Other Taxes

Introduction

This lesson covers the Other Taxes section of the return. You will determine if taxpayers owe additional taxes, and determine their total tax.

Objectives

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

- Identify the different types of other taxes on a return
- Determine if a taxpayer is liable for other taxes that are within scope of the volunteer program
- Determine how to report these additional taxes on the tax return and complete the applicable forms or schedules

What do I need?

- ☐ Intake and Interview Sheet
- ☐ Publication 4012, Volunteer Resource Guide
- ☐ Publication 17
- ☐ Publication 4491-W

Optional:

- ☐ Publication 1244
- ☐ Form 1040 Instructions
- ☐ Form 4137
- ☐ Form 5329 and Instructions
- ☐ Form 5405 and Instructions
- ☐ Form W-2
- ☐ Schedule SE

What are other taxes?

"Other taxes" are different from the income tax from the tax tables or figured using the Tax Computation Worksheet. They include:

- Self-employment tax
- Social security and Medicare taxes on tip income
- Additional taxes on IRAs and other qualified retirement plans
- Repayment of first-time homebuyer credit

These amounts are usually calculated on their own form or schedule. The taxes are added after the nonrefundable credits are calculated; the nonrefundable credits do not reduce the other taxes.

Household employment taxes are also included in the Other Taxes section. However, this topic is beyond the scope of the VITA/TCE programs. Taxpayers who must file household employment taxes should be referred to a professional tax preparer.

Two additional taxes may apply to taxpayers with higher income. These are the additional Medicare tax on wages (Form 8959) and the net investment income tax (Form 8960). Taxpayers with income levels large enough to incur these taxes should be referred to a paid professional preparer.

Tax Software Hint: The software makes most of the calculations and displays the resulting tax on Form 1040.

CAUTION

Social security and Medicare taxes on tip income is covered under the Advanced course. Self-employment tax, additional tax on IRAs and other qualified retirement plans, and repayment of first-time homebuyer credit are Advanced-level topics. If an issue related to an Advanced-level topic arises at a volunteer site, be sure that a volunteer with required certification provides assistance.

TIP

Refer to the Affordable Care Act (ACA) lesson contained in this publication for information on the advance premium tax credit, the premium tax credit, and the shared responsibility payment.

What is self-employment tax?

Self-employment (SE) tax is Social Security and Medicare taxes collected primarily from individuals who work for themselves, similar to the Social Security and Medicare taxes withheld from the pay of most wage earners. Payments of SE tax contribute to the taxpayer's coverage under the Social Security system. Social security coverage provides the taxpayer with retirement, disability, survivor, and hospital insurance (Medicare) benefits.

Who must pay self-employment tax?

SE tax must be paid if either of the following applies:

- The taxpayer had income as a church employee of $108.28 or more.
- The taxpayer receives net earnings from self-employment income in the amount of $400 or more (excluding church employee income).

Generally, taxpayers who are independent contractors and receive Form 1099-MISC must file Schedule C/C-EZ and Schedule SE. Since taxes are not withheld from independent contractors' pay, it is the taxpayer's responsibility to pay income and SE tax.

Schedule SE contains two ways to compute the tax: the long version and the short version. The instructions on the form guide you in deciding which version the taxpayer needs. The short version is used more often in the VITA/TCE programs, but you should understand both versions.

TIP

The VITA/TCE programs' scope includes Schedule C, with limits. The Schedule C criteria is the same as Schedule C-EZ, although expenses up to $25,000 are allowed.

TIP

Self-employed taxpayers who receive tips should include the tips in gross receipts on Schedule C/C-EZ.

How do I figure and report this tax?

As a volunteer, you may be qualified to assist self-employed taxpayers who need to complete Schedule C (with limits) or Schedule C-EZ, Net Profit from Business (covered in an earlier lesson). When assisting a taxpayer with self-employment income, first complete Schedule C or C-EZ. Schedule SE is used to calculate the self-employment tax. The deductible part of the self-employment tax is reflected as an adjustment to income on Form 1040, page 1. This amount is from line 6 of Schedule SE, the deduction for employer-equivalent portion of self-employment tax. The adjustment to income is similar to the benefit that employees receive because their employers pay a portion of the Social Security and Medicare taxes.

Tax Software Hint: The software automatically transfers the appropriate information from Schedule C or C-EZ to Schedule SE and calculates the self-employment tax and the adjustment of the deductible part of the self-employment tax.

What about taxes on unreported tip income?

All tip income is subject to federal income tax. However, tips of less than $20 per month that are not reported to the employer are not subject to Social Security and Medicare taxes.

Individuals who receive $20 or more per month in tips from any one job must report their tip income to their employer. The employer reports these tips as part of the wages on Form W-2, box 1. The employer withholds Social Security and Medicare taxes and federal income tax on that income.

What about allocated tips?

An employer may "allocate" tips to an employee if the employee worked in a restaurant, cocktail lounge, or similar business and reported tips that were less than the employee's share of 8% of food and drink sales. If the employer allocates tips to employees, the amount is reported on Form W-2, box 8, and included in income on Form 1040. Social security and Medicare taxes are not withheld on allocated tips. The employee pays the Social Security and Medicare taxes by completing Form 4137, Social Security and Medicare Tax on Unreported Tip Income.

If the employee can show, using Publication 1244, Employee's Daily Record of Tips and Report to Employer, or some similar daily tip record, that the actual tips received are different from the allocated amount, then the actual amount is reported on Form 1040. The actual tips received are also reported on Form 4137 to calculate Social Security and Medicare taxes.

What about tips that the employee did not report to the employer?

If the employee received $20 or more in unreported cash and charge tips in any month from any job, the employee must report that income on Form 1040 and pay the Social Security and Medicare taxes on that income. But, if the employee received less than $20 in tips in any month from any job, they are not required to report them to the employer. However, these amounts *do* need to be included on Form 1040. They will not be subject to Social Security or Medicare taxes.

Tax Software Hint: See Volunteer Resource Guide, Income tab for instructions on reporting tip income. The software calculates Social Security and Medicare taxes only on the applicable tips. The software will also add unreported tips to Form 1040, line 7.

example

Carla waits tables at a café. Her employer reports all tips that customers add to their credit card tabs, but she leaves it up to Carla to keep track of her cash tips. Carla receives more than $20 per month in cash tips. Carla keeps a record but, because she doesn't report her cash tips to her employer, they are not included on her Form W-2. Carla includes the unreported tips as income on Form 1040, line 7. Carla also uses Form 4137 to calculate and pay the Social Security and Medicare taxes on those tips.

How do I figure and report these taxes?

To figure the tax, determine if during any month the taxpayer received $20 or more in cash and charge tips that were not reported to the employer. Unreported tips are entered on the W-2 screen.

Report the tax amount on the applicable line on Form 1040.

Tax Software Hint: The tax software will compute the correct tax on allocated and unreported tip income. Go to the Volunteer Resource Guide, Income tab, for software entries.

TIP

As part of your interview, explain to taxpayers that sometimes people do not realize they owe taxes on tips they do not report to their employer. Also explain the taxes paid on those tips actually boost the taxpayer's future Social Security benefits.

EXERCISES

Answers follow the lesson summary.

Question 1: Nancy had a summer job at a coffee hut. She made $18 in tips in May, $755 in June, $600 in July, and $45 in August. Until a co-worker told her, she didn't realize she had to report her tips to their employer. She then reported $1,000 in tips to her boss.

What amount of tips will Nancy have to add to her Form 1040, line 7?

A. $1,418

B. $1,000

C. $418

D. $18

Question 2: What amount of unreported tips does Nancy have to pay Social Security and Medicare taxes on when she files her tax return?

A. $1,418

B. $400

C. $45

D. $18

What about taxes on IRAs and other qualified retirement plans?

Traditional IRAs and other qualified plans allow individuals to defer paying taxes on contributions and earnings until the funds are distributed.

If the rules for contributions and distributions are not followed, additional penalty taxes may be due. For example, the taxpayer must pay income tax plus an additional tax if any of the following apply:

- A distribution is taken before the individual reaches the age of 59½ and is not rolled over into another qualified plan or IRA and no other exception applies (in scope)
- Minimum distributions are not withdrawn when required (out of scope)
- Excess contributions are not removed by the due date of the return including extensions (out of scope)

TIP

If the taxpayer is under the age of 59½, earnings on excess contributions withdrawn *by the due date* of the return are early distributions and subject to the 10% additional tax. Refer to the Adjustments to Income lesson for more information.

The additional tax for each situation is outlined on Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.

Only Part I of Form 5329 is in scope. This part provides for the exceptions to the additional tax on part or all of the early distributions from IRAs or qualified pension plans. The other parts of Form 5329 are out of scope; refer taxpayers with these issues to a professional tax preparer.

Refer to the intake and interview sheet, Part III – Income, for the question regarding pension or IRA distributions. If the answer is “yes,” ask for any Form 1099-R that reports these payments to determine if the taxpayer is subject to the additional tax or qualifies for an exception.

If Form 1099-R correctly shows code 1 in box 7 indicating an early distribution, the additional tax applies unless the taxpayer qualifies for an exception. Guidelines permit entering 10% of the taxable amount directly on Form 1040, on the applicable line for additional tax on IRAs or other qualified retirement plans. “No” is entered to the left of this line to indicate Form 5329 is not required. Tax software does this automatically based on entries on Form 1099-R.

CAUTION

Some exceptions apply only to IRA distributions, some apply only to distributions from a qualified retirement plan, and some exceptions apply to both IRA and retirement plan distributions. Refer to Publication 17 chapters Retirement Plans, Pensions, and Annuities or Individual Retirement Arrangements for the list of exceptions

New early distribution exceptions

Public Laws 114-26 and 114-113 added federal law enforcement officers, federal customs and border protection officers, federal firefighters, air traffic controllers, nuclear materials couriers, members of the United States Capitol Police or Supreme Court Police, and diplomatic security special agents of the Department of State to the definition of qualified public safety employees under 72(t)(10(B)) eligible for an early distribution exception for distributions made after separation from service in or after the year the employee has reached age 50. These changes are effective for distributions made after December 31, 2015.

Frequently, taxpayers who receive Form 1099-R with code 1 in box 7 *are* subject to the 10% additional tax for early distribution because the money was spent for items that are not on the list of exceptions, for example, household expenses or bills. This situation does not require completion of Form 5329.

example

John is 39 years old and received Form 1099-R with code 1 in box 7. He used the money to pay for car repairs. For the additional tax, enter 10% of the taxable amount on the applicable line of Form 1040. The word “no” appears to the left of this line to indicate that Form 5329 is not required.

How do you complete Form 5329, Part I?

If an exception to the additional tax on early distributions applies, Form 5329, Part I, must be completed.

- Form 5329, line 1, is the amount of the distribution included in income.
- Line 2 is the amount that qualifies for the exception. The applicable code is also entered. Refer to the Volunteer Resource Guide, Other Taxes and Payments tab, for a screen shot of Form 5329, Part I, and the exceptions. For additional information, see Form 5329 Instructions.
- For line 3 the amount from line 2 is subtracted from line 1. This is the amount subject to the additional tax.
- Line 4 is the additional tax that is carried over to the Other Taxes section of the return.

Tax Software Hint: The software doesn’t use code numbers. Select from the drop down box on the 3rd line of the software.

example

Laura is 41 years old and received an early distribution from her 401(k) account. The volunteer determines that Laura used the money for unreimbursed qualified medical expenses, and she meets the requirements for exception code 05. In this case Form 5329, Part I, would be completed. Laura would not have to pay the additional tax on this distribution.

IRA distributions, pensions, and annuities are covered in the Retirement Income lesson. Tax preparers certified at the Basic level may prepare returns having retirement income with taxable amount determined. If the taxable amount has not been determined or if one of the exceptions to the additional tax on early distributions applies, refer the taxpayer to a volunteer with Advanced certification.

What about repayment of the first-time homebuyer credit?

Certain situations may require the credit to be repaid and reported in the Other Taxes section of Form 1040.

Review the Life Events section of the intake and interview sheet to determine if the taxpayer claimed the 2008 homebuyer credit and must pay back a portion of the credit each year.

If the taxpayer received the first-time homebuyer credit in 2010 and the home ceases to be their main home within the 36-month period beginning on the purchase date, the taxpayer generally must repay the credit.

If the taxpayer received the first-time homebuyer credit for a home purchased in 2008, generally they must repay the credit over a 15-year period in 15 equal installments. The repayment period began in 2010. However, if the home ceases to be the taxpayer's main home before the 15-year period is up, the taxpayer must repay all remaining annual installments.

The home ceases to be the main home if the taxpayer sells the home; converts the entire home to business or rental property; the home is destroyed, condemned, or disposed of under threat of condemnation; or the lender forecloses on the mortgage. There are certain exceptions to the repayment rule. See the general instructions for Form 5405, First-Time Homebuyer Credit and Repayment of the Credit, for details.

The credit is repaid by including it as additional tax on the return for the year the home ceases to be the taxpayer's main home. If the taxpayer is required to repay the credit, it is calculated on Form 5405 and reported on the applicable line in the Other Taxes section of Form 1040. Certain taxpayers who are repaying an installment of the credit claimed for homes purchased in 2008 are not required to file Form 5405.
See Form 5405 Instructions for more information.

CAUTION

The 2008 homebuyer credit had different rules. The credit functions like a no-interest loan and must be paid back. Taxpayers who received the credit in 2008 continue to repay the credit over a 15-year period that began with the 2010 tax return.

TIP

If the taxpayer dies, they do not have to repay the balance of the credit.

Taxpayers who filed a joint return for 2008 and claimed the first-time homebuyer credit may have special rules apply. If the home is transferred to a spouse (or ex-spouse as part of a divorce), the spouse receiving the home is responsible for repaying the credit, unless an exception applies. Or if one of the spouses dies, their half of the remaining credit is forgiven and does not need to be paid back.

How do I figure total tax?

The Other Taxes section provides a total of income tax and other taxes that may apply to the taxpayer. Adding the amounts on these lines gives the total tax. This amount reflects the tax on all income, adjustments to income, deductions, nonrefundable tax credits, and other taxes. The next step is entering tax payments and refundable credits. Then calculate the taxes owed or the amount overpaid that will result in a refund.

Tax Software Hint: The tax software will calculate the total tax automatically. Go to the Volunteer Resource Guide, Other Taxes and Payments tab, for software entries.

Summary

This lesson explained how to complete the Other Taxes section of the return. Other taxes are not calculated using the income tax tables or the Tax Computation Worksheet. They include:

- Self-employment tax
- Social security and Medicare taxes on unreported tip income
- Additional taxes on IRAs and other qualified retirement plans
- Repayment of first-time homebuyer credit

Tax Software Hint: These amounts are calculated on separate forms or schedules. The tax software provides all of the forms and performs most of the calculations.

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.

- Household employment taxes
- IRA minimum distributions not withdrawn when required
- Excess contributions to an IRA that are not removed by the due date of the return including extensions
- Parts II through VIII of Form 5329 (only Part I is in scope)
- Distribution from an ABLE account that exceeds the qualified disability expenses
- Individuals subject to the additional Medicare tax on Form 8959
- Individuals subject to the net investment income tax on Form 8960

TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem or practice exercise(s) for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L&LT.

EXERCISE ANSWERS

Answer 1: *C. Nancy's combined tips for May, June, July, and August were $1,418, and she reported only $1,000 to her employer. She needs to add $418 to line 7 of her tax return.*

Answer 2: *B. Nancy does not have to pay Social Security and Medicare taxes on the tips she received in May, because they amounted to less than $20 for the month.*

Notes