does not include:

• Dividends
• Interest
• Capital gains
• Alimony
• Social Security benefits
• Pensions
• Annuities

example
Alisa, a U.S. resident, is a member of the Armed Forces and has lived in Japan since 2010. Her military pay is not eligible for the foreign earned income exclusion. In her spare time, she is a self-employed DJ in Tokyo. The income from her self-employment may qualify for the exclusion.

What are sources of earned income?

To qualify for the exclusion, services must be performed in a foreign country. Where the payments come from or where they are deposited is not a factor in determining the source of the income.

If a taxpayer works predominantly in a foreign country, but does some work in the U.S., an adjustment must be made to the total foreign earned income.

example
Earl works and lives in the Bahamas. During the tax year, he worked 49 weeks in the Bahamas. He attended a business meeting in Florida for one week, and was on vacation for two weeks. One-fiftieth or 2% of his wages are not foreign earned income because of the week spent working in Florida.

example
Ron and his wife Amy, both U.S. citizens, have lived in England for two years. Ron is in the military and Amy works in a pastry shop in a nearby town. Ron’s military income does not qualify for the foreign earned income exclusion but Amy’s wages from the company in England does qualify. The source of Amy’s income is England.

EXERCISES (continued)

Question 12: Juanita lives in Scotland. She is retired and her income consists of U.S. Social Security, a pension, and several stock dividends. Does she qualify for the foreign earned income exclusion?

☐ Yes  ☐ No
**How do I complete Form 2555?**

Use the following guidelines when completing Form 2555.

- Part I is completed by all taxpayers
- Part II is completed by taxpayers who qualify under the bona fide residence test
- Part III is completed by all taxpayers who qualify under the physical presence test
- Part IV is completed by all taxpayers – list all foreign earned income
- Part V is completed by all taxpayers
- Part VI is completed by taxpayers claiming the housing exclusion and/or housing deduction
- Part VII is completed by taxpayers claiming the foreign earned income exclusion
- Part VIII is completed by taxpayers claiming the foreign income exclusion, the foreign housing exclusion, or both.
- Part IX is completed by taxpayers claiming the housing deduction if line 33 is more than line 36, and line 27 is more than line 43

**Tax Software Hint:** To review information related to the software, go to the Volunteer Resource Guide, Tab D, Income, Form 2555.

**Taxpayer Interview and Tax Law Application**

Look at the following sample interview for taxpayers Hudson and Hope Howard.

<table>
<thead>
<tr>
<th>VOLUNTEER SAYS...</th>
<th>HOPE RESPONDS...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Will we be able to exclude any of my income on our tax return? I worked for Bavaria Advertising in Munich this past year and made $24,000 in U.S. dollars. I heard that you don’t have to pay taxes on income earned in a foreign country and I’ve never done this before.</td>
<td></td>
</tr>
<tr>
<td>That is possible. First, we will have to determine if you meet the requirements. Were you working as a military or civilian employee of the U.S. government?</td>
<td>No, Bavaria Advertising is a foreign company owned by a family right there in Munich.</td>
</tr>
<tr>
<td>Great. That would qualify, but Hudson’s military pay won’t. Let’s see. You are a U.S. citizen. You earned wages in a foreign country and the total was less than the maximum amount. You have no self-employment income or business/moving expenses and since you lived on base, you won’t have a foreign housing exclusion.</td>
<td>Yeah, that all sounds right.</td>
</tr>
<tr>
<td>Now we have to determine if you meet the bona fide residence or physical presence test and if your tax home is in a foreign country.</td>
<td>It sounds complicated to me.</td>
</tr>
<tr>
<td>Don’t worry, I just need to ask you a few questions. How long did you say you were in Germany?</td>
<td>We moved on base in Germany on March 3, 2011 and just returned to the states on January 10 this year.</td>
</tr>
</tbody>
</table>

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**Sample Interview**

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SAMPLE INTERVIEW

VOLUNTEER SAYS... HOPE RESPONDS...

No problem then. You were living in Germany for the entire year so you are considered a bona fide resident this tax year. Since your home and place of employment were both in Germany, you meet the tax home test. Now, what was your address while you were living in Germany?

1567 Albion Street, Munich.

What did you do for Bavaria Advertising?

I was a copywriter.

Do you have Bavaria Advertising’s address?

I sure do; it is right here on this statement.

Were you present in the U.S. during this tax year? I have to enter the dates on this form.

Not this year. But we did come home for the holidays last year.

Summary

Total income from all sources is entered on Form 1040. Taxpayers are sometimes alarmed at how high their total income is. If this happens, reassure the taxpayer that the return is not finished yet! It is very likely that adjustments, deductions, and credits will considerably reduce the total tax owed.

Other income includes any taxable income for which there is not a specific line identified on Form 1040. This income is reported on the other income line of Form 1040, Schedule 1. If a taxpayer receives Form 1099-C for canceled credit card debt and was solvent immediately before the debt was canceled, all the canceled debt will be included on the tax return as other income.

U.S. citizens and resident aliens are taxed on worldwide income. They must file a U.S. tax return even if all the income is from foreign sources, and even if they pay taxes to another country. When taxpayers living abroad receive income in foreign currency, the amounts reported on the return must be converted into U.S. dollars. Use the exchange rate prevailing when the taxpayer receives the pay or accrues the item. If there is more than one exchange rate, use the one that most properly reflects the income.

If the taxpayers are eligible to exclude some or all of their foreign earned income, then Form 2555 must be completed. The excludable amount will be entered as a negative number on the other income line to offset income reported as wages or self-employment income.

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.

- Distributions from an ABLE account in which the funds were not fully used for qualified disability expenses
- Distributions from Educational Savings Accounts in which the:
  - Funds were not used for qualified education expenses, or
  - Distribution was more than the amount of the qualified expenses
- Taxpayers who are insolvent and had debt canceled
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.

EXERCISE ANSWERS

Answer 1: B. Greg is fairly certain that he has more debt than he has assets, which means he is insolvent. This situation is beyond the scope of the VITA/TCE programs.

Answer 2: Yes. Kay was solvent and not in bankruptcy, and the credit card company issued her a Form 1099-C.

Answer 3: D. Kay would report $7,500 on her Form 1040.

Answer 4: B. Marta’s gross income includes her wages and interest, both of which should be reported on her tax return.

Answer 5: C. Mary’s gross income includes her wages, interest, and gambling winnings, all of which should be reported on her tax return. Her child support payments are her only nontaxable income.

Answer 6: A. Dividing 200 Euros by the .75514 exchange rate comes to $264.85.

Answer 7: C. Dividing 36,000 Euros by the .7000 exchange rate comes to $51,428.57.

Answer 8: No. Miranda is not eligible for the foreign earned income exclusion because Puerto Rico is not a foreign country.

Answer 9: True. Generally, the tax home is the country in which taxpayers maintain their place of business. Because Alan works in China, it is considered to be his tax home. For taxpayers who do not have a regular place of business because of the nature of the work, their tax home is the place where they regularly live.

Answer 10: No. Stan is considered to have a residence in the United States and does not satisfy the tax home test in the foreign country. He is not eligible for the foreign earned income exclusion.

Answer 11: Yes. Since Zach went to Spain to work and has established a permanent residence there with his spouse, he meets the bona fide residence test.

Answer 12: No. Social Security benefits, pension, and dividends do not qualify as earned income; therefore, Juanita does not qualify for the foreign earned income exclusion.
Notes