Other Taxes

Introduction

This lesson covers the Other Taxes reported on the return. You will determine if taxpayers owe additional taxes, which can decrease a refund or increase a balance due.

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 VITA/TCE programs
- Determine how to report these additional taxes on the tax return and complete the applicable forms or schedules

What do I need?

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

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, but are not limited to:

- 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 and entered on Form 1040, Schedule 2. 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 Other Taxes. 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, Additional Medicare Tax) and the net investment income tax (Form 8960, Net Investment Income Tax Individuals, Estates, and Trusts). Taxpayers with income levels large enough to incur these taxes should be referred to a paid professional preparer.

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 Premium Tax Credit lesson contained in this publication for information on the repayment of the advanced premium tax credit.

What is self-employment tax?

Self-employment (SE) tax is Social Security and Medicare taxes collected primarily from individuals who work for themselves. It is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners except a self-employed individual pays both the employee part and what would be the employer part. 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).

TIP The VITA/TCE programs' scope includes Schedule C, with limits.

Generally, taxpayers who are independent contractors or sole proprietors must file Schedule C and Schedule SE. Since taxes are not withheld from independent contractors' pay, it is the taxpayer's responsibility to pay income and SE tax. Taxpayers should make quarterly estimated tax payments during the year to pay these taxes.

TIP The Social Security Administration uses the information from Schedule SE to figure a person's benefits under the social security program. Not reporting all of a taxpayer's self-employment income could cause their social security benefits to be lower when they retire.

This tax applies no matter how old the taxpayer is and even if they are already getting social security or Medicare benefits.

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

How do I figure and report this tax?

Net Profit from Business was covered in an earlier lesson. When assisting a taxpayer with self-employment income, first complete Schedule C. 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, Schedule 1. The adjustment to income is similar to the benefit that employers receive when they deduct their share of the Social Security and Medicare taxes as payroll taxes.

TIP Self-employment 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.

The self-employment tax rate on net earnings is 15.3% (12.4% social security tax plus 2.9% Medicare tax).

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

Partial tax deferral for certain Schedule SE filers

Self-employed individuals may have deferred the employer portion of the Social Security tax on self-employment income earned from March 27, 2020 through December 31, 2020. Half of the deferred Social Security tax is due by December 31, 2021, and the remainder is due by December 31, 2022. Refer taxpayers who have questions regarding payment of deferred tax to **https://www.irs.gov/newsroom/how-self-employed-individuals-and-household-employers-repay-deferred-social-security-tax**

Who does not pay self-employment tax?

Some professions do not have a requirement to pay the self-employment tax:

- Notaries public are not subject to the self-employment tax by law. Be sure to identify notaries on the input forms.
- Statutory employees have Social Security and Medicare tax withheld and do not have to pay the self-employment tax even though they report their income and expenses on Schedule C.

Tax Software Hint: Enter the net profit from a notary's business on the SE Tax input screen so that SE tax is not computed.

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 and you will need to indicate that on Form 4137.

Tax Software Hint: See Volunteer Resource Guide, Tab D, Income, for instructions on reporting tip income. The software calculates Social Security and Medicare taxes on the tips based on your entries on the W-2 input and Form 4137 input. The software will also add unreported tips to Form 1040 as wages.

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. 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?

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.

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

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 as wages?

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 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, is not rolled over into another qualified plan or IRA, and no exception applies
- Minimum distributions are not withdrawn when required (out of scope)
- Excess contributions are not withdrawn 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.

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 the Volunteer Resource Guide, Tab H for the list of exceptions.

Refer to the intake and interview sheet, Part III – Income, for the question regarding retirement income or payments from pensions, annuities, and/or IRA. If yes is checked, review 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. In some circumstances, Form 5329 is not required. Tax software does this automatically based on entries on Form 1099-R.

Early distribution in case of birth or adoption of child

An IRA owner or a participant in a workplace-defined contribution plan, such as a 401(k) or 403(b) plan, can withdraw up to $5,000 for the birth or adoption of a child without incurring the usual 10% additional tax on early distributions. The distribution must be made within one year after the child is born or the adoption is finalized and cannot be from a defined benefit plan. Any time after receiving the distribution, the IRA owner or plan participant may generally recontribute any portion of the distribution as a rollover contribution to an eligible retirement plan, including an IRA.

Early distribution exception for public safety employees

Qualified public safety employees who receive distributions from a governmental defined benefit pension plan aren't subject to the additional tax on early distributions. Qualified public safety employees include those who provide police protection, firefighting services, or emergency medical services for a state or municipality, and who separated from service in or after the year they attained age 50.

The definition of qualified public safety employees also includes 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.

example

John is 39 years old and received Form 1099-R with code 1 in Box 7. John has qualified education expenses that he paid during the year, which are on the list of exceptions. He can reduce the amount of the early distribution that is subject to the additional tax by the amount of qualified education expenses. Note that John can also use the qualified education expenses for another education benefit if he meets those requirements. See the Education Credits lesson.

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. Refer to the Volunteer Resource Guide, Tab H for the software entries and exception codes.

When the early distribution is from a SEP IRA and it is made within two years from when participation in the plan began, the addition to tax is computed using a rate of 25% instead of 10%. Such a distribution is designated by Code S in Box 7 of Form 1099-R.

Do not reduce medical expenses or education expenses eligible for a deduction or credit for the amounts used to reduce the addition to tax on an early distribution. This is not a double dip situation and is allowable.

example

Laura is 41 years old and received an early distribution from her 401(k) account. The volunteer determines that Laura paid for unreimbursed qualified medical expenses in excess of 7.5% of her AGI, which is more than the amount of her distribution. In this case Form 5329, Part I, would be completed. Laura would not have to pay the additional tax on this distribution. If Laura is itemizing deductions, she can claim the whole amount of her medical expenses even though she used the expenses to reduce the additional tax.

What about repayment of the first-time homebuyer credit?

Certain situations may require the first-time homebuyer credit to be repaid and reported on Form 1040, Schedule 2. 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 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 for details.

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

Special rules apply for taxpayers who filed a joint return for 2008 and claimed the first-time homebuyer credit. 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.

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 Form 1040, Schedule 2. 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.

Summary

This lesson explained how to report Other Taxes on 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

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.

- Employment taxes for household employees
- IRA minimum distributions not withdrawn when required
- Excess contributions to an IRA that are not withdrawn by the due date of the return including extensions
- Distributions or excess contributions shown on parts II through IX 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

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: *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 as wages on 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