Income – Other Income

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, or Form 2555-EZ, Foreign Earned Income Exclusion.

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, or Form 2555-EZ, Foreign Earned Income Exclusion

What do I need?

- ☐ Form 13614-C
- ☐ Publication 4012
- ☐ Publication 17
- ☐ Publication 54
- ☐ Form 1040 Instructions
- ☐ Form 2555
- ☐ Form 2555-EZ

Optional:

- ☐ Form W-2G
- ☐ Form 1099-MISC
- ☐ Form 1099-Q
- ☐ Form 525
- ☐ Form 970

How do I handle other income?

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

- Prizes and awards
- Gambling winnings, including lotteries and raffles
- Jury duty pay
- Alaska Permanent Fund dividends
- 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.

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 a specialty course on Link & Learn taxes for volunteers with a Basic or higher certification. This online course is optional. Check with your Site Coordinator to determine if you should be certified in this topic. To access this course and earn a certification, go to irs.gov and use the keyword/search "Link & Learn."

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.

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.

Inmate's 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.

Qualified Medicaid Waiver Payments

IRS Notice 2014-7 addresses the income tax treatment of certain payments to an individual care provider under a state Home and Community-Based Services Waiver (Medicaid waiver) program. The notice provides that "qualified Medicaid waiver payments" as difficulty of care payments are excludable from gross income. Qualified Medicaid waiver payments are payments by a state, a political subdivision of a state, or a certified Medicaid provider under a Medicaid waiver program to an individual care provider for nonmedical support services provided under a plan of care to an individual (whether related or unrelated) living in the individual care provider's home. Payments to the care provider who did not live in the same home as the care recipient are fully taxable.

If taxpayers received payments described in Notice 2014-7, they may receive a Form 1099-MISC reporting these payments in box 3, Other income, or in box 6, Medical and health care payments. In most circumstances, an amount reported in box 3 or box 6 of Form 1099-MISC is included as income on the tax return. However, qualified Medicaid waiver payments must be excluded and should not be included as other income. If filing a paper return, enter "Notice 2014-7" on the dotted line next to the other income line of Form 1040, Schedule 1. Refer to the Volunteer Resource Guide for specific software instructions.

If the taxpayer is in the business of providing care services, refer to the business income lesson earlier in this publication.

If the taxpayer received a Form W-2 with the amount of the payments reported in box 1, include the full amount of those payments on Form 1040 on the wages line. Enter the excludable portion of the payments as a negative amount on the other income line on Form 1040, Schedule 1. This will reduce the adjusted gross income. If filing a paper return, enter "Notice 2014-7" on the dotted line next to the other income line. No additional entry is needed if filing electronically. Refer to the Volunteer Resource Guide, Tab D, Income, for specific software instructions.

TIP For more information, go to irs.gov and search for Certain Medicaid Waiver Payments.

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.

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 now include qualified educational expenses for elementary and secondary public, private, and religious schools of up to $10,000 per year for each qualified 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.

TIP An American opportunity credit or lifetime learning credit or tuition and fees deduction (if extended) can be claimed in the same year the beneficiary takes a tax-free distribution from a QTP or Coverdell ESAs, as long as the same expenses are not used for both benefits. See Publication 17 and Publication 970, Tax Benefits for Education, for more details.

Cancellation of Debt – Nonbusiness Credit Card Debt

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

Use the Insolvency Determination Worksheet as a resource to determine whether a taxpayer is considered insolvent.

Insolvency Determination Worksheet

IRS

Assets (FMV)	
Homes	
Cars	
Recreational vehicles, etc.	
Bank accounts	
IRAs, 401Ks, etc.	
Jewelry	
Furniture	
Clothes	
Misc.	
Other assets	
Total Assets:	**$0.00**

Liabilities	
Mortgages	
Home equity loans	
Vehicle loans	
Personal signature loans	
Credit card debts	
Past-due mortgage interest, real estate taxes, utilities, and child care costs	
Student loans	
Other liabilities	
Total Liabilities:	**$0.00**

Total Assets minus Total Liabilities =
(Negative amount equals insolvency)
(Positive amount equals solvency)

CAUTION 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.

TIP 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.

SAMPLE INTERVIEW

VOLUNTEER SAYS...	MICHELLE RESPONDS...
I notice you received a 1099-C from a credit card company.	Yes, I negotiated with them to cancel $3,000 of my debt.
Yes, Form 1099-C shows the amount of debt discharged.	I could only afford to pay them $1,000, so it really helped me.
Do you think your debts at the time exceeded your assets?	I'm not sure, but it's certainly possible.
Let's fill out the Insolvency Determination Worksheet to help us determine whether you were insolvent.	O.K.
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.	Oh, I understand.
I suggest you seek assistance from a professional tax preparer.	I will, thank you.

Insolvency Determination Worksheet

IRS

Assets (FMV)	
Homes	**$120,000.00**
Cars	**$15,000.00**
Recreational vehicles, etc.	
Bank accounts	**$1,000.00**
IRAs, 401Ks, etc.	**$60,000.00**
Jewelry	
Furniture	**$2,000.00**
Clothes	**$1,550.00**
Misc.	
Other assets	
Total Assets:	**$199,550.00**

Liabilities	
Mortgages	**$180,000.00**
Home equity loans	**$50,000.00**
Vehicle loans	**$18,000.00**
Personal signature loans	
Credit card debts	**$3,000.00**
Past-due mortgage interest, real estate taxes, utilities, and child care costs	
Student loans	
Other liabilities	
Total Liabilities:	**$251,000.00**

Total Assets minus Total Liabilities = **($51,450.00)**
(Negative amount equals insolvency)
(Positive amount equals solvency)

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.

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

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

CAUTION 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:

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

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

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-EZ or 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.

TIP 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 either Form 2555-EZ or 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

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, 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 50 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

When do I complete and file Form 2555 or Form 2555-EZ?

If the taxpayer qualifies to exclude foreign earned income, Form 2555 or Form 2555-EZ must be completed. Publication 54 has an illustration of a tax return with Form 2555 completed for the husband and Form 2555-EZ completed for the wife.

To be able to use Form 2555-EZ, the taxpayer must:

- Be a U.S. citizen or resident alien who has wages and salaries, but not self-employment income
- Have total foreign earned income of the annual maximum amount or less
- Have no business deductions

Taxpayers who do not meet these requirements must use Form 2555 to claim the exclusion. For example, a taxpayer who receives self-employment income and is eligible for the exclusion must use Form 2555.

example

Michael and his wife, Eva, have been stationed in Australia since 2009. Michael is a member of the U.S. Armed Forces and Eva operates a home day-care business. Their tax home is Australia, and they meet the bona fide residence test. Eva wants to exclude her self-employment income from U.S. taxation.

Because her income is from self-employment, she will need to complete Form 2555 instead of Form 2555-EZ to exclude the income, and must complete Schedule SE to pay Social Security and Medicare taxes.

EXERCISES (continued)

Question 13: Mallory is a U.S. citizen who has $34,000 of foreign earned income (wages). She has no other income. Which form should she file?

A. Form 2555

B. Form 2555-EZ

How do I complete Form 2555-EZ?

Taxpayers who are eligible to file Form 2555-EZ should complete Parts I, II, and IV of the form. Complete Part III if the taxpayer was in the United States or any of its possessions during the tax year.

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.

SAMPLE INTERVIEW

VOLUNTEER SAYS...	HOPE RESPONDS...
	Will we be able to exclude any of my income on our tax return? I worked for Bavaria Advertising in Munich this past year and made $24,000 in U.S. dollars. I heard that you don't have to pay taxes on income earned in a foreign country and I've never done this before.
That is possible. First, we will have to determine if you meet the requirements. Were you working as a military or civilian employee of the U.S. government?	No, Bavaria Advertising is a foreign company owned by a family right there in Munich.
Great. That would qualify, but Hudson's military pay won't. [Volunteer links to Form 2555–EZ on the tax software.] *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. OK, we can use Form 2555-EZ.*	Yeah, that all sounds right.
Now we have to determine if you meet the bona fide residence or physical presence test and if your tax home is in a foreign country.	It sounds complicated to me.
Don't worry, I just need to ask you a few questions. How long did you say you were in Germany?	We moved on base in Germany on March 3, 2011 and just returned to the states on January 10 this year.
No problem then. You were living in Germany for the entire year so you are considered a bona fide resident this tax year. Since your home and place of employment were both 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 or Form 2555-EZ 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 comprehensive problem or practice exercise(s) for your course of study on TaxSlayer.

For practice using the tax preparation software, complete the scenarios 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.*

Answer 13: *B. Since Mallory's earned income is wages (not self-employment) and is less than the ceiling amount, she can file Form 2555-EZ.*