

# **SYSTEM THREE**

## **INDIVIDUAL INCOME TAX**

THE TAX SCHOOL  
7080 DONLON WAY STE 201  
DUBLIN, CA 94568  
(800) 327-1040

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## **PREFACE**

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## SUMMARY FOR INDIVIDUAL INCOME TAX

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# System 3 – Individual Taxation

## LEARNING OBJECTIVES

### **CHAPTER 1 – CHARITABLE CONTRIBUTIONS** – Learn about

- The IRS's official list of qualified organizations.
- How tax preparers can maximize deductions for clients.
- The rules on students living with you.
- Contributions of property – Special rules.
- Cash contributions – How to document.

### **CHAPTER 2 – MEDICAL EXPENSES** – Learn about

- Which capital improvements may be deductible?
- How you can advise clients to schedule medical payments for their deductible advantage.
- Cosmetic surgery – What is deductible?
- The latest on stop-smoking deductions.

### **CHAPTER 3 – CHILD AND DEPENDENT CARE CREDIT** – Learn about

- The qualifying person test. A special rule that allows your spouse to qualify.
- The earned income test. Why your client may not have to work to qualify.
- Which expenses qualify and which do not.
- When a married couple does not have to file a joint return to qualify.
- When the care provider does not have a social security number – What to do?

### **CHAPTER 4 – EARNED INCOME CREDIT** – Learn about

- The requirements to qualify for the credit.
- Who will qualify for the credit.
- What is earned income.
- How much is the credit.
- The rules for qualifying children.

### **CHAPTER 5 – TAXABLE AND NONTAXABLE INCOME** – Learn about

- The IRS code (61a) definition of income – just 15 items included.
- Taxation of fringe benefits.
- Disability income – Sometimes taxable, sometimes not.
- Cancelled debt – Sometimes taxable, sometimes not.
- An alphabetized list of 170 items – some taxable, some not, some “maybe”.

## **CHAPTER 6 – FOREIGN TAX CREDIT FOR INDIVIDUALS – Learn about**

- Choosing to take a foreign tax credit or a deduction.
- Who can take the credit.
- What foreign taxes qualify for the credit.
- What foreign taxes are not eligible for the credit.
- How to figure the credit.
- Foreign tax carry back and carryover.
- How to claim the credit.

## **CHAPTER 7 – SALE OF RESIDENCE – Learn about**

- How your clients gain on a sale of residence may be reduced.
- When the IRS will allow an exclusion of gain because of “unforeseen” circumstances.
- Safe harbor rules on the sale of your client’s principal residence.
- Special rules on escrow closing costs.



# SYSTEM 3

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# CHAPTER 1

## CHARITABLE CONTRIBUTIONS

Generally, an individual's maximum charitable contributions in one year are limited to his or her **contribution base**. An individual's **contribution base** is his or her adjusted gross income without regard to any net operating loss carryback.

**Impact of The Tax Cut and Jobs Act on Charitable Contributions.** The TCJA has raised the Adjusted Gross Income limit from 50% to 60% for contributions to 50% charities. The new law applies to contributions made from tax year 2018 through 2025. The increase 60% is for cash contributions only. Any disallowed contributions can be carried forward for five years. With standard deductions in 2018 almost doubled chances are that less taxpayers would be able to take advantage of the increase from 50% to 60%.

**Limit on Deduction.** If your contributions are **more than 20% of your adjusted gross income**, the amount of your deduction may be limited to 20%, 30%, or 50%(60% if cash) of your adjusted gross income, depending on the type of property you give and the type of organization you give it to. These types of property and organizations will be discussed later.

Any unallowed charitable contributions may be **carried over** for 5 years within limits. These carryover limits will be discussed later.

Many organizations that qualify for deductible charitable contributions are well known such as churches, Boy/Girl Scouts, Red Cross, etc. However, there are literally thousands of qualified organizations nationwide that are known in limited local areas or are for groups with limited specific interest.

The Internal Revenue Service's Publication 78, ***Cumulative List of Organizations...*** contains a list of most eligible organizations. Publication 78 is a two volume set with approximately 2,200 combined total pages that lists approximately 600,000 qualifying organizations. The publication indicates whether contributions made to a listed organization qualifies for the 50% or the 30% limitation. There is a quarterly update of newly qualified organizations.

You can find Publication 78 on the Internet at [apps.irs.gov/app/pub/78](https://apps.irs.gov/app/pub/78). Or you can also call the IRS to find out if an organization is qualified. Call 1-877-829-5500. (For TTY/TDD help, call 1-800-829-4059.)

A list of organizations whose exempt status has been revoked or terminated is published on a monthly basis in the Internal Revenue Bulletin. However, if the IRS

revokes or terminates an organization's exempt status by a ruling or determination letter, contributions by taxpayers **unaware** of the revocation may still be deductible.

And finally, gifts to organizations **not listed** in Publication 78 **may still** be deductible if the organization is **otherwise qualified** under the basic rules that follow.

Churches and certain other religious organizations are not required to apply for recognition of their tax-exempt status. However, they may find it advantageous to do so. To be included would give prospective donors advance assurance that contributions were deductible.

## **TYPES OF QUALIFIED ORGANIZATION**

Generally, only the five following type of organizations can be qualified organizations.

1. A community chest, corporation, trust, fund, or foundation organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the United States (including Puerto Rico). It must be organized and operated only for one or more of the following purposes.
  - a. Religious.
  - b. Charitable.
  - c. Educational.
  - d. Scientific.
  - e. Literary.
  - f. The prevention of cruelty to children or animals.

Also, certain organizations that foster national or international amateur sports competition also qualify.

2. War veterans' organizations, including posts, auxiliaries, trusts, or foundations, organized in the United States or any of its possessions.
3. Domestic fraternal societies, orders, and associations operating under the lodge system.

**Note.** Your contribution to this type of organization is deductible only if it is to be used solely for charitable, religious, scientific, literary, or

educational purposes, or for the prevention of cruelty to children or animals.

4. Certain nonprofit cemetery companies or corporations.

**Note.** Your contribution to this type of organization is not deductible if it can be used for the care of a specific lot or mausoleum crypt.

5. The United States or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions.

**Note.** To be deductible, your contribution to this type of organization must be made solely for public purposes.

**Example 1.** You contribute cash to your city's police department to be used as a reward for information about a crime. The city police department is a qualified organization, and your contribution is for a public purpose. You can deduct your contribution.

**Example 2.** You make a voluntary contribution to the social security trust fund, not earmarked for a specific account. Because the trust fund is part of the U.S. Government, you contributed to a qualified organization. You can deduct your contribution.

## **A QUICK CHECK LIST OF CONTRIBUTIONS YOU CAN DEDUCT**

Money or property you give to:

- Churches, synagogues, temples, mosques, and other religious organizations
- Federal, state, and local governments, if your contributions are solely for public purposes (for example, a gift to reduce the public debt)
- Nonprofit schools and hospitals
- Public parks and recreation facilities
- Salvation Army, Red Cross, CARE, Goodwill Industries, United Way, Boy Scouts, Girl Scouts, Boys and Girls Clubs of America, etc.

- War veterans' groups
- Expenses paid for a student living with you, sponsored by a qualified organization.
- Out-of-pocket expenses when you serve a qualified organization as a volunteer.

## **A QUICK CHECK LIST OF CONTRIBUTIONS YOU CANNOT DEDUCT**

Money or property you give to:

- Civic leagues, social and sports clubs, labor unions, and chambers of commerce
- Foreign organizations (except certain Canadian, Israeli, and Mexican charities)
- Groups that are run for personal profit
- Homeowners' associations
- Individuals
- Political groups or candidates for public office

Additionally, contributions under the following situation **do not** qualify to be deducted.

- The cost of raffle, bingo, or lottery tickets
- Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups
- The cost of tuition paid for yourself or others
- The value of your time or services
- The value of blood given to a blood bank

## **CONTRIBUTIONS TO CHARITIES OF FOREIGN COUNTRIES**

You may be able to deduct contributions to charities of the countries of Canada, Mexico and Israel. In each case you must have income from these countries. The specific rules are governed by treaties between the United States and those countries.

## DEDUCTIBLE CONTRIBUTIONS

Generally, you may deduct your contributions of money or property that you make to, or for the use of, qualified organizations. If you give property to a qualified organization, you generally may deduct the ***fair market value*** of the property ***at the time*** of the contribution.

The contributions must be made to a qualified organization and not set aside for use by a specific person.

**Benefits Received.** If you contribute to a charitable organization and also receive a benefit from it, you may deduct only the amount that is more than the value of the benefit you receive. If you pay more than fair market value to a qualified organization for merchandise, goods, or services, the amount you pay that is more than the value of the item may be a charitable contribution.

**Example 1.** You pay \$75 for a dinner-dance at a church. All the proceeds of the function go to the church. If the dinner, plus any entertainment or other services provided, has a fair market value of \$25, ***the excess paid***, \$50, is a contribution to the church.

**Example 2.** At a fund-raising auction conducted by a charity, you pay \$600 for a week's occupancy of a house at the beach. The amount you pay is no more than the fair rental value. You ***have not*** made a deductible charitable contribution.

**Athletic Events.** Under prior tax law, if you made a payment to or for the benefit of a college or university and as a result, you receive the ***right to buy tickets*** for an athletic event in the athletic stadium of the college or university, you were able to ***deduct 80%*** of the payment as a charitable contribution. ***This is no longer deductible under The Tax Cut and Jobs Act.***

**Token Items.** If you receive only token items (such as bookmarks, calendars, mugs, or caps) in connection with your payment, you may be able to deduct the entire payment as a charitable contribution. You ***must be notified by the charity*** that the item you received is of insubstantial value and that the payment can be deducted in full.

**Dues, Fees, or Assessments.** These are deductible if you pay them to qualified organizations. However, you may deduct ***only the amount*** that is ***more than the value of the benefits that you receive***. You may not deduct dues, fees, or assessments paid to country clubs and other social organizations.

## EXPENSES PAID FOR STUDENT LIVING WITH YOU

You may be able to deduct some expenses of having a student live with you. You can deduct qualifying expense for a foreign or American student who:

1. Lives in your home under a written agreement between you and a qualified organization (defined later) as part of a program of the organization to provide educational opportunities for the student,
2. Is not your dependent or relative, and
3. Is a full-time student in the twelfth or any lower grade at a school in the United States.

You can deduct up to \$50 a month for each full calendar month the student lives with you. Any month when conditions (1) through (3) above are met for 15 or more days counts as a full month.

**Qualified Organization.** A qualified organization is any organization described earlier in ***Qualified Organizations***, except it does not include any state or other governmental body that may enter into an agreement with you to provide a home for a student.

**Example.** If you are providing a home for a child through a ***state or local agency***, ***you may not*** deduct amounts you spend as ***charitable*** contributions.

**Qualifying Expenses.** Qualifying expenses include the cost of books, tuition, food, clothing, transportation, medical and dental care, entertainment, and other amounts you actually spend for the well-being of the student. Depreciation on your home and the fair market value of lodging or any similar item is ***not considered*** an amount spent by you. In addition, general household expenses, such as taxes, insurance, repairs, etc., ***do not*** qualify for the deduction.

If you are compensated or reimbursed for any part of the costs of having a student living with you, none of the costs may be deducted. However, if you are reimbursed for only an extraordinary or nonrecurring item, such as a hospital bill or vacation trip, which you paid in advance at the request of the student's parents or the sponsoring organization, you may deduct your other expenses for the student.

**Mutual Exchange Program.** You may not deduct the cost of a foreign student living in your home ***under a mutual exchange program*** whereby your child will live with a family in a foreign county.



## OUT OF POCKET EXPENSES

You may deduct some amounts you pay in giving services to a charitable organization. However, you **may not** deduct the value of your time or services.

The contributions must be made to a qualified organization and not set aside for use by a specific person. However, **you may deduct** reasonable unreimbursed out-of-pocket expenses you pay for underprivileged juveniles to attend athletic events, movies, or dinners, if they are selected by a charitable organization whose goal is to reduce juvenile delinquency. Your own similar expenses in accompanying the juveniles are not deductible.

**Conventions.** If you are a chosen representative attending a convention of a qualified organization, you may deduct unreimbursed expenses for travel and transportation, including a reasonable amount for meals and lodging, while away from home overnight in connection with the convention.

You cannot deduct personal expense for sightseeing, fishing parties, theater tickets, or nightclubs. You also cannot deduct travel, meals and lodging, and other expenses for your spouse or children.

You cannot deduct your expenses in attending a church convention if you go only as a member of your church rather than as a chosen representative. You can deduct unreimbursed expenses that are directly connected with giving services for your church during the convention.

**Uniforms.** You may deduct the **cost and upkeep** of uniforms that you must wear while performing donated services for a charitable organization if they are not suitable for everyday use.

**Foster Parents.** If you are a foster parent (foster care provider) and have **no profit motive** in providing foster care, you may deduct expenses you pay that **exceeds any nontaxable payments you receive** to provide foster care for individuals placed in your home by a charitable organization. The expenses must be amounts spent to provide support for the individual.

**Car Expenses.** You may deduct unreimbursed out-of-pocket expenses, such as the cost of gas and oil, which are directly related to the use of your car in giving services to a charitable organization. You **may not** deduct general repair and maintenance expenses, depreciation, or insurance.

If you do not want to deduct your actual expenses, you may use the standard mileage rate to figure your contribution.

You may deduct parking fees and tolls, **whether** you use your actual expenses or the standard rate.

**Travel.** You may claim a charitable contribution deduction for travel expenses while you are away from home performing services for a charitable organization **only** if there is no significant element of personal pleasure, recreation, or vacation in such travel.

The deduction will not be denied simply because you enjoy providing services to the charitable organization.

**Example 1.** You sail from one island to another and spend 8 hours a day counting whales and other forms of marine life. The project is sponsored by a charitable organization. ***In most circumstances***, no charitable contribution is allowed for the expenses you incur.

**Example 2.** You work for ***several hours*** each morning on an archeological excavation sponsored by a charitable organization. The rest of the day is free for recreation and sight-seeing.

No charitable deduction is allowed even though you work during the morning hours.

**Example 3.** You spend the ***entire day*** attending a charitable organization's regional meeting. In the evening you go to the theater. You may qualify to claim your travel expenses as charitable contributions.

**Daily Allowances (Per Diem).** If you provide services for a charitable organization and receive a daily allowance to cover reasonable travel expenses, including meals and lodging while away from home overnight, include in income the amount that is more than your ***actual*** travel expenses. You may deduct your necessary travel expenses that are more than the allowance.

**Deductible Travel Expenses.** Travel expenses that are deductible include:

1. Air, rail, and bus transportation,
2. Out-of-pocket expenses for your car,
3. Taxi fares or other costs of transportation between the airport or station and your hotel.
4. Lodging costs, and
5. The cost of meals.

## WHEN TO DEDUCT

You can deduct your contributions only in the year you actually make them in cash or other property (or in a succeeding carryover year, as explained under ***How to Figure Your Deduction When Limits Apply***, later). This applies whether you use the cash or accrual method of accounting.

**Time of Making Contribution.** Usually, you make a contribution at the time of its unconditional delivery.

***Checks.*** A check that you mail to a charity is considered delivered ***on the date you mail it.***

***Credit card.*** Contributions charged on your bank credit card are deductible ***in the year*** you make the charge.

***Pay-by-Phone account.*** If you use a pay-by-phone account, the date you make a contribution is the date the financial institution pays the amount. This date should be shown on the statement the financial institution sends to you.

***Stock certificate.*** The gift to a charity of a property endorsed stock certificate is completed ***on the date of mailing*** or to the deliver to the charity or the charity's agent. However, if you give a stock certificate to your agent or to the issuing corporation for transfer to the name of the charity, your gift is not completed until the date the stock ***is transferred*** on the books of the corporation.

***Promissory note.*** If you issue and deliver a promissory note to a charitable organization as a contribution, it is not a contribution until you make the note payments.

***Option.*** If you grant an option to buy real property at a bargain price to a charitable organization, you cannot take a deduction until the organization exercises the option.

***Borrowed funds.*** If you make a contribution with borrowed funds, you ***can deduct*** the contribution in the year you make it, regardless of when you repay the loan.

***Conditional gift.*** If your contribution is a conditional gift that depends on a future act or event that ***may not*** take place, you ***cannot*** take a deduction. But if there is only a negligible chance that the act or event will not take place, you can take a deduction.

If your contribution would be undone by a later act or event, you cannot take a deduction. But if there is only a negligible chance the act or event will take place, you can take the deduction.

**Example 1.** You donate cash to a local school board, which is a political subdivision of a state, to help build a school gym. The school board will refund the money to you if it does not collect enough to build the gym. You cannot deduct your gift as a charitable contribution until there is no chance of a refund.

**Example 2.** You donate land to a city for as long as the city uses it for a public park. The city does plan to use the land for a park, and there is no chance (or only a negligible chance) of the land being used for any different purpose. You can deduct your charitable contributions.

## **CONTRIBUTIONS OF PROPERTY**

If you donate property to a qualified organization, you generally may deduct the fair market value of the property at the time of the contribution. However, if the property has increased in value, you may have to make some adjustments.

### **CONTRIBUTIONS SUBJECT TO SPECIAL RULES**

Special rules apply if you contributed:

- Property subject to a debt,
- A partial interest in property,
- A future interest in tangible personal property, or
- Inventory from your business.

These special rules are described next.

**Property Subject to a Debt.** If you contribute property subject to a debt (such as mortgage), you must reduce the fair market value of the property by:

1. Any allowable deduction for interest that you paid (or will pay) attributable to any period after the contribution, and
2. If the property is a bond, the lesser of:
  - a. Any allowable deduction for interest you paid (or will pay) to buy or carry the bond that is attributable to any period before the contribution, or

- b. The interest, including bond discount, receivable on the bond that is attributable to any period before the contribution, and that is not includible in your income due to your accounting method.

This prevents a double deduction of the same amount as investment interest and also as a charitable contribution.

If the debt is assumed by the recipient (or another person), you must also reduce the fair market value of the property by the amount of the outstanding debt.

If you sold the property to a qualified organization at a bargain price, the amount of the debt is also treated as an amount realized on the sale or exchange of property.

**Partial Interest in Property.** Generally, no deduction is allowed for a charitable contribution of *less than* your entire interest in property. A contribution of the right to use property is a contribution of less than your entire interest in that property and is not deductible.

**Example 1.** You own a 10-story office building and donate rent free use of the top floor to a charitable organization. Since you still own the building, you have contributed to a partial interest in the property and cannot take a deduction for the contribution.

**Example 2.** Pam owns a vacation home at the beach that she sometimes rents to others. For a fund-raising auction at her church, she donated the right to use the vacation home for one week. At the auction, the church received and accepted a bid from Sue equal to the fair rental value of the home for one week. Pam cannot claim a deduction because of the partial interest rule just discussed.

**Future Interest in Tangible Personal Property.** You can deduct the value of a charitable contribution of a future interest in tangible personal property only after all intervening interests in and rights to the actual possession or enjoyment of the property have either expired or been turned over to someone other than yourself, a related person, or a related organization.

Related persons include your spouse, children, grandchildren, brothers, sisters, and parents. Related organizations may include a partnership or corporation that you have an interest in or an estate or trust that you have a connection with.

***Tangible personal property.*** This is any property, other than land or buildings, which can be seen or touched. It includes furniture, books, jewelry, paintings, and cars.

***Future interest.*** This is any interest that is to begin at some future time, regardless of whether it is designated as a future interest under state law.

**Example.** You own an antique car that you contribute to a museum. You give up ownership, but retain the right to keep the car in your garage with your personal collection. Since you keep an interest in the property, you cannot deduct the contribution. If you turn the car over to the museum in a later year, giving up all rights to its use, possession, and enjoyment, you can take a deduction for the contribution in that later year.

**Inventory.** If you contribute inventory (property that you sell in the course of your business), the amount you can claim as a contribution deduction is the lesser of its fair market value on the day you contributed it or its basis. The basis of donated inventory is any cost incurred for the inventory in an earlier year that you would otherwise include in your opening inventory for the year of the contribution. You must remove the amount of your contribution deduction from your opening inventory. It is not part of the cost of goods sold.

If the cost of donated inventory is not included in your opening inventory, the inventory's basis is zero and you cannot claim a charitable contribution deduction. Treat the inventory's cost as you would ordinarily treat it under your method of accounting. For example, include the purchase price of inventory bought and donated in the same year in the cost of goods sold for that year.

## **DETERMINING FAIR MARKET VALUE**

This section discusses general guidelines for determining the fair market value (FMV) of various types of donated property.

**Used Clothing.** The fair market value of used clothing and other personal items is usually far less than the price you paid for them. You should claim as the value, the price that buyers of used items actually pay in used clothing stores, such as consignment or thrift shops. You cannot take a deduction for used clothing items unless they are in good condition or better.

**Household Goods.** The FMV value of used household goods, such as furniture, appliances, and linens, is usually much lower than the price paid when new. Such used property may have little or no market value because of its worn condition. It may be out of style or no longer useful. For these reasons, formulas, such as 15% of the replacement cost new, are not acceptable in determining value. You cannot take a deduction for used household items unless they are in good condition or better.

You should support your valuation with photographs, canceled checks, or receipts from your purchase of the items.

**Large Quantities.** If you contribute a large number of the same item, fair market value is the price at which comparable numbers of the item are being sold.

**Example.** You purchase 500 bibles for \$1,000. The retail value of these bibles is \$3,000. If you contribute these bibles to a qualified organization, you may claim a deduction only for the price at which similar numbers of the same bible are currently being sold. Your charitable contribution would be \$1,000, unless you could show that similar numbers of that bible at the time of the contribution were selling at a different price.

## **GIVING PROPERTY THAT HAS INCREASED IN VALUE**

If you donate property with a fair market value that is **more than** your basis in it, you may have to reduce the fair market value by the amount of appreciation (increase in value) when you figure your deduction. Different rules apply, depending on whether the property is ordinary income property or capital gain property.

**Ordinary Income Property.** Property is ordinary income property if its sale at fair market value on the date it was contributed would have resulted in ordinary income or in short-term capital gain.

**Example.** Ordinary income property is inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held one year or less.

The deduction for a gift of ordinary income property is its fair market value **less** the amount that would be ordinary income or short-term capital gain if the property were sold at its fair market value. Generally, this rule limits the deduction to your basis in the property.

**Example.** You donate stock that you held for 5 months to your church. The value of the stock is \$1,000, but you paid only \$800 (your basis). Because the \$200 of appreciation would be short-term capital gain if you sold the stock, your deduction is limited to \$800 (fair market value less the appreciation).

**Property Used in a Trade or Business.** Property used in a trade or business is considered ordinary income property to the extent of any gain that would have been treated as ordinary income because of depreciation, had the property been sold.

**Capital Gain Property.** Property is capital gain property if its sale at fair market value on the date of the contribution would have resulted in long-term capital gain. It includes capital assets held more than one year, as well as certain real property and depreciable property used in your trade or business and generally, held more than one year.

**Deducting a Gift of Capital Gain Property.** You usually may deduct a gift of **capital gain property** at its fair market value. However, in certain situations, the fair market value is reduced to the property's cost or other basis. You **must reduce** the fair market value by any increase in value if:

1. The property (other than qualified appreciated stock) is contributed to certain private nonoperating foundations,
2. You choose the 50% limit instead of the special 30% limit, discussed later, or
3. The contributed property is tangible personal property that is put to an **unrelated** use by the charity.

**Tangible Personal Property Put to an Unrelated Use.** The term unrelated use means a use that is unrelated to the exempt purpose or function of the charitable organization. For a governmental unit, it means the use of the contributed property for **other than** exclusively public purposes.

**Example.** If a painting contributed to an educational institution is used by that organization for educational purposes by being placed in its library for display and study by art students, the use is **not** an **unrelated** use. But if the painting is **sold** and the proceeds are used by the organization for educational purposes, the use is **unrelated** use.

**Alternative Minimum Tax.** If you deduct a gift of capital gain property at its fair market value, the difference between the value and the adjusted basis of the property is a **tax preference item** subject to the alternative minimum tax rules.

**Exception.** You do not reduce your charitable contribution if you include the ordinary or capital gain income in your gross income in the same year as the contribution. This may happen when you transfer installment or discount obligations or when you assign income to a charitable organization.

**Penalty.** You may be liable for a **penalty** if you **overstate the value** or adjusted basis of donated property.

The penalty is 20% of the underpayment of tax related to the overstatement if:

1. The value or adjusted basis claimed on the return is 150% or more of the correct amount and,
2. You underpaid your tax by more than \$5,000 because of the overstatement.



The penalty is 40% of the underpayment of tax related to the overstatement if:

1. The value or adjustment basis claimed on the return is 200% or more of the correct amount, and
2. You underpaid your tax by more than \$5,000 because of the overstatement.

## **LIMITS ON DEDUCTION**

If your total contributions for the year are 20% or less of your adjusted gross income, they are fully deductible (provided they otherwise qualify), and it is not necessary to figure whether the limits discussed here apply.

If your contributions are more than 20% of your adjusted gross income, the amount of your deduction may be limited to 20%, 30% or 50% (In 2018 it's 60% if your gift is in cash) of your adjusted gross income, depending on the type of property you give and the type of organization you give it to.

Your maximum charitable contribution deduction is 50% of your adjusted gross income for the year. Adjusted gross income is not reduced by net operating loss carryback due to losses you have in later tax years.

**The 50% Limit.** The 50% limit applies to gifts (other than capital gain property deducted at fair market value) to organizations listed later under **50% Limit Organizations**.

**The 30% Limit.** The 30% limit applies to:

1. Gifts for the use of any organization, **and**
2. Gifts (other than capital gain property) to all qualified organizations other than 50% limit organizations. This includes gifts to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations.

**Special 30% Limit.** A special 30% limit applies to gifts of capital gain property (if deducted at fair market value) to 50% limit organizations.

**The 20% Limit.** The 20% limit applies to gifts of capital gain property to all qualified organizations other than 50% limit organizations.

**50% Limit Organizations.** The following are 50% limit organizations:

1. Churches, or conventions or associations of churches,

2. Educational organizations with a regular faculty and curriculum and a regular student body attending resident classes,
3. Hospitals and, under certain circumstances, organizations directly engaged in continuous medical research with these hospitals,
4. Organizations that receive substantial support from the United States or any state or their political subdivisions, or from the general public, and that are operated only to hold and administer property for state and municipal colleges and universities, and
5. A state, a possession of the United States, or any political subdivision of any of the foregoing, or the United States, or the District of Columbia, if the contribution is made for public purposes only.

These 5 are the most common known 50% limit organizations. There is a long list of private operating foundations, private nonoperating foundations, controlled organizations, corporations, and trusts. A detailed list of these additional 50% limit organizations can be found in IRS Publication 526, **Charitable Contributions**.

**Student Living With You.** Amounts you spend on behalf of a student *living with you* are subject to the 30% limit. These amounts are considered a contribution for the use of a qualified organization.

**Out-of-Pocket Expenses.** Amounts you spend performing services for a charitable organization are subject to the limit of the organization.

**Example.** The 50% limit applies to amounts you spend on behalf of a church, a 50% organization. These amounts are considered a contribution to a qualified organization.

## HOW TO FIGURE YOUR DEDUCTION WHEN LIMITS APPLY

If your contributions are more than the limits just discussed, deduct them *in the following order* (up to 50% of your adjusted gross income):

1. Contributions qualifying for the 50% limit,
2. Contributions qualifying for the 30% limit to the extent *of the lesser of:*
  - a. 30% of adjusted gross income, *or*

- b. 50% of adjusted gross income minus contributions to 50% limits organizations (including contributions of capital gain property subject to the special 30% limit).
- 3. Contributions of capital gain property subject to the special 30% limit, up to the lesser of:
  - a. 30% of adjusted gross income, or
  - b. 50% of adjusted gross income minus your other contributions to 50% limits organizations.
- 4. Contributions qualifying for the 20% limit to the extent **of the lesser of**:
  - a. 20% of adjusted gross income,
  - b. 30% of adjusted gross income **minus** contributions to which the special 30% limit applies,
  - c. 30% of adjusted gross income minus your contributions of capital gain property subject to the special 30% limit, or
  - d. 50% of adjusted gross income minus the total of your contributions to 50% limit organizations and your contributions subject to the 30% limit.

**Example.** Your adjusted gross income is \$50,000. During the year, you gave your church \$2,000 cash and land with a fair market value of \$28,000. You had purchased the land in 5 years ago and its basis is \$22,000. You held the land for investment purposes. The deduction for the gift of land does not have to be reduced by the appreciation in value. You also gave \$5,000 cash to a private foundation to which the 30% limit applies.

The \$2,000 cash donation to the church is considered first and is **fully** deductible. Your contribution to the private foundation is considered next. However, because your contributions to 50% limit organizations (\$2,000 + \$28,000) are **more than** \$25,000 (50% of \$50,000), your contribution to the private foundation is **not** currently deductible. It may be carried over to later years. See, **Carryovers**, later. The deduction for the gift of land is limited to \$15,000 (30% of \$50,000). The unused part of the land (\$13,000) may be carried over. Therefore, your deduction is limited to \$17,000 (\$2,000 + \$15,000).

**Capital Gain Property Election.** You may choose the 50% limit for gifts of capital gain property to 50% limit organizations, but you must reduce the fair market value of the property by the appreciation in value that would be long-term capital gain if the property had been sold. If you make this choice, it applies to all 30% capital gain property. You must make the choice on your original return or on an amended return filed by the due date for filing the original return.

**Example.** In the previous example, if you choose to have the 50% limit apply to the land (the 30% capital gain property), you must reduce the fair market value of the property by the appreciation in value. Therefore, your deduction for the land would be its basis to you of \$22,000. You add this amount to the \$2,000 cash contributed to the church. You may now deduct \$1,000 for the amount donated to the private foundation because your contributions to 50% limit organizations (\$24,000) are \$1,000 less than 50% of adjusted gross income. Your total deduction is \$25,000 (\$2,000 cash to your church, \$22,000 for property donated to your church, and \$1,000 cash to the private foundation). The excess contribution (\$4,000) to the private foundation may be carried over.

**Carryovers.** You may carry over your contributions that you are not able to deduct in the current year because they exceed your adjusted gross income limit. The excess may be deducted in ***each*** of the 5 succeeding years until it is used up, ***but not beyond*** that time. Your total contribution deduction for the year to which you carry your contributions cannot exceed 50% of your adjusted gross income for that year.

Contributions you carry over are subject to the same percentage limitations in the year to which they are carried.

**Example 1.** Contributions subject to the 20% limit in the year in which they are made are 20% limit contributions in the year to which they are carried. For each category of contributions, you deduct carryover contributions only after deducting all allowable contributions in that category for the current year.

**Example 2.** Last year, you contributed \$11,000 to a 60% limit organization, but because of the limit you deducted only \$10,000 and carried over \$1,000 to this year. This year your adjusted gross income is \$20,000 and you contribute \$9,500 to a 60% limit organization. You can deduct \$10,500 (60% of \$20,000 = \$12,000) this year. Consequently, in addition to your contribution of \$9,500 for this year, you can deduct \$1,000 of your carryover contribution from last year.

**Example 3.** This year your adjusted gross income is \$24,000. You made a cash contribution of \$6,000 to which the 60% limit applies and \$3,000 to which the 30% limit applies. You have a contribution carryover from last year of \$5,000 for capital gain property contributed to a 50% organization and subject to the 30% limit for contributions of capital gain property.

Your contribution deduction for this year is limited to \$14,400 (60% of \$24,000). Your 60% limit contributions of \$6,000 are fully deductible.

The deduction for your 30% limit contribution of \$3,000 is limited to \$1,000. This is the **lesser of**:

1. \$7,200 (30% of \$24,000), **or**
2. \$1,000 (\$12,000 minus \$11,000). (The \$12,000 amount is 50% of \$24,000, your adjusted gross income. The \$11,000 amount is the sum of your current and carryover contributions to 50% limit organizations, \$6,000 + \$5,000.)

The deduction for your \$5,000 carryover is subject to the 30% limit for contributions of capital gain property. This means it is limited to the smaller of:

1. \$7,200 (your 30% limit), **or**
2. \$6,000 (\$12,000, your 50% limit, minus \$6,000, the amount of your cash contributions to 50% limit organizations this year).

Since your \$5,000 carryover is less than both \$7,200 and \$6,000, you can deduct it in full.

Your deduction is \$12,000 (\$6,000 + \$1,000 + \$5,000). You carry over the \$2,000 balance of your 30% limit contributions for this year to next year.

**Nonitemizers.** If you do not itemize deductions in **any** of the carryover years, **you must reduce** the carryover by the amount **that would have been deductible** had you itemized your deductions.

**Example.** You have a contribution carryover of \$500 from Year One to Year Two. In Year Two your adjusted gross income is \$10,000, your deductible contributions are \$300, and you do not itemize deductions. If you had itemized your deductions, the total of your contributions paid during Year Two plus the carryover from Year One would have fallen below 50% of your adjusted gross income and would have been deductible. Therefore, you must consider that your carryover is used up in Year Two.

## **RECORDS TO KEEP**

You are required to keep records to prove the amount of the cash and noncash contributions during the year. The kind of records you must keep depends on the amount of your contribution and whether they are cash or noncash contributions.

**Note.** An organization generally must give you a written statement if it receives a payment from you that is more than \$75 and is partly a contribution and partly for goods or services. Keep the statement for your records. It may satisfy all or part of the recordkeeping requirements explained in the following discussions.

## **CASH CONTRIBUTIONS**

Cash contributions include those paid by cash, check, credit card, payroll deduction, or electronic funds transfer. They also include your out-of-pocket expenses when donating your services.

You cannot deduct a cash contribution, regardless of the amount, unless you keep one of the following:

1. A bank record that shows the name of the qualified organization, the date of the contribution, and the amount of the contribution.  
Bank records may include:
  - a. A canceled check,
  - b. A bank or credit union statement, or
  - c. A credit card statement.
2. A receipt (or a letter or other written communication) from the qualified organization showing the name of the organization, the date of the contribution, and the amount of the contribution.
3. The payroll deduction records described next.

**Payroll Deductions.** If you make a contribution by payroll deduction, you must keep:

1. A pay stub, Form W-2, or other document furnished by your employer that shows the date and amount of the contribution, and
2. A pledge card or other document prepared by or for the qualified organization that shows the name of the organization.

**Amount of Contribution.** In figuring whether your contribution is \$250 or more, do not combine separate contributions. For example, if you gave your church \$25 each week, your weekly payments do not have to be combined. Each payment is a separate contribution.

**Contributions of \$250 or More.** You can claim a deduction for a cash contribution of \$250 or more **only** if you have an acknowledgement of your contribution from the qualified organization or adequate payroll deduction records.

**Amount of Contribution.** If figuring whether your contribution is \$250 or more, do not combine separate contributions. However, two checks written on the same date to the same qualified organization may be considered one contribution.

If contributions are made by payroll deduction, the deduction from each paycheck is treated as a separate contribution.

**Acknowledgement.** The acknowledgement must meet these tests:

1. It must be written.
2. It must include:
  - a. The amount of cash you contributed,
  - b. Whether the qualified organization gave you any goods or services (other than token items of little value) as a result of your contribution, and
  - c. A description and good faith estimate of the value of any goods or services described in (b). If the only benefit you received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative's context, the acknowledgement must say so and does not need to describe or estimate the value of the benefit.
3. You must get it on or before the earlier of:
  - a. The date you file your return for the year you make the contribution, or
  - b. The due date, including extensions, for filing the return.

**Payroll Deduction Records.** If you make a contribution by payroll deduction, you do not need an acknowledgement from the qualified organization. But if your employer deducted \$250 or more from a single paycheck, you must keep:

1. A pay stub, Form W-2, or other documents furnished by your employer that proves the amount withheld, and
2. A pledge card or other documents from the qualified organization that states the organization does not provide goods or services in return for any contribution made to it by payroll deduction.

## **NONCASH CONTRIBUTIONS**

For a contribution not made in cash, the records you must keep depend on whether your deduction for the contribution is:

1. Less than \$250,
2. At least \$250 but not more than \$500,
3. Over \$500 but not more than \$5,000, or
4. Over \$5,000.

**Amount of Deduction.** In figuring whether your deduction is \$500 or more, combine your claimed deductions for all similar items of property donated to any charitable organization during the year.

## **DEDUCTIONS OF LESS THAN \$250**

If you make any noncash contribution, you must get and keep a receipt from the charitable organization showing:

1. The name of the charitable organization,
2. The date and location of the charitable contribution, and
3. A reasonably detailed description of the property.

The letter or other written communication from the charitable organization acknowledging receipt of the contribution and containing the information in (1), (2), and (3) will serve as the receipt.

You are not required to have a receipt where it is impractical to get one (for example, if you leave property at a charity's unattended drop site.)



**Additional Records.** You must also keep reliable written records for each item of donated property. Your written records must include the following information.

1. The name and address of the organization to which you contributed.
2. The date and location of the contribution.
3. A description of the property in detail reasonable under the circumstances.
4. The fair market value of the property at the time of the contribution and how you figured the fair market value. If it was determined by appraisal, you should also keep a signed copy of the appraisal.
5. The cost or other basis of the property if you must reduce its fair market value by appreciation.
6. The amount you claim as a deduction for the tax year as a result of the contribution, if you contribute less than your entire interest in the property during the tax year.
7. The terms of any conditions attached to the gift of property.

**Deductions of at Least \$250 But not More Than \$500.** If you claim a deduction of at least \$250 but not more than \$500 for a noncash charitable contribution, you must get and keep an acknowledgement of your contribution from the qualified organization. If you made more than one contribution of \$250 or more, you must have either a separate acknowledgement for each or one acknowledgement that shows your total contributions.

The acknowledgement must contain the information in items (1) through (3) listed under ***Deductions of Less Than \$250***, earlier, and your written records must include the information listed in that discussion under ***Additional Records***.

The acknowledgement must also meet these tests.

1. It must be written.
2. It must include:
  - a. A description (but not necessarily the value) of any property you contributed,
  - b. Whether the qualified organization gave you any goods or services as a result of your contribution

(other than certain token items and membership benefits), and

- c. A description and good faith estimate of the value of any goods or services described in (b).
3. You must get the acknowledgement on or before the earlier of:
    - a. The date you file your return for the year you make the contribution, or
    - b. The due date, including extensions, for filing the return.

### **DEDUCTIONS OVER \$500 BUT NOT OVER \$5,000**

If you claim a deduction over \$500 but not over \$5,000 for noncash charitable contributions, you must have the acknowledgement and written records described under ***Deductions of at Least \$250 But Not More Than \$500***. Your records must also include:

1. How you got the property, for example, by purchase, gift, bequest, inheritance, or exchange.
2. The approximate date you got the property or, if created, produced, or manufactured by or for you, the approximate date the property was substantially completed.
3. The cost or other basis and any adjustments to the basis, of property held less than 12 months and, if available, the cost or other basis of property held 12 months or more. This requirement, however, does not apply to publicly traded securities.

If you are not able to provide information on either the date you got the property or the cost basis of the property and you have a reasonable cause for not being able to provide this information, attach a statement of explanation to your return.

### **DEDUCTIONS OVER \$5,000**

If you claim a deduction of ***over*** \$5,000 for a charitable contribution of one property item or a group of similar property items, you must have the acknowledgement and the written records described under ***Deductions Over \$500 But Not Over \$5,000***. In figuring whether your deduction is over \$5,000, combine your claimed deductions for all similar items donated to any charitable organization during the year.

Generally, you must also obtain a qualified written appraisal of the donated property from a qualified appraiser.

For deductions of more than \$5,000 of noncash property, IRS Publication 561, ***Determining the Value of Donated Property***, could be very helpful.

## **CONTRIBUTIONS OF CARS, BOATS AND AIRPLANES**

The following rules apply to any donation of a qualified vehicle. A qualified vehicle is:

- A car or any motor vehicle manufactured mainly for use on public streets, roads, and highways,
- A boat, or
- An airplane.

**Deduction more than \$500.** If you donate a qualified vehicle to a qualified organization and you claim a deduction of more than \$500, you can deduct the smaller of:

- The gross proceeds from the sale of the vehicle by the organization, or
- The vehicle's fair market value on the date of contribution. If the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to figure the deductible amount, as described under ***Giving Property That Has Increased in Value***, later.

***Form 1098-C.*** You must attach to your return the copy of the Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes, (or other statement containing the same information as Form 1098-C) you received from the organization. The Form 1098-C (or other statement) will show the gross proceeds from the sale of the vehicle.

If you do not attach Form 1098-C (or other statement), you cannot deduct your contribution. You must get Form 1098-C (or other statement) within 30 days of the sale of the vehicle. But if exception 1 or 2 (described next) applies, you must get Form 1098-C (or other statement) within 30 days of your donation.

**Exceptions.** There are two exceptions to the rules just described for donations of \$500.

**Exception 1.** Vehicle used or improved by organization. If the qualified organization makes a significant intervening use of material improvement to the vehicle before transferring it, and you claim a deduction of more than \$500, you generally can deduct the vehicle's fair market value at the time of contribution. But if the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount.

**Exception 2** Vehicle given or sold to needy individual. If the qualified organization will give the vehicle, or sell it for a price well below fair market value, to a needy individual to further the organization's charitable purpose, and you claim a deduction a deduction of more than \$500, you can generally deduct the vehicle's fair market value at the time of contribution. But if the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount.

# PRACTICE REVIEW QUESTIONS

## CHAPTER 1 CHARITABLE CONTRIBUTIONS

1. Which one of the following statements is **correct** in regard to deductible charitable contributions carry-overs?
  - A. They can be carried forward a maximum of 3 years.
  - B. They can be carried forward a maximum of 5 years.
  - C. They can be carried forward a maximum of 7 years.
  - D. They can be carried forward a maximum of 10 years.
  
2. IRS Publication 78 contains a list of organizations that are eligible to receive deductible contributions. Which one of the followings statements is **correct** in this regard?
  - A. To officially qualify to receive contributions that are deductible, an organization must be included on that list.
  - B. Publication 78 publishes an annual update.
  - C. Publication 78 does not distinguish between the 30% or 50% limitation on deductible contributions.
  - D. Churches are not required to apply for their tax-exempt status.
  
3. Which one of the following statements is **incorrect** in regard to organizations that qualify for tax-exempt status?
  - A. A community chest qualifies.
  - B. A war veteran's organization qualifies.
  - C. Domestic fraternal societies not operating under the lodge system qualify.
  - D. Certain nonprofit cemetery companies qualify.
  
4. Which one of the following statements is **incorrect** in regard to entities being eligible to receive tax deductible contributions?
  - A. Homeowners' associations are not eligible.
  - B. Individuals are not eligible.
  - C. The Federal government is not eligible.
  - D. The chamber of commerce is not eligible.

5. Which one of the following statements is **incorrect** regarding expenses paid for a student living with you in order to qualify as a charitable deduction?
- A. To qualify as a student, the student must not be your relative.
  - B. To qualify, the agreement must be in writing.
  - C. To qualify, the student may be either full-time or part-time.
  - D. You can deduct up to \$50 per month for each student who qualifies.
6. Which one of the following statements is **incorrect** in regard to deducting as charitable contributions amounts you pay in giving services to charitable organizations?
- A. The contributions must be made to a qualified organization.
  - B. You may deduct out-of-pocket expenses you pay for certain underprivileged juveniles.
  - C. You may deduct the cost of uniforms that you must wear while performing donated services.
  - D. You may not deduct the cost of cleaning the uniforms you must wear.
7. Which one of the following statements is **incorrect** in regard to deducting car expenses incurred in your service to a charitable organization?
- A. You may deduct your cost of gasoline.
  - B. You may not deduct the cost of insurance.
  - C. You may use either the actual expense method or the standard mileage rate.
  - D. You may not deduct parking fees.
8. Which one of the following statements is **incorrect** in regard to the charitable deduction of donated property?
- A. If you donate property to a charitable organization, you may deduct the fair market value of the property.
  - B. A contribution of only 50% interest in a property is not deductible.
  - C. A contribution of the right to use property is deductible.
  - D. A contribution of a painting to a qualified organization is deductible.

9. Gifts to certain organizations allow the donor to deduct 50% of the value of the gift. Which one of the following statements is ***incorrect*** in this regard?
- A. Contributions to churches qualify for the donor's 50% deduction.
  - B. Contributions to certain educational organizations qualify for the donor's 50% deduction.
  - C. Contributions to any U.S. state qualify for the 50% limit if the contribution is made for public purposes.
  - D. Amounts you spend on behalf of a qualified student living with you are subject to the 50% limit.
10. In order to deduct a cash contribution you must have a written record. Which one of the following statements is ***incorrect*** in this regard?
- A. A cancelled check is acceptable
  - B. A bank statement is acceptable.
  - C. A pledge card by the donee organization is acceptable.
  - D. A pay stub is not acceptable.





# RESPONSES TO REVIEW QUESTIONS

## CHAPTER 1 -- CHARITABLE CONTRIBUTIONS

1.
  - A. **Incorrect.** The regulations specifically allow for 5 years carry forward.
  - B. **Correct.** They can be carry forward 5 years subject to the basic maximum allowable deduction in each of those years.
  - C. **Incorrect.** Any unused excess not carry forward within 5 years are no longer deductible and are lost.
  - D. **Incorrect.** The IRS specifically limits unallowed carry forward charitable contributions to a maximum of 5 years.
2.
  - A. **Incorrect.** However, any gifts to organizations **not** listed in Publication 78 may still be deductible if the recipient organization is otherwise qualified under the basic rules.
  - B. **Incorrect.** Publication 78 publishes a quarterly update of **newly qualified** organizations.
  - C. **Incorrect.** Publication 78 indicates which organizations qualify for a 50% or a 30% limitation.
  - D. **Correct.** Churches are not required to apply for their tax-exempt status but may find it advantageous to do so.
3.
  - A. **Correct.** A community chest qualifies if it is organized for religious, charitable, educational, scientific or literary purposes.
  - B. **Correct.** War veteran's organizations that are organized in the United States or any of its possessions qualify.
  - C. **Incorrect.** Domestic fraternal societies must operate under the lodge system in order to qualify.
  - D. **Correct.** Nonprofit cemeteries qualify if the contribution **is** used for a specific lot or crypt.
4.
  - A. **Correct.** Homeowners' dues are for real estate maintenance obligations and not as contributions.
  - B. **Correct.** Otherwise a taxpayer could reduce his or her tax liability by reducing part of his or her income on to family members or others.
  - C. **Incorrect.** Contributions to the federal government are deductible **only** if the contributions are solely for public purposes. An example would be a gift to reduce the public debt.
  - D. **Correct.** Chambers of Commerce is organizations associated with, for profit, business groups.

- 5.
- A. **Correct.** The student may be a foreign or an American student, but he or she cannot be your relative.
  - B. **Correct.** The student must live in your home under a written agreement between you and a qualified organization.
  - C. **Incorrect.** The student must be a ***full-time*** student in the first through the twelfth grade. The school must be located in the United States.
  - D. **Correct.** You can deduct up to \$50 per month for each ***full calendar month*** the student lives with you. Fifteen days or more qualify as a month.
- 6.
- A. **Correct.** However, the contributions ***may not*** be set aside for a specific individual and you ***may not*** deduct the value of your time or services.
  - B. **Correct.** Your expenses are deductible if the organization's goal is to reduce juvenile delinquency. However, your own expenses are ***not*** deductible.
  - C. **Correct.** You may deduct the cost of uniforms if they ***are not*** suitable for every day wear.
  - D. **Incorrect.** You ***may deduct*** the cost of the ***upkeep*** of uniforms that are unsuitable for every day wear.
- 7.
- A. **Correct.** The cost of gasoline which is related to giving service to a charitable organization is equivalent to giving money to the organization.
  - B. **Correct.** The IRS takes the position that you would have had insurance without regard to your service to a charitable organization, so there is actually no extra cost to you.
  - C. **Correct.** The two methods for deducting car expenses have been calibrated to be equal in the amount to your expenses, so either method is acceptable.
  - D. **Incorrect.** Because parking fees are extra expenses in giving service to a charitable organization the fees are the equivalent to giving that amount of cash.

8.

- A. **Correct.** However, you must reduce the fair market value by any interest you paid (or will pay) for any period **after** the contribution is made. In other words, no double deduction is allowed.
- B. **Correct.** Also, a contribution of the **right to use** the property is considered as a partial interest in the property.
- C. **Incorrect.** Generally, no deduction is allowed for a charitable contribution of **less than** your entire interest in property. A contribution of the right to **use** property is a contribution of less than your entire interest and therefore is not deductible.
- D. **Correct.** Any tangible personal property qualifies, such as, furniture, clothing, books and paintings.

9.

- A. **Correct.** Because churches are not profit making organizations and because freedom of religion is one of the basic liberties of the United States, donors are allowed to make the maximum percentage allowable
- B. **Correct.** However, to qualify the institution must have a regular faculty and curriculum and a regular student body attending classes.
- C. **Correct.** The 50% donation deduction applies **only** if the contribution is made for public purposes.
- D. **Incorrect.** The amounts spent on a qualified student living with you are considered a contribution subject to the 30% limit.

10.

- A. **Correct.** A cancelled check is acceptable if it is accompanied by a bank record that is made payable to the subject organization.
- B. **Correct.** A bank record is acceptable if it shows the date and amount of the contribution and the name of the qualified recipient organization.
- C. **Correct.** A pledge card prepared by the organization that shows the name of the organization is acceptable.
- D. **Incorrect.** Either a pay stub or Form W-2 is acceptable but only if the date and amount is shown.



## CHAPTER 2

### MEDICAL EXPENSES

This chapter explains how to claim a deduction for your medical and dental expenses. It contains an alphabetized list of items that you can or cannot include in figuring your deduction. It also explains how to treat insurance reimbursements and other reimbursements you may receive for medical care.

Medical care expenses include amounts paid for the diagnosis, cure, treatment, or prevention of disease, and for treatments affecting any part or function of the body. The expenses ***must be to alleviate or prevent*** a physical defect or illness. Expenses for ***solely*** cosmetic reasons generally ***are not*** expenses for medical care. Also, expenses that are merely beneficial to one's general health (for example, vacations) are ***not*** expenses for medical care.

The **Tax Cut and Jobs Act** will keep the deduction for medical expenses and for tax year 2018 reduces the threshold back to 7.5% for all taxpayers. For tax years 2019 through 2025 the percentage will be 10% for all ages.

### WHOSE MEDICAL EXPENSES CAN BE DEDUCTED

A taxpayer may deduct medical expenses he pays for himself and for the following individuals.

**Spouse.** You may deduct medical expenses you paid for your spouse. You must have been married at the time your spouse received the medical services ***or at the time you paid*** the medical expenses.

**Example.** Mary received medical treatment before she married Bill. Bill paid for the treatment after they married. Bill may include these expenses in figuring his medical expense deduction even if Bill and Mary file separate returns.

**Dependents.** You may deduct medical expenses you paid for a person who was your dependent at the time the medical services ***were provided*** or at the time ***you paid*** the expenses.

You also may deduct medical expenses you paid for a person ***you could have claimed*** as a dependent if that person had not had gross income in excess of his or her personal exemption amount, ***or*** had not filed a joint return.

**Example 1.** Your son, age 22 earned \$4,000. You may not claim him as a dependent because he earned more than his personal exemption amount and he is not a student. You provided more than half of his support, including \$800 medical expenses. You **may include** the \$800 in figuring your medical expense deduction.

**Example 2.** You provided more than half of your married daughter's support, including medical expenses of \$1,200. She and her husband must file a return. They file a joint return. You may not claim your daughter **as a dependent** but you **may include** in your medical expenses the \$1,200 medical expenses you paid for her.

**Tax Tip.** In some cases a tax savings may be realized by married taxpayers filing separately.

**Example.** Jack and Ann were married all of the year. Ann incurred \$2,000 medical expenses **early** in the year. Jack earned \$20,000 and Ann earned \$10,000 in the year and their AGI was \$30,000 for the year. If they file jointly, they can deduct **only** the amount of medical expenses in excess of 7.5% of their AGI, which is \$2,250. So they do not get the benefit of any of the \$2,000 expenses.

If Jack and Ann had their return prepared by a Tax School student, they would not have lost **all** of the medical expenses deduction. They would have been advised to have Ann pay her medical expenses out of her **separate** funds and then file a separate return. Her separate return AGI would be \$10,000. She would be able to deduct **\$1,000** of her medical expenses. ( $\$10,000 \times 7.5\%$  equals \$750.  $\$2,000$  expenses less \$750 = \$1,250.)

**Caution.** This scenario is **not this simple** in a community property state. In a community property state Jack and Ann's earnings **and** the medical expenses would have to be split equally. **Each** would have \$15,000 AGI and **each** would be allowed to deduct **only** \$1,000 in medical deductions. Consequently neither would be eligible, because 7.5% of \$15,000 AGI is \$1,125. It would be technically possible to do so, but **only** if Ann had **"true" separate income** that **was not** community income. Tax professionals in community property states are probably familiar with this rule.

**Adopted Child.** You can include medical expenses that you paid for a child **before** adoption, if the child qualified as your dependent **when the medical services were provided** or **when you paid** the expenses. If you pay back an adoption agency or other persons for medical expenses they paid under an agreement with you, you are treated as having paid those expenses. But if you pay back medical expenses incurred and paid **before** adoption negotiations began, you **cannot** include them as medical expenses.

**Child of Divorced or Separated Parents.** If either parent can claim a child as a dependent under the rules for divorced or separated parents, either parent can include the medical expenses he **or** she pays for the child.

**Decedents.** The survivor or personal representative of a decedent can choose to treat certain expenses paid by the decedent's estate for the decedent's medical care as paid by the decedent **at the time** the medical services were provided. The expenses must be paid **within the one-year period** beginning with the day after the date of death. If you are the survivor or personal representative making this choice, you must attach a statement to the decedent's Form 1040 or Form 1040X saying that the expenses **have not** been and **will not** be claimed on the estate tax return.

If you paid medical expenses for your deceased spouse or dependent, include them as medical expenses on your Form 1040 in the year paid, whether they are paid before or after the decedent's death.

## DEDUCTIBLE MEDICAL EXPENSES

You can include **only** the medical and dental expenses **you paid during the year**, regardless of when the services were provided. If you pay medical expenses by check, the day you mail or **deliver the check** is the date of payment. If you use a "pay-by-phone" account to pay your medical expenses, the date reported on the statement of the financial institution showing when payment was made is the date of payment. You can include medical expenses **you charge to your credit card in the year the charge is made**. It does not matter when you **actually pay** the amount charged.

## ALPHABETIZED MEDICAL EXPENSES

Following is a list of items that you can or cannot include in figuring your medical expense deduction. The items are listed in alphabetical order.

**Abortion.** You can include in medical expenses the amount you pay for a **legal** abortion.

**Acupuncture.** You can include in medical expenses the amount you pay for acupuncture.

**Alcoholism.** You can include in medical expenses, payments for an inpatient's treatment at a therapeutic center for alcohol or drug addiction. This **includes** meals and lodging provided by the center during medical treatment.

**Ambulance.** You can include in medical expenses amounts you pay for ambulance service.

**Artificial Limb.** You can include in medical expenses amounts you pay for an artificial limb.

**Artificial Teeth.** You can include in medical expenses the amount you pay for artificial teeth.

**Autoette.** See *Wheelchair*, later.

**Birth Control Pills.** You can include in medical expenses the amount you pay for birth control pills prescribed by your doctor.

**Braille Books and Magazines.** You can include in medical expenses the part of the cost of Braille books and magazines for use by a visually-impaired person ***that is more than the price for regular printed*** editions.

**Capital Expenses.** You can include in medical expenses amounts you pay for special equipment installed in your home, or for improvements, if their ***main purpose*** is medical care. The cost of permanent improvements that increase the value of the property may be ***partly*** included as a medical expense. The cost of the improvement is ***reduced*** by the ***increase*** in the value of the property. The ***difference*** is a medical expense. If the value of the property is ***not increased*** by the improvement, the ***entire*** cost is included as a medical expense.

Certain improvements made to modify a home for your disabled condition, or that of your spouse or your dependents that live with you, ***do not usually increase*** the value of the residence and the ***cost can be included in full*** as medical expenses. These improvements include, but are not limited to, the following items:

- Constructing entrance or exit ramps to your residence,
- Widening doorways at entrances or exits to your residence,
- Widening or otherwise modifying hallways and interior doorways,
- Installing railing, support bars, or other modifications to bathrooms,
- Lowering or modifying kitchen cabinets and equipment,
- Moving or modifying electrical outlets and fixtures,
- Installing porch lifts, and other forms of lifts but generally not elevators,



- Modifying fire alarms, smoke detectors, and other warning systems,
- Modifying stairways,
- Adding handrails or grab bars anywhere in the house,
- Modifying hardware on doors,
- Modifying areas in front entrance and exit doorways, and
- Grading the ground to provide access to the residence.

Only reasonable costs to accommodate a personal residence to a disabled condition are considered medical care. Additional cost for personal motives, such as for architectural or aesthetic reasons are not medical expenses.

**Example.** You have a heart ailment. On your doctor's advice, you install an elevator in your home so that you will not have to climb stairs. The elevator cost \$2,000. An appraisal shows that the elevator increases the value of your home by \$1,400. Your medical expense deduction is \$600 (\$2,000 cost less \$1,400 increase in value).

***Operation and upkeep.*** If a capital expense qualifies as a medical expense, amounts you pay for ***operation and upkeep also qualify*** as medical expenses, as long as the medical reason for the capital expense still exists. This is so even if none or only part of the original capital expense qualified as a medical care expense.

**Example.** If, in the previous example, the elevator increased the value of your home by \$2,000, you would have no medical expense for the cost of the elevator. However, the cost of electricity to operate the elevator and repairs to maintain it are medical expenses as long as the medical reason for the elevator exists.

**Improvements to Property Rented by a Person With Disabilities.** Amounts paid by a person with disabilities to buy and install special plumbing fixtures, mainly for medical reasons, in a rented house are medical expenses.

**Example.** John has arthritis and a heart condition. He cannot climb stairs or get into a bathtub. On his doctor's advice, he installs a bathroom with a shower stall on the first floor of his two-story rented house. The landlord did not pay for any of the cost of buying and installing the special plumbing and did not lower the rent. John can include in medical expenses the entire amount he paid.

**Car.** You can include in medical expenses the cost of special hand controls and other special equipment installed in a car for the use of a person with disabilities.

***Special design.*** The amount by which the cost of a car specially designed to hold a wheelchair is more than the cost of a regular car is a medical expense.

***Cost of operation.*** You cannot deduct the cost of operating a specially equipped car, except as discussed under ***Transportation.***

**Chiropractors.** You can include in medical expenses fees you pay to a chiropractor for medical care.

**Christian Science Practitioners.** You can include in medical expenses fees you pay to Christian Science Practitioners.

**Contact Lenses.** See ***Eyeglasses.***

**Cosmetic Surgery.** Generally, you cannot include in medical expenses the amount you pay for unnecessary cosmetic surgery. This applies to any procedure that is directed at improving the patient's appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease. Procedures such as face lifts, hair transplants, hair removal (electrolysis), and liposuction generally are not deductible.

You can include in medical expenses the amount you pay for cosmetic surgery if it is necessary to improve a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or a disfiguring disease.

**Crutches.** You can include in medical expenses the amount you pay to buy or rent crutches.

**Dancing Lessons, Swimming Lessons, Etc.** You cannot include the cost of dancing lessons, swimming lessons, etc., even if they are recommended by your doctor for the improvement of your general health.

**Dental Treatment.** You can include in medical expenses the amounts you pay for dental treatment. This includes fees paid to dentists for X-rays, fillings, braces, extractions, dentures, etc.

**Diaper Service.** You ***cannot*** include in medical expenses the amounts you pay for diapers or diaper services, ***unless*** they are needed to relieve the effects of a particular disease.

**Drugs.** See *Medicines*.

**Drug Addiction.** See *Alcoholism*.

**Electrolysis or Hair Removal.** See *Cosmetic surgery*.

**Eyeglasses.** You can include in medical expenses amounts you pay for eyeglasses and contact lenses you need for medical reasons. You can also include fees paid for eye examinations.

**Founder's Fee.** See *Lifetime care--advance payments*.

**Funeral Expenses.** You cannot include in medical expenses amounts you pay for funerals. However, funeral expenses may be deductible on the decedent's federal estate tax return.

**Guide Dog or Other Animal.** You can include in medical expenses the cost of a guide dog or other animal to be used by the visually impaired. You can also include the cost of a dog or other animal trained to assist persons with other physical disabilities. Amounts you pay *for the care* of these specially trained animals are also medical expenses.

**Hair Transplant.** See *Cosmetic surgery*.

**Health Club Dues.** You cannot include health club dues, YMCA dues, or amounts paid for steam baths for your general health or to relieve physical or mental discomfort not related to a particular medical condition.

**Hearing Aids.** You can include in medical expenses the cost of a hearing aid and the batteries you buy to operate it.

**HMO-Health Maintenance Organization.** You can include in medical expenses amounts you pay to entitle you to receive medical care from a health maintenance organization. These amounts are treated as medical insurance premiums. See *Insurance premiums*.

**Hospital Services.** You can include in medical expenses amounts you pay for the cost of inpatient care at a hospital or similar institution if your main reason for being there is to receive medical care. This *includes* amounts paid for *meals and lodging*. Also see *Lodging*.

**Household Help.** You *cannot* include in medical expenses the cost of *household help*, even if your doctor recommends it because you are physically unable to do housework. However, you *can include* certain expenses paid to an attendant providing *nursing-type* services. See *Nursing services*.

**Insurance Premiums.** You can include in medical expenses insurance premiums you paid for policies that cover medical care. Policies can provide payment for:

- Hospitalization, surgical fees, X-rays, etc.,
- Prescription drugs,
- Replacement of lost or damaged contact lenses, or
- Membership in an association that gives cooperative or so-called "free-choice" medical service, or group hospitalization and clinical care.

The insurance policy can pay you, the patient, or the care provider (hospital, doctor, dentist, etc.) directly.

If you have a policy that provides more than one kind of payment, you can include the premiums for the medical care part of the policy if the charge for the medical part is reasonable. The cost of the medical portion must be separately stated in the insurance contract or given to you in a separate statement.

***Prepaid insurance premiums.*** Premiums you pay before you are 65 for insurance for medical care for yourself, your spouse, and your dependents after you reach 65 are medical care expenses. These premiums are included in your medical expenses in the year paid if they are:

1. Payable in equal yearly installments, or more often, and
2. Paid for at least 10 years, or until you reach age 65 (but not for less than 5 years).

**You cannot include premiums you pay for:**

- Life insurance policies,
- Policies providing payment for ***loss of earnings***,
- Policies for loss of life, limb, sight, etc.,
- Policies that ***pay you a guaranteed amount each week*** for a stated number of weeks if you are hospitalized for sickness or injury, or
- The ***part of your car insurance premiums*** that provides ***medical*** insurance coverage for all persons injured in or by your car ***because*** the part of the premium for you and your

dependents is ***not stated separately*** from the part of the premium for medical care for others.

**Laboratory Fees.** You can include in medical expenses the amounts you pay for laboratory fees that are part of your medical care.

**Lead-Based Paint Removal.** You can include in medical expenses the cost of removing lead-based paints from surfaces in your home to prevent a child who has or has had lead poisoning from eating the paint. These surfaces must be in poor repair (peeling or cracking) or within the child's reach. The cost of ***repainting the scraped area*** is not a medical expense.

If, instead of removing the paint, you cover the area with wallboard or paneling, treat these items as capital expenses. See ***Capital expenses***, earlier. Do not include the cost of painting the wallboard as a medical expense.

**Learning Disability.** You can include in medical expenses tuition fees you pay to a special school for a child who has severe learning disabilities caused by mental or physical impairments, including nervous system disorders. Your doctor must recommend that the child attend the school. See ***Schools, special***, later.

You can also include tutoring fees you pay on your doctor's recommendation for the child's tutoring by a teacher who is specially trained and qualified to work with children who have severe learning disabilities.

**Legal Fees.** You can include in medical expenses legal fees paid to authorize treatment for mental illness. However, if part of the legal fee includes, for example, a guardianship or estate management fee, you cannot include that part in medical expenses.

**Lifetime Care-Advance Payments.** You can include in medical expenses a part of a ***life-care fee*** or "founder's fee" you pay either monthly or as a lump sum under an agreement with a retirement home. The part of the payment ***you include*** is the amount ***properly allocable*** to medical care. The agreement must require a specified fee payment as a condition for the home's promise to provide lifetime care that includes medical care.

***Dependents with disabilities.*** You can include in medical expenses advance payments to a private institution for lifetime care, treatment, and training of your physically or mentally impaired dependent upon your death or when you become unable to provide care. The payments must be a condition for the institution's future acceptance of your dependent and must not be refundable.

**Lodging.** You can include in medical expenses the ***cost of lodging*** (not provided in a hospital or similar institution) while away from home if you meet ***all*** of the following requirements.

1. The lodging is primarily for and essential to medical care.
2. Medical care is provided by a doctor in a licensed hospital or in a medical care facility related to, or the equivalent of, a licensed hospital.
3. The lodging is not lavish or extravagant under the circumstances.
4. There is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

The amount you include in medical expenses **cannot exceed \$50** for each night for each person. Lodging is included for a person for whom transportation expenses are a medical expense because that person is traveling with the person receiving the medical care. For example, if a **parent is traveling with a sick child**, up to \$100 per night is included as a medical expense for lodging. (Meals are **not** deductible).

**Do not include** the cost of your meals and lodging while you are away from home for medical treatment **that you do not receive at a medical facility**, or that is not for the relief of a specific condition, even if the trip is made on the advice of your doctor.

**Example.** You have a heart condition. You live in an area that has cold winters, which makes your condition worse. Your doctor advises you to spend the winter in a warmer place. You and your family spend the winter in a rented house in Arizona. The trip was made for a specific medical reason. You cannot include any of the expenses for food and lodging between your home and Arizona, or while you are in Arizona, as a medical expense. However, **your share of transportation expenses** between your home and Arizona **is included** as a medical expense. Your family's transportation **is not** deductible. See **Transportation**, later.

**Maternity Clothes.** You cannot include in medical expenses amounts you pay for maternity clothes.

**Meals.** See **Lodging and Hospital services**, earlier.

**Medical Information Plan.** You can include in medical expenses amounts paid to a plan that keeps your medical information so that it can be retrieved from a computer data bank for your medical care.

**Medical Services.** You can include in medical expenses amounts you pay for medical services provided by physicians, surgeons, specialists, or other medical practitioners.

**Medicines.** You can include in medical expenses amounts you pay for prescribed medicines and drugs. A prescribed drug is one which requires a prescription by a doctor for its use by an individual. You can also include amounts you pay for insulin. Except for insulin, you cannot include in medical expenses amounts you pay for a drug that is not prescribed.

**Mentally Challenged, Special Home for.** You can include in medical expenses the cost of keeping a mentally retarded person in a special home, ***not the home of a relative***, on the recommendation of a psychiatrist to help the person adjust from life in a mental hospital to community living.

**Nursing Home.** You can include in medical expenses the cost of ***medical care*** in a nursing home or home for the aged for yourself, your spouse, or your dependents. This includes the cost of meals and lodging in the home if the ***main reason*** for being there ***is to get medical care***.

Do not include the cost of meals and lodging if the reason for being in the home is personal. You can, however, include in medical expenses the part of the cost that is for medical or nursing care.

**Nursing Services.** You ***can include*** in medical expenses wages and other amounts you pay for ***nursing services***. Services need not be performed by a nurse as long as the services are of a kind generally performed by a nurse. This includes services connected with caring for the patient's condition, such as giving medication or changing dressings, as well as bathing and grooming the patient.

***Only*** the amount spent for ***nursing services*** is a medical expense. If the attendant also provides ***personal and household services***, these amounts must be divided between the times spent performing household and personal services and the time spent for nursing services. However, certain expenses for household services or for the care of a qualifying individual incurred to allow you to work may qualify for the child and dependent care credit.

You ***can also include*** in medical expenses part of the amounts you pay for that ***attendant's meals***. Divide the food expense among the household members to find the cost of the attendant's food. Then apportion that cost in the same manner, as described above, that you apportioned the attendant's wages between nursing services and all other services. If you had to pay additional amounts for household upkeep because of the attendant, you can include the extra amounts with your medical expenses. This includes extra rent or utilities you pay because you moved to a larger apartment to provide space for the attendant.

**Employment Taxes.** You can include ***social security tax and Medicare tax*** you pay for a nurse, attendant, or other person who provides medical care ***as a medical expense***.

**Healthy Baby.** Do not include the cost of nursing services for a normal, healthy baby. But you may be able to take a credit for child care expenses.

**Operations.** You can include in medical expenses amounts you pay for legal operations that are not for unnecessary cosmetic surgery.

**Optometrist.** See ***Eyeglasses***, earlier.

**Oxygen.** You can include in medical expenses amounts you pay for oxygen or oxygen equipment to relieve breathing problems caused by a medical condition.

**Personal Use Items.** You cannot include in medical expenses an item ordinarily used for personal, living, or family purposes ***unless*** it is used primarily to prevent or alleviate a physical or mental defect or illness. For example, ***the full cost of a wig purchased upon the advice of a physician for the mental health of a patient who has lost all of his or her hair from disease*** can be included with medical expenses.

Where an item purchased in a special form primarily to alleviate a physical defect is one that in normal form is ordinarily used for personal, living, or family purposes, the excess of the cost of the special form over the cost of the normal form is a medical expense (see ***Braille books and magazines***).

**Prosthesis.** See ***Artificial Limb***, earlier.

**Psychiatric Care.** You can include in medical expenses amounts you pay for psychiatric care. This includes the cost of supporting a mentally ill dependent at a specially equipped medical center where the dependent receives medical care. See ***Psychoanalysis*** and ***Transportation***.

**Psychoanalysis.** You can include in medical expenses payments for psychoanalysis. You cannot include payments for psychoanalysis that you must get as a part of your training to be a psychoanalyst.

**Psychologist.** You can include in medical expenses amounts you pay to a psychologist for medical care.

**Schools, Special.** You can include in medical expenses payments to a special school for a mentally impaired or physically disabled person if the main reason for using the school is its resources for relieving the disability. You can include, for example, the cost of a school that:



- **Teaches Braille** to a visually impaired child,
- **Teaches lip reading** to a hearing impaired child, or
- Gives remedial language training to correct a condition caused **by a birth defect**.

The cost of meals, lodging, and ordinary education supplied by a special school can be included in medical expenses **only if** the main reason for the child's being there is the resource the school has for relieving the mental or physical disability.

You **cannot include** in medical expenses the cost of sending a **problem child** to a special school for benefits the child may get from the course of study and the disciplinary methods.

**Stop-Smoking Programs.** You can include the amount you pay for a program to stop smoking as a medical expense on Schedule A. However, you cannot include any amount you pay for drugs designed to help stop smoking that do not require a prescription, such as nicotine gum or patches.

**Sterilization.** You **can include** in medical expenses the cost of a legal sterilization (a legally performed operation to make a person unable to have children).

**Surgery.** See **Operations**, earlier.

**Swimming Lessons.** See **Dancing Lessons**, earlier.

**Telephone.** You can include in medical expenses the cost and repair of special telephone equipment that lets a deaf person communicate over a regular telephone.

**Television.** You **can include** in medical expenses the cost of equipment that displays the audio part of television programs as **subtitles for the deaf**. This may be the cost of an adapter that attaches to a regular set. It also may be the cost of a specially equipped television that exceeds the cost of the same model regular television set.

**Therapy.** You can include in medical expenses amounts you pay for the therapy you receive as medical treatment.

**"Patterning" exercises.** Payments you make to an individual for giving "patterning" exercises to a mentally retarded child are medical care expenses. These exercises consist mainly of coordinated physical manipulation of the child's arms and legs to imitate crawling and other normal movements.

**Transplants.** You can include in medical expenses payments you made for surgical, hospital, laboratory, and transportation expenses for a donor or a possible

donor of a kidney or other organ. You cannot include expenses if you did not pay for them.

A donor or possible donor can include surgical, hospital, laboratory, and transportation expenses in medical expenses only if he or she pays for them.

**Transportation.** Amounts paid for transportation primarily for, and essential to, medical care qualify as medical expenses.

**You can include:**

- Bus, taxi, train, or plane fares, or ambulance services,
- **Actual** car expenses, such as gas and oil (**do not include** expenses for general repair, maintenance, depreciation, and insurance),
- Parking fees and tolls,
- Transportation expenses **of a parent** who must go with a child who needs medical care,
- Transportation expenses of a nurse or other person who can give injections, medications, or other treatment required by a patient who is traveling to get medical care and is unable to travel alone, or
- Transportation expenses for regular visits **to see a mentally ill dependent**, if these visits are recommended as a part of treatment.

**Note.** Instead of deducting **actual** car expenses, you can deduct the standard **medical** mileage rate for each mile you use your car for medical reasons. Add the cost of tolls and parking to this amount.

**Do not include:**

- Transportation expenses to and from work, even if your condition requires an unusual means of transportation, or
- Transportation expenses if, for nonmedical reasons only you choose to travel to another city, such as a resort area, for an operation or other medical care prescribed by your doctor.
- Travel that is merely for the general improvement of one's health.

**Trips.** You can include in medical expenses amounts you pay for transportation to another city if the trip is primarily for and essential to receiving medical services. You may be able to include up to \$50 per night for lodging. See ***Lodging***.

You cannot include in medical expenses a trip or vacation taken for a change in environment, improvement of morale, or general improvement of health, even if you make the trip on the advice of a doctor.

**Tuition.** You can include in medical expenses charges for medical care included in the tuition of a college or private school, if the charges are separately stated in the bill or given to you by the school. See ***Learning disability*** and ***Schools, special***.

**Vacation.** See ***Trips***.

**Weight Loss Program.** You can include in medical expenses amounts you pay to lose weight if it is a treatment for a specific disease diagnosed by a physician (such as obesity, hypertension, or heart disease). This includes fees you pay for membership in a weight reduction group and attendance at periodic meetings. You cannot include membership dues in a gym, health club, or spa as medical expenses, but you can include separate fees charged there for weight loss activities.

You cannot include the cost of diet food or beverages in medical expenses because the diet food and beverages substitute for what is normally consumed to satisfy nutritional needs. You can include the cost of special food in medical expenses only if:

1. The food does not satisfy normal nutritional needs,
2. The food alleviates or treats an illness, and
3. The need for the food is substantiated by a physician.

The amount you can include in medical expenses is limited to the amount by which the cost of the special food exceeds the cost of a normal diet.

**Wheelchair.** You can include in medical expenses amounts you pay for an autoette or a wheelchair used mainly for the relief of sickness or disability, and not just to provide transportation to and from work. The cost of ***operating and keeping up*** the autoette or wheelchair ***is also*** a medical expense.

**X-Ray Fees.** You can include in medical expenses amounts you pay for X-rays that you get for medical reasons.

## INSURANCE REIMBURSEMENT

You must reduce your total medical expenses for the year by all reimbursements for medical expenses that you receive from insurance or other sources during the year. This includes payments from Medicare.

Generally, you do **not** have to reduce medical expenses by payments you receive for:

- Permanent loss or loss of use of a member or function of the body (loss of limb, sight, hearing, etc.) or disfigurement,
- Loss of earnings

You must, however, reduce your medical expenses by any part of these payments that is designated for medical costs.

### EXCESS REIMBURSEMENT

**Premiums Paid by You.** If you pay the **entire** premium for your medical insurance or all the costs of a similar plan, and your insurance payments or other reimbursements are more than your total expenses for the year, you have **excess reimbursement**. Generally, you do not include the excess reimbursement in your gross income.

**Premiums Paid by You and Your Employer.** If both you and your employer contribute to your medical insurance plan and your **employer's contributions are not included** in your gross income, you **must include in your gross income** the part of your excess reimbursement that is from your employer's contribution.

**Example.** You are covered by your employer's medical insurance policy. The annual premium is \$2,000. Your employer pays \$600 of that amount and the balance of \$1,400 is taken out of your wages. The part of any excess reimbursement you receive under the policy that is from your employer's contributions is figured like this:

Total annual cost of policy..... \$2,000

Amount paid by employer..... \$600

**Employer's contribution in relation to the total annual cost of the policy** ( $\$600 \div \$2,000$ ) .....30%

You must include in your gross income 30% of the excess reimbursement you received for medical expenses under the policy.

# PRACTICE REVIEW QUESTIONS

## CHAPTER 2 - MEDICAL EXPENSES

1. Which one of the following statements is **correct** in regard to deducting medical expenses?
  - A. To deduct medical expenses for your spouse, you need not have been married at the time he or she received the medical services.
  - B. You can deduct medical expenses for a dependent only if he or she was your dependent at the time the medical services were provided.
  - C. You can deduct medical expenses only in the year paid.
  - D. You can deduct medical expenses for an adopted child if the child was your dependent when the expenses were **paid**.
2. Lou and Sue were married October 1 of Year One. Sue had incurred medical expenses on August 1, of Year One. Lou had charged the expenses on his charge card on September of Year One. Lou paid the charge card on February of Year Two. Lou is not allowed to deduct the expenses in Year One because they were paid in Year Two. **T/F**
3. Which one of the following statements is **incorrect** in regard to deducting medical expenses for cosmetic surgery?
  - A. Medical expenses for face lifts are not deductible.
  - B. Medical expenses for hair transplants are not deductible.
  - C. Medical expenses for hair removal are not deductible.
  - D. Medical expenses for liposuction are deductible.
4. The cost of swimming lessons can be deducted as a medical expense if they are recommended by your doctor? **T/F**

5. Which one of the following statements is ***incorrect*** in regard to deductions as a medical expense for a weight loss program?
- A. You can deduct the amount you pay to lose weight because of obesity if prescribed by a doctor.
  - B. You cannot deduct fees for a membership in a weight reduction group even if prescribed by a doctor.
  - C. You cannot deduct membership dues in a health club.
  - D. You cannot deduct the cost of diet food in medical expenses.

# RESPONSES TO REVIEW QUESTIONS

## CHAPTER 2 - MEDICAL EXPENSES

1.

- A. **Incorrect.** To qualify, you must have been married either at the time you received the medical services or at the time you paid the medical expenses.
- B. **Incorrect.** You may also deduct the expenses of the medical services, if he or she was a dependent at the time you ***paid*** the expenses.
- C. **Incorrect.** If you pay medical expenses by check, the day you mail or ***deliver*** the check is the date of payment. If you pay by credit card you can include the expenses in the year the charge is made.
- D. **Correct.** However, medical expenses paid before adoption procedures began, cannot be deducted.

2.

- A. **True.** Lou can deduct Sue's medical expenses in the year the expenses were charged to his charge card even though they were not paid until the following year. Lou and Sue must have been married at the time Sue received the medical service or at the time they were paid.
- B. **False.** The correct answer is false because Lou ***can*** deduct the charge for medical expenses in Year One. Also, Lou and Sue were married in Year 2 when Lou paid his charge card.

3.

- A. **Correct.** The cost of a face lift is not deductible as a medical expense if it only improves the individual's appearance.
- B. **Correct.** The cost of a hair transplant is not deductible because it is directed at improving an individual's appearance and does not ***promote a proper function of the body.***
- C. **Correct.** The cost of hair removal is not deductible because it does not treat illness or disease.
- D. **Incorrect.** The cost of liposuction is not deductible because it is considered cosmetic surgery and is not a personal injury resulting from an accident or a disfiguring disease.

4.

- A. **True.** You ***cannot deduct*** the cost of swimming lessons even if they are recommended by your doctor for the improvement of your general health. This rule also applies to dancing lessons. However, a ***limited amount*** of the cost of the installation of a swimming pool ***may be*** deductible if recommended by a physician for the alleviation of a back condition. True is incorrect.
- B. **False.** False is the correct answer because swimming lessons ***are not*** deductible even if advised by your physician for the improvement of your ***general*** health.

5.

- A. **Correct.** You ***can deduct*** the amount you pay to lose weight if the treatment is to alleviate obesity, hypertension or heart disease.
- B. **Incorrect.** You ***can deduct*** fees you pay for membership in a weight reduction group and for attendance at periodic meetings if these activities are prescribed by a doctor.
- C. **Correct.** You ***cannot deduct*** membership dues in a gym or spa as a medical expense. However, you can deduct separate fees charged there for weight loss activities.
- D. **Correct.** You ***can deduct*** the cost if the food does not satisfy normal nutritional needs, it treats an illness and the need for the food is recommended by a physician. However, the deductible amount is limited to the amount the cost exceeds the cost of a normal diet.



## CHAPTER 3

### CHILD AND DEPENDENT CARE EXPENSES

This material explains the tests you must meet to claim the credit for child and dependent care expenses. It also explains how to figure the credit and how to claim it.

If you pay someone to care for your dependent under age 13 or for your spouse or dependent who is not capable of self-care, you may be able to get a credit of up to 35% of your expenses. To qualify, you must pay these expenses so you can work or look for work.

#### TESTS TO CLAIM THE CREDIT

To be able to claim the credit for child and dependent care expenses, you must file Form 1040 or Form 1040A, not Form 1040EZ, and meet all the following tests.

1. The care must be for one or more qualifying persons who are identified on the form you use to claim the credit. (See ***Qualifying Person Test***.)
2. You (and your spouse if you are married) must have earned income during the year. (However, see ***Rule for student-spouse or spouse not able to care for self*** under ***Earned Income Test***, later.)
3. You must pay child and dependent care expenses so you (and your spouse if you are married) can work or look for work. (See ***Work-Related Expense Test***, later.)
4. You must make payments for child and dependent care to someone you (and your spouse) cannot claim as a dependent. If you make payments to your child, he or she cannot be your dependent and must be age 19 or older by the end of the year. You cannot make payments to your spouse or to the parent of your qualifying child who is your qualifying person and is under age 13. (See ***Payments to Relatives*** under ***Work-Related Expense Test***, later.)
5. Your filing status is single, head of household, qualifying widow (er) with dependent child, or married filing jointly. You must file a joint return if you are married, unless an exception applies to you. See ***Joint Return Test*** later.

6. You must identify the care provider on your tax return. (See ***Provider Identification Test***, later.)
7. If you exclude or deduct dependent care benefits provided by a dependent care benefit plan, the total amount you exclude or deduct must be less than the dollar limit for qualifying expenses (generally, \$3,000 if one qualifying person was cared for, or \$6,000 if two or more qualifying persons were cared for). If two or more qualifying persons were cared for, the amount you exclude or deduct will always be less than the dollar limit, since the total amount you can exclude or deduct is limited to \$5,000. See ***Reduced Dollar Limit*** under ***How to Figure the Credit***, later.

### QUALIFYING PERSON TEST

Your child and dependent care expenses must be for the care of one or more qualifying persons.

A qualifying person is:

1. Your qualifying child who is your dependent and who was ***under age 13*** when the care was provided.
2. Your spouse who was physically or mentally not able to care for himself or herself and ***lived with you*** for ***more than half*** the year, or
3. A person who was physically or mentally not able to care for himself or herself, lived with you for more than half the year, and ***either:***
  - a. Was your dependent, ***or***
  - b. Would have been your dependent except that:
    - i. He or she received gross income in the amount of the standard deduction or more,
    - ii. He or she filed a joint return, or
    - iii. You, or your spouse if filing jointly, could be claimed as a dependent on someone else's return.

If you are divorced or separated, see ***Child of divorced or separated parents***, later, to determine which parent may treat the child as a qualifying person.

**Dependent Defined.** A dependent is a person, ***other than you or your spouse***, for whom you can claim an exemption. To be your dependent, a person must be your qualifying child (or your qualifying relative).

***Qualifying child.*** To be your **qualifying child**, a child ***must live with you for more than half the year*** and meet other requirements.

**Physically or Mentally Unable to Care for Oneself.** Persons who cannot dress, clean, or feed themselves because of physical or mental problems are considered not able to care for themselves. Also, persons who must have constant attention to prevent them from injuring themselves or others are considered not able to care for themselves.

**Person Qualifying for Part of Year.** You determine a person's qualifying status ***each day***. For example, if the person for whom you pay child and dependent care expenses no longer qualifies on September 16, count only those expenses through September 15. Also, see ***Dollar Limit*** under ***How to Figure the Credit***, later.

**Taxpayer Identification Number.** You must include on your return the name and taxpayer identification number (generally the social security number) of the qualifying person(s). If the correct information is not shown, the credit may be reduced or disallowed.

***Individual taxpayer identification number (ITIN) for aliens.*** If your qualifying person is a nonresident or resident alien who does not have and cannot get a social security number (SSN), use that person's ITIN. The ITIN is entered wherever an SSN is requested on a tax return. If the alien does not have an ITIN, he or she must apply for one.

An ITIN is for ***tax use only***. It does not entitle the holder to social security benefits or change the holder's employment or immigration status under U.S. law.

***Adoption taxpayer identification number (ATIN).*** If your qualifying person is a child who was placed in your home for adoption and for whom you do not have an SSN, you must get an ATIN for the child.

**Child of Divorced or Separated Parents.** Even if you cannot claim your child as a dependant, he or she is treated as your qualifying person if:

- The child was under age 13 or was physically or mentally not able to care for himself or herself,

- The child received over half of his or her support during the calendar year from one or both parents who are divorced or legally separated under a decree of divorce or separate maintenance, are separated under a written separation agreement, or lived apart at all times during the last six months of the calendar year.
- The child was in the custody of one or both parents for more than half the year, and
- You were the child's custodial parent (the parent with whom the child lived for the greater part of the year).

The noncustodial parent cannot treat the child as a qualifying person even if that parent is entitled to claim the child as a dependent under the special rules for a child of divorced or separated parents.

## **EARNED INCOME TEST**

To claim the credit, you (and your spouse if you are married) must have earned income during the year.

**Earned Income.** Earned income includes wages, salaries, tips, other taxable employee compensation, and net earnings from self-employment. A net loss from self-employment reduces earned income. Earned income also includes strike benefits and any disability pay you report as wages.

Generally, only taxable compensation is included. However, you can elect to include nontaxable combat pay in earned income. If you are filing a joint return and both you and your spouse received nontaxable combat pay, you can each make your own election. Including this income will give you a larger credit only if your (or your spouse's) other earned income is less than the amount entered on line 3 of Form 2441. You should figure your credit both ways and make the election if it gives you a greater tax benefit.

**Note:** You can choose to include your nontaxable combat pay in earned income when figuring your credit for child and dependent care expenses, even if you choose not to include it in earned income for the earned income credit or the exclusion or deduction for dependent care benefits.

**Members of Certain Religious Faiths Opposed to Social Security.** This section is for persons who are members of certain religious faiths that are opposed to participation in Social Security Act programs and have an IRS-approved form that exempts certain income from social security and Medicare taxes. These forms are:

- Form 4361, ***Application for Exemption From Self-Employment Tax for Use by Minister, Members of Religious Orders and Christian Science Practitioners, and***
- Form 4029, ***Application for Exemption from Social Security and Medicare Taxes and Waiver of Benefits***, for use by members of recognized religious groups.

Each form is discussed in this section in terms of what is or is not earned income for purposes of the child and dependent care credit.

**Form 4361.** Whether or not you have an approved Form 4361, amounts you received for performing ministerial duties as an employee are earned income. This includes wages, salaries, tips, and other employee compensation. Other employee compensation includes earned income that is not taxable, such as a housing allowance or the rental value of a parsonage that you receive as part of your pay for services as an employee.

However, amounts you received for ministerial duties, but not as an employee, are not net earnings from self-employment for purposes of the child and dependent care credit. Examples include fees for performing marriages and honoraria for delivering speeches. Any income from these activities is not taken into account in figuring earned income.

**Form 4029.** Whether or not you have an approved Form 4029, all wages, salaries, tips, and other employee compensation are earned income.

However, amounts you received as a self-employed individual are not net earnings from self-employment for purposes of the child and dependent care credit, and are not taken into account in figuring earned income.

**Rule for a Student-Spouse or a Spouse Not Capable of Self-Care.** Your spouse is treated as having earned income for any month that he or she is:

1. A full-time student, or
2. Physically or mentally not able to care for himself or herself. (Your spouse also must live with you for more than half the year.)

This rule applies to only one spouse for any one month. If, in the same month, both you and your spouse do not work and are either full-time students or are physically or mentally not able to care for yourselves, only one of you can be treated as having earned income in that month.

**Full-time student.** You are a full-time student if you are enrolled at and attend a school for the number of hours or classes that the school considers full time. You must have been a student for some part of each of 5 calendar months during the year. (The months need not be consecutive.)

If you enrolled in school before August 25, 2005, you are treated as a full-time student for any amount of the enrollment period you were unable to attend classes because of Hurricane Katrina.

**School.** The term “school” includes elementary schools, junior and senior high schools, colleges, universities, and technical, trade, and mechanical schools. A school does not include an on-the-job training course, correspondence schools, or a school offering courses only through the internet.

## **WORK-RELATED EXPENSE TEST**

Child and dependent care expenses must be work related to qualify for the credit. Expenses are considered work related only if both of the following are true.

- They allow you (and your spouse if you are married) to work or look for work, **and**
- They are for a qualifying person’s care.

**Working or Looking for Work.** To be work-related, your expenses must be to allow you to work or look for work. If you are married, generally both you and your spouse must work or look for work. Your spouse is treated as working during any month he or she is a full-time student or is physically or mentally not able to care for him or herself.

Your work can be for others or in your own business or partnership. It can be either full time or part time.

Work also includes actively looking for work. However, if you do not find a job and have no earned income for the year, you cannot take this credit. See **Earned Income Test**, earlier.

Whether your expenses allow you to work **or look for work** depends on the facts. For example, the cost of a baby sitter while you and your spouse go out to eat is not normally a work-related expense.

**Volunteer Work.** For this purpose **you are not** considered to be working if you do unpaid volunteer work or volunteer work for nominal salary.

**Work for Part of Year.** If you work or actively look for work during only part of the period covered by the expenses, then you must ***figure your expenses for each day***. For example, if you work all year and pay care expenses of \$250 a month (\$3,000 for the year), all the expenses are work related. However, if you work or look for work for only 2 months and 15 days during the year and pay expenses of \$250 a month, your work-related expenses are limited to \$625 (2 ½ months x \$250).

***Care of a qualifying person.*** To be work-related, your expenses must be to provide care for a qualifying person. You do not have to choose the least expensive way of providing the care.

Expenses are for the care of a qualifying person only if their main purpose is the person's well-being and protection.

Expenses for household services qualify if part of the services is for the care of qualifying persons. For details, see ***Household Services***, later.

**Expenses not for Care.** Expenses for care ***do not include*** amounts you pay for ***food, clothing, education and entertainment***. However, you can include small amounts paid for these items if they are incident to and cannot be separated from the cost of caring for the qualifying person. Otherwise, see the discussion of ***Expenses partly work-related***, later.

**Education.** Expenses for a child in nursery school, pre-school, or similar programs for children below the level of kindergarten are expenses for care.

Expenses ***to attend kindergarten*** or a higher grade are ***not expenses*** for care. Do not use these expenses to figure your credit.

**Example 1.** You take your 3-year-old child to a nursery school that provides lunch and a few educational activities as part of its preschool childcare service. You can count the total cost when you figure the credit.

**Example 2.** You place your 10-year-old child in a boarding school so you can work full-time. Only the part of the boarding school expense that is for the care of your child is a work-related expense. You can count that part of the expense in figuring your credit if it can be separated from the cost of education. You cannot count any part of the amount you pay the school for your child's education.

**Care Outside Your Home.** You can count the cost of care provided ***outside your home*** if the care is for your dependent under age 13, or any other qualifying person who regularly spends at least 8 hours each day in your home.

**Dependent care center.** You can count care provided outside your home by a dependent care center **only if** the center **complies with all** state and local regulations that apply to these centers.

A dependent care center is a place that provided care for more than six persons (other than persons who live there) and receives a fee, payment, or grant for providing services for any of those persons, even if the center is not run for profit.

**Camp.** The cost of sending your child to an overnight camp **is not** considered a work-related expense.

The cost of sending your child to a day camp may be a work-related expense, even if the camp specializes in a particular activity, such as computers or soccer.

**Transportation.** The cost of getting a qualifying person from your home to the care location and back, or from the care location to school and back, **is considered** a work-related expense. This includes the costs of bus, subway, taxi, or private car. Also, if you pay the transportation cost for the care provider to come to your home, you cannot count this cost as a work-related expense.

**Household services.** Expenses you pay for household services meet the work-related expenses test if they are **at least partly** for the well-being and protection of a qualifying person.

**Definition.** Household services are ordinary and usual services done in and around your home that are necessary to run your home. They include the services of a housekeeper, maid, or cook. However, they do not include the services of a chauffeur, bartender, or gardener.

**Housekeeper.** In this material the term housekeeper refers to any household employee whose services include the care of a qualifying person.

**Expenses Partly Work-Related.** If part of an expense is work-related (for either household services or the care of a qualifying person) and part is for other purposes, you have to divide the expense. To figure your credit, count only the part that is work-related. However, you do not have to divide the expense if only a small part is for other purposes.

**Example.** You pay a housekeeper to care for your 9-year-old and 15-year-old children so you can work. The housekeeper spends most of the time doing normal household work and spends 30 minutes a day driving you to and from work. You do not have to divide the expenses. You can treat the entire expense of the housekeeper as work-related because the time spent driving is minimal. Nor do you have to divide the expenses between the two children, even though the expenses are partly for the 15-year-old



child who is not a qualifying person, because the expense is also partly for the care of your 9-year-old child, who is a qualifying person. However, the dollar limit (discussed later) is based on one qualifying person, not two.

**Meals and Lodging Provided for Housekeeper.** If you have expenses for meals that your housekeeper ***eats in your home*** because of his or her employment, count these as work-related expenses. If you have extra expenses for providing lodging in your home to the housekeeper, count these as work-related expenses also.

**Example.** To provide lodging to the housekeeper, you move to an apartment with an extra bedroom. You can count the extra rent and utility expenses for the housekeeper's bedroom as work-related. However, if your housekeeper moves into an existing bedroom in your home, you can count only the extra utility expenses as work-related.

**Taxes Paid on Wages.** The ***taxes you pay*** on wages for qualifying child and dependent care services are work-related expenses. For more information on a household employer's tax responsibilities, see ***Employment Taxes for Household Employers***, later.

***Payments to relatives or dependents.*** You can count work-related payments you make to relatives ***who are not your dependents***, even if they live in your home. However, do not count any amounts you pay to:

1. A dependent for whom you (or your spouse if you are married) can claim an exemption, or
2. Your child who is ***under age 19*** at the end of the year, even if he or she is not your dependent,
3. Your spouse, or
4. The parent of your qualifying child who is your qualifying person and is under age 13 (The mother or father of the "under 13" child that is your qualifying child.)

## **JOINT RETURN TEST**

Generally, married couples must file a joint return to take the credit. However, if you are legally separated or living apart from your spouse, you may be able to file a separate return and still take the credit.

**Legally Separated.** You are not considered married if you are legally separated from your spouse under a decree of divorce or separate maintenance. You are eligible to take the credit on a separate return.

**Married and Living Apart.** You are not considered married and are eligible to take the credit ***if all the following apply.***

1. You file a separate return.
2. Your home is the home of a qualifying person for more than half the year.
3. You ***pay more than half the cost*** of keeping up your home for the year. (Keep in mind that this rule is for married couples living apart. The “more than half upkeep” rule has been eliminated in other situations.)
4. Your spouse does not live in your home ***for the last 6 months*** of the year.

***Costs of keeping up a home.*** The costs of keeping up a home normally include property taxes, mortgage interest, rent, utility charges, home repairs, insurance on the home, and food eaten at home.

The costs of keeping up a home ***do not include*** payments for clothing, education, medical treatment, vacations, life insurance, transportation, or mortgage principal.

They also ***do not include*** the purchase, permanent improvement, or replacement of property. For example, you cannot include the cost of replacing a water heater. However, you can include the cost of repairing a water heater.

**Death of Spouse.** If your spouse died during the year and you do not remarry before the end of the year, you generally must file a joint return to take the credit. If you do remarry before the end of the year, the credit can be claimed on your deceased spouse’s separate return.

## **PROVIDER IDENTIFICATION TEST**

You must identify all persons or organizations that provide care for your child or dependent.

**Information Needed.** To identify the care provider, you must give the provider’s:

1. Name,
2. Address, and

### 3. Taxpayer identification number.

If the care provider is an individual, the taxpayer identification number is his or her social security number or individual taxpayer identification number. If the care provider is an organization, then it is the employer identification number (EIN).

You do not have to show the taxpayer identification number if the care provider is one of certain tax-exempt organizations (such as a church or school). In this case, write "Tax-Exempt" in the space where the tax form calls for the number.

If you cannot provide all of the information required, or the information is incorrect, you must be able to show ***that you used due diligence*** (discussed later) in trying to furnish the necessary information.

**Getting the Information.** You can use Form W-10, ***Dependent Care Provider's Identification and Certification***, to request information from the care provider. If you do not use Form W-10, you can get the required information from:

1. A copy of the provider's social security card,
2. A copy of the provider's driver's license (in a state where the license includes the social security number),
3. A copy of the provider's completed Form W-4, ***Employee's Withholding Allowance Certificate***, if he or she is your household employee,
4. A copy of the statement furnished by your employer if the provider is your employer's dependent care plan, or
5. A letter or invoice from the provider if it shows the necessary information.

**Due Diligence.** If the care provider information you give is incorrect or incomplete, your credit may not be allowed. However, if you can show that ***you used due diligence*** in trying to supply the required information, ***you can still claim*** the credit.

You can show due diligence by getting and keeping the provider's completed Form W-10 or one of the other sources of information listed earlier. Care providers can be penalized if they do not provide this information to you or if they provide incorrect information.

**Provider refusal.** If the provider refuses to give you the required information, you should report whatever information you have (such as the name and address) on the form you use to claim the credit. Write “See Attached Statement” in the columns calling for the information you do not have. Explain that you requested the information from the care provider, but the provider did not give you the information. The statement will show that ***you used due diligence*** in trying to furnish the necessary information.

## HOW TO FIGURE THE CREDIT

Your credit is a percentage of your work-related expenses. Your expenses are subject to the earned income limit and the dollar limit. The percentage is based on your adjusted gross income.

**Amount of Credit.** To determine the amount of your credit, multiply your work-related expenses (after applying the earned income and dollar limits) by a percentage. This percentage depends on your adjusted gross income shown on Form 1040, or Form 1040A. The following table shows the applicable percentage based on adjusted gross income.

### IF YOUR ADJUSTED GROSS INCOME IS:

OVER	BUT NOT OVER	THEN THE % IS
0	15000	35
15000	17000	34
17000	19000	33
19000	21000	32
21000	23000	31
23000	25000	30
25000	27000	29
27000	29000	28
29000	31000	27
31000	33000	26
33000	35000	25
35000	37000	24
37000	39000	23
39000	41000	22
41000	43000	21
43000	NO LIMIT	20

## FIGURING TOTAL WORK-RELATED EXPENSES

To figure the credit for the year's work-related expenses, count only those you paid by December 31.

**Expenses Paid in an Earlier Year.** If you pay for services *before they are provided*, you can count the prepaid expenses only in the year the care is received. Claim the expense for the later year as if they were *actually paid* in that later year.

**Expenses Not Paid until the Following Year.** Do not count a previous year's expenses that you paid in the current year as work-related expense for the current year.

You may be able to claim an additional credit for them on your current year's return, but you must figure it separately. See *Payments for previous year's expenses under Amount of Credit*, later.

**Expenses Reimbursed.** If a state social services agency pays you a nontaxable amount to reimburse you for some of your child and dependent care expense, you cannot count the expenses that are reimbursed as work-related expenses.

**Example.** You paid work-related expenses of \$3,000. You are reimbursed \$2,000 by a state social services agency. You can use only \$1,000 to figure your credit.

**Medical Expenses.** Some expenses for the care of qualifying persons who are not able to care for themselves may qualify as work-related expenses and also as medical expenses. You can use them *either way*, but you cannot use the same expenses to claim both a credit and a medical expense deduction.

If you use these expenses to figure the credit and they are more than the earned income limit or the dollar limit, discussed later, you can add the excess to your medical expenses. However, if you use your total expenses to figure your medical expense deduction, you cannot use any part of them to figure your credit.

Amounts excluded from your income under your employer's dependent care benefits plan cannot be used to claim a medical expense deduction.

## DEPENDENT CARE BENEFITS

If you receive dependent care benefits, your dollar limit for purposes of the credit may be reduced. See *Reduced Dollar Limit*, later. But, even if you cannot take the credit, you may be able to take an exclusion or deduction for the dependent care benefits.

**Dependent Care Benefits.** Dependent care benefits include:

1. Amounts paid directly to either you or your care provider for the care of your qualifying person while you work,
2. The fair market value of care in a daycare facility provided or sponsored by your employer, and
3. Pre-tax contributions you made under a dependent care flexible spending arrangements.

Your salary may have been reduced to pay for these benefits. If you received benefits, they should be shown on your Form W-2, wage and tax statement. See ***Statement for Employee***, later.

**Exclusion or Deduction.** If your employer provides dependent care benefits under a qualified plan, you may be able to exclude these benefits from your income. Your employer can tell you whether your benefit plan qualifies.

If you are self-employed and receive benefits from a qualified dependent care benefit plan, you ***are treated as both employer and employee***. Therefore, you would not get an exclusion from wages but instead a deduction on Form 1040, Schedule C, Schedule E, or Schedule F.

If your plan qualifies, you must complete Part III of either Form 2441 to claim the exclusion. You cannot use Form 1040EZ. You must use Form 2441 to claim the deduction.

The amount you can exclude or deduct is ***limited to the smallest of:***

1. The total amount of dependent care benefits you received during the year,
2. The total amount of qualified expenses you incurred during the year,
3. Your earned income,
4. Your spouse's earned income, or
5. \$5,000 (\$2,500 if married filing separately).

**Figuring Earned Income.** When figuring your exclusion or deduction, the definition of earned income is ***not exactly*** the same as the definition used when figuring the credit except that:

- Earned income for the exclusion or deduction does not include any dependent care benefits you receive, and
- You can elect to include nontaxable combat pay in earned income for the exclusion or deduction even if you did not choose to include it in earned income for the credit for child and dependent care expenses or the earned income credit.

If you are filing a joint return and both you and your spouse received nontaxable combat pay, you can each make your own election. You should figure your exclusion or deduction both ways and make the election if it gives you a greater tax benefit.

**Note.** Earned income does not include any dependent care benefits you receive.

**Statement for Employee.** Your employer must give you a Form W-2 (or similar statement), showing the total amount of dependent care benefits provided to you during the year under a qualified plan. Your employer will also include any dependent care benefits over \$5,000 in your wages shown on your Form W-2 in box 1.

**Effect of Exclusion.** If you exclude dependent care benefits from your income, the amount of the excluded benefits:

1. Is not included in your work-related expenses, and
2. Reduces the dollar limit, discussed later.

## **EARNED INCOME LIMIT**

The amount of work-related expenses you use to figure your credit ***cannot be more than:***

1. Your **earned income for the year**, if you are single at the end of the year, ***or***
2. The ***smaller*** of your or your spouse's earned income for the year, if you are married at the end of the year.

Earned income for the purposes of figuring the credit is defined under Earned Income Test, earlier.

For purposes of item (2), use your spouse's earned income for the entire year, even if you were married for only part of the year.

**Example.** You remarried on December 1. Your earned income for the year was \$18,000. Your new spouse's earned income for the year was \$2,000. You paid work-related expenses of \$3,000 for the care of your 5-year-old child and qualify to claim the credit. The amount of expense you use to figure your credit **cannot be more than** \$2,000 (the smaller of your earned income or that of your spouse).

**Separated Spouse.** If you are legally separated or married and living apart from your spouse (as described under **Joint Return Test**, earlier), you are not considered married for purposes of the earned income limit. **Use only your income** when figuring the earned income limit.

**Surviving Spouse.** If your spouse died during the year and you file a joint return as a surviving spouse, you are **not considered married** for purposes of the earned income limit. Use **only your income** in figuring the earned income limit.

**Community Property Laws.** **Disregard** community property laws when you figure your earned income for this credit.

**Self-Employment Earnings.** If you are self-employed, include your net earnings in earned income. For purposes of the child and dependent care credit, net earnings from self-employment generally mean the amount from Schedule SE **minus** any deduction for self-employment tax. Include your self-employment earnings in earned income, even if they are less than \$400 and you did not file Schedule SE.

**Statutory employee.** If you filed Schedule C or C-EZ to report income as a statutory employee, also include as earned income the amount from that Schedule C or C-EZ.

**Net loss.** You **must reduce** your earned income by any net loss from self-employment.

**Optional method if earnings are low or a net loss.** If your net earnings from self-employment are low or you have a net loss, you may be able to figure your net earnings by using an optional method instead of the regular method.

**Student-Spouse or Spouse Not Able to Care for Self.** Your spouse who is a full-time student or not able to care for himself or herself is treated as having earned income. His or her earned income for each month **is considered to be** at least \$250 if there is one qualifying person in your home, or **at least \$500** if there are two or more.

**Spouse works.** If your spouse works during that month, use the higher of \$250 (or \$500) or his or her actual earned income for that month.



**Spouse qualifies for part of month.** If your spouse is a full-time student or not able to care for himself or herself for only part of a month, the full \$250 (or \$500) still applies for that month.

**Both spouses qualify.** If, in the same month, both you and your spouse are either full-time students or not able to care for yourselves, only one spouse can be considered to have this earned income of \$250 ( or \$500) for that month.

**Example.** Jim works and keeps up a home for himself and his wife Sharon. Because of an accident, Sharon is not able to care for herself for 11 months during the tax year. During the 11 months, Jim pays \$3,300 of work-related expenses for Sharon's care. These expenses also qualify as medical expenses. Their adjusted gross income is \$29,000 and the entire amount is Jim's earned income.

Jim and Sharon's earned income limit is the smallest of the following amounts.

Jim and Sharon's Earned Income Limit

1. Work-related expenses Jim paid.....\$ 3,300
2. Jim's earned income .....\$ 29,000
3. Income considered earned by Sharon (11 x \$250) ..... \$ 2,750

Jim and Sharon use \$2,750 to figure the credit and treat the balance of \$550 (3,300 - \$2,750) as a medical expense. However, if you use the \$3,300 first as medical expense, you cannot use any part of that amount to figure the credit.

## DOLLAR LIMIT

There is a dollar limit on the amount of your work-related expenses you can use to figure the credit. This limit is \$3,000 for one qualifying person or \$6,000 for two or more qualifying persons.

If you paid work-related expenses for the care of two or more qualifying persons, the \$6,000 limit does not need to be divided equally among them. For example, if your work-related expenses for the care of one qualifying person are \$3,200 and your work-related expenses for another qualifying person are \$2,800, you can use the total \$6,000, when figuring the credit.

**Yearly Limit.** The dollar limit is a yearly limit. The amount of the dollar limit remains the same no matter how long, during the year, you have a qualifying person in your household. Use the \$3,000 limit if you paid work-related expenses for the care of one qualifying person at any time during the year. Use \$6,000 if you paid work-related expenses for the care of more than one qualifying person at any time during the year.

**Example.** In July of this year, to permit your spouse to begin a new job, you enrolled your 3-year old daughter in a nursery school that provides preschool childcare. You paid \$300 per month for the childcare. You can use the full \$1,800 you paid (300 x 6 months) as qualified expenses because it is not more than the \$3,000 yearly limit.

***Reduced dollar limit.*** If you received dependent care benefits that you exclude or deduct from your income, you must subtract that amount from the dollar limit that applies to you. Your reduced dollar limit is figured on Form 2441. See ***Dependent Care Benefits***, earlier, for information on excluding or deducting these benefits.

**Example.** George is a widower with one child and earns \$24,000 a year. He pays work-related expenses of \$2,900 for the care of his 4-year-old child and qualifies to claim the credit for child and dependent care expenses. His employer pays an additional \$1,000 under a qualified dependent care benefit plan. This \$1,000 is ***excluded*** from George's income.

Although the dollar limit for his work-related expenses is \$3,000 (one qualifying person), George figures his credit on only \$2,000 of the \$2,900 work-related expenses he paid. This is because his dollar limit is reduced as shown next.

George's Reduced Dollar limit:

1. Maximum allowable expenses for one  
qualifying person .....\$3,000
2. Minus: Dependent care benefits George  
excludes from income..... 1,000
3. Reduced dollar limit on expenses George can use for  
the credit ..... \$2,000

**Payments for Previous Year's Expenses.** If you had work-related expense in the previous year that you paid in the current year, you may be able to increase the credit on your current year's return.

Attach a statement to your form showing how you figured the additional amount from the previous year. Also enter the name and taxpayer identification number of the person for whom you paid the prior year's expenses.

**Example.** In Year One (the previous year) Dan and Fran had childcare expenses of \$2,600 for their 12-year old child. Of the \$2,600, they paid \$2,000 in Year One and \$600 in Year Two, (the current year). Their adjusted gross income for Year One was \$30,000. Dan's earned income of \$14,000 was less than Fran's earned income. A credit for their Year One expenses paid in Year Two is not allowed in Year One. It is allowed for the Year Two tax year, but they must use their adjusted gross income for Year One to compute the amount.

## EMPLOYMENT TAXES FOR HOUSEHOLD EMPLOYERS

If you pay someone to come to your home and care for your dependent or spouse, **you may be** a household employer. If you are a household employer, you will need an employer identification number (EIN) and you may have to pay employment taxes. If the individuals who work in your home are self-employed, you are not liable for any of the taxes discussed in this section. Self-employed persons who are in business for themselves are not household employees. Usually, you are not a household employer if the person who cares for your dependent or spouse does so at his or her home or place of business.

If you use a placement agency that exercises control over what work is done and how it will be done by a babysitter or companion who works in your home, that person is not your employee. This control could include providing rules of conduct and appearance and requiring regular reports. In this case, you do not have to pay employment taxes. But, if an agency merely gives you a list of sitters and you hire one from that list, the sitter may be your employee.

If you have a household employee you may be subject to:

1. Social security and Medicare taxes,
2. Federal unemployment tax, and
3. Federal income tax withholding.

Social security and Medicare taxes are generally withheld from the employee's pay and matched by the employer. Federal unemployment (FUTA) tax is paid by the employer only and provides for payments of unemployment compensation to workers who have lost their jobs. Federal income tax is withheld from the employee's total pay if the employee asks you to do so and you agree.

**State Employment Tax.** You may also have to pay state unemployment tax. Contact your state unemployment tax office for information. You should also find out whether you need to pay or collect other state employment taxes or carry worker's compensation insurance.

# PRACTICE REVIEW QUESTIONS

## CHAPTER 3 -- CHILD AND DEPENDENT CARE EXPENSES

1. In order to qualify to claim a child care credit, your expenses must be work-related. Which one of the following statements is **incorrect** in this regard?
  - A. The expenses may be claimed if paid for child care to allow you to work.
  - B. The expenses may be claimed if paid for child care to allow you to look for work.
  - C. Expenses paid for child care may be claimed if you work part-time.
  - D. Expenses paid for child care to allow you to work in a partnership may not be claimed.
2. Which one of the following statements is **incorrect** in regard to claiming the child and dependent care?
  - A. If you are married, both you and your spouse must have earned income.
  - B. If you are married, but living apart from your spouse, you are not eligible to take the credit.
  - C. You cannot deduct expenses unless they are required to enable you to work.
  - D. You cannot deduct payments paid to an individual who can be claimed as a dependent.
3. If you exclude or deduct dependent care benefits paid by a dependent care benefit plan there is a maximum amount you can deduct for two or more qualifying persons. What is that amount?
  - A. \$5,000
  - B. \$6,000
  - C. \$3,000
  - D. \$10,000
4. A non-spouse dependent who is not your child and is not able to physically care for him or herself may qualify for the child and dependent care credit. **T/F**

5. Ann, who is single, had a qualifying child for the child care credit. Ann received \$20,000 in wages, \$2,000 in strike benefits and a \$1,000 loss from a self-employment activity. What is Ann's earned income for the child?
- A. \$21,000
  - B. \$20,000
  - C. \$19,000
  - D. \$18,000
6. Which one of the following statements is **incorrect** in regard to a student-spouse?
- A. A student-spouse is treated as having earned income for any month he or she is a full-time student.
  - B. A student-spouse who is not physically able to care for himself or herself must have lived with his or her spouse for more than half the year in order to be treated as having earned income for any month he or she is disabled.
  - C. To qualify as a full-time student, a student-spouse must have been a student for some part of each of five calendar months during the year.
  - D. To qualify as a full-time student, the qualifying months for a student-spouse must have been consecutive.
7. In regard to a qualified school for a student-spouse, which one of the following statements is **incorrect**?
- A. A high school is a qualified school.
  - B. A trade school is a qualified school.
  - C. A school includes an on-the-job training course.
  - D. An elementary school is a qualified school.
8. Which one of the following statements is **incorrect** in regard to deductible expenses for child care outside your home?
- A. You can deduct the cost of care outside your home if your dependent is under age 13.
  - B. You can deduct the cost of care is for a qualifying person who regularly spends at least eight hours each day in your home.
  - C. A day care center qualifies if it complies with all local and state regulations.
  - D. The cost of sending your child to an overnight camp is considered a work-related expense.

9. Dee paid the transportation cost of getting a care provider to come to her home to care for her daughter. The cost does not qualify as a work-related expense. **T/F**
10. Which one of the following statements is **incorrect** in regard to household services qualifying as a work-related expense?
- A. The services must be performed for the benefit and well-being of a qualified person.
  - B. The services of a housekeeper do not qualify.
  - C. The services of a gardener do not qualify.
  - D. The services of a maid qualify.
11. In order to count work-related payments you make to your relatives, certain conditions apply. Which one of the following statements is **incorrect** in this regard?
- A. You cannot count the payments if he or she is under age 19 at the end of the year.
  - B. You can count the payments made to an individual for whom you can claim an exemption.
  - C. You cannot count payments you make to the parent of your qualifying child.
  - D. You cannot count payments you make to your spouse.
12. Married couples must file a joint return or be living apart to claim the credit. Which one of the following statements is **correct** in regard to qualifying under the “living apart” rules?
- A. You must file a separate return.
  - B. Your home is the home of a qualifying person for all of the year.
  - C. You must pay over 75% of the cost of keeping up the home.
  - D. Your spouse must not have lived in your home at any time during the year.
13. In order for a separated spouse to qualify to take a child care credit, he or she must pay certain costs to keep a home for a qualifying individual. Which one of the following statements is **incorrect** in this regard?
- A. You can include the cost of mortgage interest.
  - B. You can include the cost of mortgage principal.
  - C. You can include the cost of utilities.
  - D. You can include the cost of food eaten in the home.

14. The cost of replacing a water heater may be included as a cost of the upkeep of a house for the purpose of the child care credit. **T/F**
15. "X" and "Y" were legally divorced for all of the year. Both paid work-related expenses for their qualifying child to allow them to work. "X" wishes to claim all of the credit. Which one of the following statements is **correct** in this regard?
- A. "X" must file a separate return.
  - B. "X"'s home must have been a home for the child for the entire year.
  - C. "X" must have paid the cost of keeping up the home for the entire year.
  - D. "Y" must not have lived in "X"'s home at any time during the year.
16. In order to deduct child care expenses you must identify the care provider on your tax return. Which one of the following statements is **incorrect** in this regard?
- A. You must include the provider's name.
  - B. You must include the provider's address.
  - C. You must include the provider's taxpayer identification number.
  - D. If you cannot comply with either a, b or c, you still can deduct child or dependent care expenses.
17. Jan had \$32,000 gross income for the year and \$30,000 adjusted gross income. She had \$2,000 in qualified child care expenses for the year. What is the maximum child care credit Jan is allowed to claim?
- A. \$540
  - B. \$520
  - C. \$832
  - D. \$2,000
18. Fran incurred qualified child care expenses through December 31 of Year One. She paid these expenses on January 5 of Year Two. Fran cannot claim the expenses on her return on Year One. **T/F**



19. Pam paid qualified work-related expenses to care for her two qualifying children. She paid \$2,600 for one and \$3,800 for the other child. What is the maximum combined amount she can deduct?
- A. \$6,000
  - B. \$6,400
  - C. \$5,800
  - D. \$3,000
20. Sam and Pam were married and had one qualifying child. Pam was a full-time student and did not work. For purposes of the child and dependent care deduction, what amount of income is Pam treated as having each month?
- A. \$0
  - B. \$250
  - C. \$400
  - D. \$500



# RESPONSES TO REVIEW QUESTIONS

## CHAPTER 3 CHILD AND DEPENDENT CARE CREDIT

1.
  - A. **Correct.** If you are married, both you and your spouse must work or look for work
  - B. **Correct.** Work also includes **actively** looking for work. Note that the cost of a babysitter while going out to eat is not considered work related.
  - C. **Correct.** Expenses for child care can be claimed if either you work or were looking for work. However, if you do not find a job and have no earned income for the year, you cannot take the credit.
  - D. **Incorrect.** Qualified work can be in your own business or a partnership. It can be either full-time or part-time.
2.
  - A. **Correct.** However if your spouse is a student or is not able to care for himself or herself, he or she may be eligible for an arbitrary assignment of a certain amount of income.
  - B. **Incorrect.** If you are married and living apart you can still take the credit if you file a separate return if your home is the home of a qualifying person for over six months of the year; you pay more than half the cost of keeping up the home for the year and your spouse does not live in the home for the last six months of the year.
  - C. **Correct.** You can take the expenses if they are required to allow you to **look for** work.
  - D. **Correct.** You cannot deduct payments made to someone you can claim as a dependent. Also, you cannot deduct payments you make to your spouse or to the parent of your qualifying child.
3.
  - A. **Incorrect.** The maximum amount you can deduct is \$6,000. it does not have to be \$3,000 for each dependent.
  - B. **Correct.** \$6,000 is the correct amount. The amount for each dependent may be a different amount but the maximum combined amount cannot be more than \$6,000.
  - C. **Incorrect.** \$3,000 is the maximum for one dependent.
  - D. **Incorrect.** \$3,000 is the maximum amount for one dependent. If the total combined amount is \$10,000 or more for two dependents, the \$6,000 is the maximum deductible amount.

- 4.
- A. **True.** A is correct because even if the non-spouse is not your dependent, he or she would qualify if he or she would have been your dependent except that he or she received gross income in excess of the standard deduction.
  - B. **False.** A non-spouse dependent who cannot physically or mentally take care of themselves **can** qualify for the child and dependent care credit unless their gross income exceeds the standard deduction. False is the incorrect answer.
- 5.
- A. **Correct.** Wages plus strike benefits less a \$1,000 net loss from self-employment equals a total of \$21,000 earned income for Ann.
  - B. **Incorrect.** Ann must add her wages and strike benefits (\$20,000 + \$2,000) and subtract her \$1,000 loss from self-employment.
  - C. **Incorrect.** The \$1,000 loss must be subtracted from the combined total of Ann's wages and strike benefits to give her a net amount of \$21,000 to apply as an earned income credit.
  - D. **Incorrect.** Ann must add her \$20,000 W-2 wages and her \$2,000 strike benefits but cannot ignore her \$1,000 self-employment loss. It must be subtracted.
- 6.
- A. **Correct.** A spouse is treated as having earned income for any month that he or she is a full-time student. This rule applies **to only** one spouse for any one month.
  - B. **Correct.** A physically disabled spouse must have lived with you more than half the year in order to qualify as having earned income for any one month.
  - C. **Correct.** For purposes of the earned income credit, a full-time student must have attended a school for the number of hours that the school considers full-time.
  - D. **Incorrect.** The five calendar months do not need to be consecutive. The only requirement is that the five months be in a calendar year.
- 7.
- A. **Correct.** A senior high school is a qualified school. Also a junior high school **is** a qualified school.
  - B. **Correct.** A trade school is a qualified school. Also, a mechanical school **is** a qualified school.
  - C. **Incorrect.** On-the-job training is not a qualifying school.
  - D. **Correct.** An elementary school **is** a qualifying school. But an on-the-job training school **is not** a qualifying school.

8.

- A. **Correct.** The cost of child care provided **outside** your home for a dependent under age 13 can be counted as a child care expense.
- B. **Correct.** You can count the cost of care for any qualifying person who regularly spends at least eight hours each day in your house.
- C. **Correct.** You can count the care provided outside your home by a dependent care center **only** if it complies with all state and local regulations. A qualifying dependent care center is a place that provides care for more than six persons.
- D. **Incorrect.** The cost of sending your child to an overnight camp **is not** considered a work-related expense. However, the cost of sending your child to a day camp **may be** considered as a **work-related** expense.

9.

- A. **True.** True is correct because the cost of getting a qualifying person from your home to the care location and back is considered a work-related expense.
- B. **False.** However, if you pay the transportation cost for the care provider to come to your home, you cannot count this as a work-related expense. B is the incorrect answer.

10.

- A. **Correct.** Household services meet the work-related expense test if they are **at least partly** for the well-being and protection of a qualifying person.
- B. **Incorrect.** The service of a housekeeper qualifies as a work-related expense. Also, the services of a cook qualify.
- C. **Correct.** The services of a gardener **do not** qualify. Also, the services of a chauffeur do not qualify.
- D. **Correct.** The services of a maid qualify but the services of a bartender do not.

11.

- A. **Correct.** Also, you cannot claim any amounts paid to your child who is under age 19 even if he or she is not your dependent.
- B. **Incorrect.** Example: Fran's sister, Jan, lived with Bob & Fran and was taken as a dependent by them. Bob and Fran claimed an exemption for Jan. Bob and Fran cannot claim expenses paid to Jan. Also, if Fran filed a separate return, she could not claim expenses if Bob claimed Jan as an exemption.
- C. **Correct.** This applies to the parent of a child under age 19 if that child is your dependent.
- D. **Correct.** You cannot claim expenses paid to your spouse even if you and your spouse file separate returns.

12.

- A. **Correct.** You may take the credit if you file a separate return and meet other conditions. You are not considered married if you are legally separated under a decree of divorce or separate maintenance.
- B. **Incorrect.** Your home needs only to be the home of a qualifying person for ***more than half*** the year.
- C. **Incorrect.** You need only pay ***more than half*** the cost of keeping up your home for the year. (This rule is only for married couples living apart).
- D. **Incorrect.** This does not apply if your spouse did live in your home at any time from July thru December.

13.

- A. **Correct.** You can include the mortgage interest you pay. This includes the prorated amount of points that were paid to refinance the mortgage loan on your home.
- B. **Incorrect.** Although the mortgage interest may be included in child care expenses, the amount paid on the principal balance may not be included.
- C. **Correct.** The cost of heating, water supply (utilities) may be included in expenses.
- D. **Correct.** The cost of food eaten in the home may be included in the cost of upkeep of the home. Also the payment of property taxes and insurance on the home may be included.

14.

- A. **True.** You can include the cost of repairs (including the repair of a water heater) but not the cost of ***replacement*** of the water heater or any permanent improvements. A is the incorrect answer.
- B. **False.** False is correct because the cost of replacing the water heater ***cannot*** be included in the cost of the upkeep of the home for child care purposes.

15.

- A. **Correct.** If you are married and living apart, you must file a separate return. This separate return could be married filing separate, single, or head of household.
- B. **Incorrect.** Your home must be the home for a qualifying dependent for more than half the year.
- C. **Incorrect.** You need only pay more than half the cost of keeping up your home for half the year.
- D. **Incorrect.** Your spouse must not have lived in your house for the last six months of the year.

16.

- A. **Correct.** You must give the provider's name.
- B. **Correct.** You must give the provider's address.
- C. **Incorrect.** You do not have to show the taxpayer identification number if the care provider is one of certain tax-exempt organizations such as a church or school. In this case, write "Tax-Exempt" in the space where the tax form calls for the number.
- D. **Correct.** However, you may be allowed to take a deduction if you can show that you used due diligence in trying to furnish the necessary information.

17.

- A. **Correct.** Jan's \$30,000 adjusted gross income allows her to multiply 27% times her \$2,000 work-related expenses for a total credit of \$540.
- B. **Incorrect.** Jan has incorrectly used her **gross** income (\$32,000) as the amount to determine the percentage (26%) to be applied.
- C. **Incorrect.** Jan has incorrectly used her **adjusted** gross income (\$30,000) as the amount to determine the percentage (27%) to be used and has incorrectly multiplied the 27% times the adjusted gross income, **not** her \$2,000 work-related expenses.
- D. **Incorrect.** Jan has incorrectly used the **total** work-related expenses as her allowable child care credit.

18.

- A. **True.** A is the correct answer; however, Fran may be able to **increase** the credit on her Year Two return. She must attach a statement to her Year Two return explaining how she figured the amount from Year One. Fran must use the adjusted gross income from Year One to calculate the credit that is to be claimed on her Year Two return.
- B. **False.** Fran must claim the credit in Year Two with a statement to the return explaining how Fran calculated the amount from Year One. B is incorrect.

19.

- A. **Correct.** Even though Pam paid less than the \$3,000 maximum for her first child, she is allowed to add part of the excess from the second child to claim the maximum amount allowable for two children.
- B. **Incorrect.** The maximum combined amount of expense allowed for two children is \$6,000. The \$800 excess for Pam's second child is not allowed. Also any excess payments in one year cannot be carried over.
- C. **Incorrect.** Fran is not limited to \$3,000 for the second child in this case. She can add a part of the excess amount (\$400). To the first child's \$2,600 amount to claim the \$6,000 maximum allowed for two children.
- D. **Incorrect.** Fran is allowed a maximum of \$3,000 for ***each*** child.

20.

- A. **Incorrect.** Pam is allowed to use \$250 per month as earned income.
- B. **Correct.** Pam qualifies for \$250 for a full month ***or*** for only part of the month.
- C. **Incorrect.** The IRS limit is \$250 per month for each qualified spouse.
- D. **Incorrect.** Five hundred dollars is the amount allowed if ***both*** spouses qualify.







## CHAPTER 4

### EARNED INCOME CREDIT

The earned income credit (EIC) is a tax credit available to taxpayers who work and have earned income under \$55,952 in 2019. The maximum EIC credit for 2019 is \$6,557. If the taxpayer has investment income in 2019 of more than \$3,600 they are not eligible for the credit. In order to claim the tax credit there are various rules that must be met.

**Note.** Earned income credit has no impact on certain welfare benefits. Any refund you receive because of EIC cannot be counted as income when determining whether any individual is eligible for benefits or assistance, or how much they may receive, under any federal, state, or local program financed in whole or part with federal funds. These programs include the following:

- Temporary Assistance for Needy Families (TANF)
- Medicaid
- Supplemental security income (SSI)
- Supplemental Nutritional Assistance Program (food stamps)
- Low-income housing.

#### **RULES FOR EVERYONE**

There are seven rules that must be met to receive EIC. You must meet ***all seven*** to be eligible.

**Rule 1 - Adjusted Gross Income (AGI) Limits.** The greater of AGI or earned income in tax year 2019 must be less than:

- \$21,370 for married filing jointly (MFJ) filers and \$15,570 for all others if you have no qualifying children.
- \$46,884 for MFJ filers and \$41,094 for all others if you have one qualifying child.
- \$52,493 for MFJ filers and \$46,703 for all others if you have two qualifying children.
- \$55,952 for MFJ filers and \$50,162 for all others if you have three or more qualifying children.

***Community property.*** If you are married and can qualify to file as head of household under special rules for taxpayers living apart, and live in a state that has community property laws, your AGI includes the portion of both you and your spouse's wages that you are required to report in gross income.

**Rule 2 - The Taxpayer Must Have a Valid Social Security Number (SSN).** In order to be eligible for EIC, the taxpayer (and your spouse if filing MFJ) must have a valid SSN issued by the Social Security Administration (SSA) by the due date of your 2018 return (including extensions). Any qualifying child must also have a valid SSN by the due date of the 2018 return (including extensions) except a child that was born or died in 2018.

If the taxpayer's social security card (or your spouse's, if filing MFJ) states, "Not valid for employment" and your SSN was issued so that the taxpayer or his spouse could receive a federally funded benefit, they would not be eligible for EIC.

If the taxpayer's social security card reads "Valid for work only with INS or DHS authorization, they have a valid SSN but only if the authorization is still valid.

If the taxpayer's SSN or his spouse is missing or incorrect on the tax return, they may not receive the EIC.

If the SSN is missing from the return because the taxpayer or his spouse did not have a valid SSN by the due date of the return with the extension and they obtain a valid SSN after the due date they ***cannot file an amended return.***

Tax identification numbers ***other than SSNs do not qualify for EIC.***

**Rule 3 - The Filing Status Cannot Be Married Filing Separately (MFS).** If the filing status is MFS they would be ineligible for EIC.

If the taxpayer is married and the spouse did not live in the home of the taxpayer in the last 6 months of the year, the taxpayer may be eligible to file Head of Household (HOH) and may be entitled to EIC.

**Rule 4 - The Taxpayer Must Be a U.S. Citizen or Resident Alien All Year.** If the taxpayer or spouse, if married, were a nonresident alien for any part of the year, they would be ineligible to claim the EIC tax credit unless filing MFJ. They can use that filing status only if one spouse is a US citizen or resident alien and they choose to treat the nonresident spouse as a US resident. When this choice is made they would be taxed on their worldwide income.

**Rule 5 - Form 2555 or 2555-EZ Cannot Be Filed.** The taxpayer is not entitled to EIC if they file Form 2555, Foreign Earned Income, or 2555-EZ, Foreign Earned Income Exclusion. These forms are filed to exclude income earned in foreign countries, or to deduct or exclude a foreign housing amount.

**Rule 6 - Investment Income Must be \$3,600 or less.** For 2019, in order for the taxpayer to be eligible for EIC, the investment income must be less than \$3,600. Examples of investment income include:

- Interest income (both taxable and nontaxable income) from lines 8a and 8b, Form 1040.
- Dividends, from line 9a, Form 1040.
- Royalties from line 23b, Schedule E.
- Income from rental of personal property from line 21, Schedule E, minus expenses from line 20, Schedule E, and line 36, Form 1040.
- Net income minus any losses, but not below zero, from passive activities.

Capital losses from line 13, Form 1040 do not reduce investment income.

**Rule 7 - There Must Be Earned Income.** Earned income usually means taxable employee pay and net earnings from self-employment. Either the taxpayer or his spouse must have earned income in order to be eligible for EIC. Examples of earned income:

- Wages, salaries, tips and other taxable employees pay. Employee pay is earned only if taxable. Nontaxable employee pay, such as dependent care benefits (DCB) and adoption benefits, is not earned income.
- Net earnings from self-employment.
- Gross income received as a statutory employee.

***Wages.*** Wages you receive for working are reported on Form W-2, box 1 and is reported on Form 1040, line 7. This amount is reduced by:

- Scholarships or fellowship grants that are not reported on Form W-2.
- Amount received as a pension or annuity from a nonqualified deferred compensation plan or a nongovernmental IRC section 457 plan.

***Nontaxable combat pay election.*** There is an option to include nontaxable combat pay in earned income for the EIC. The amount of your nontaxable combat pay is shown on the W-2, box 12, code Q. This election could increase the EIC.

**Net earnings from self-employment.** You may have net earnings from self employment if either you own your own business or you are a minister or a member of a religious order.

The rental value of a home or a housing allowance provided to a minister as part of his pay usually is not subject to income tax but is included in net earnings from self-employment. This would be included in earned income for the EIC calculation.

**Statutory employee.** You are a statutory employee if you receive a Form W-2 on which the "Statutory employee" box (box 13) is checked. You report your income and expenses as a statutory employee on Schedule C or C-EZ on Form 1040. Statutory employees are basically independent contractors. Some examples would be drivers, insurance agents or salespeople.

**Strike benefits.** Strike benefits paid by a union to its members are earned income.

**Disability pay.** If you retired on disability, benefits received under your employer's disability retirement plan are considered earned income until you reach minimum retirement age. The benefits are reported on Form W-2 for the taxpayer, and are reported on line 7 of Form 1040 or 1040A.

Benefits that you receive **after** you reach minimum retirement age are taxable as a pension and are no longer considered earned income. These benefits are reported on Form 1099-R and the taxpayer reports on Form 1040, line 16a or 16b, or Form 1040A, line 12a or 12b.

Payments you received under a disability insurance policy that you paid the premiums for **are not** considered earned income. It does not matter whether you have reached minimum retirement age or not.

**Income that is not earned income.** The following are not included as earned income when calculating the Earned Income Credit:

- Interest and dividends
- Pension and annuities
- Social security and railroad retirement benefits (including disability benefits)
- Alimony and child support
- Welfare benefits
- Workers' compensation benefits
- Unemployment compensation
- Nontaxable foster care payments
- Veterans' benefits including VA rehabilitation benefits

- Amounts received for work performed while an inmate of a penal institution. This includes amounts for work performed while in a work release program or work performed in a halfway house.
- Workfare payments

**Community property.** If you are married, but qualify to file as Head of Household and you live in a state with community property laws, your earned income for the EIC does not include any amount earned by your spouse that is treated as belonging to you under those laws. That amount is not earned income for EIC, even though it must be included in gross income on the tax return. The earned income includes the entire amount that you earned, even if part of it is treated as belonging to your spouse under the state's community property laws.

**California, Nevada, and Washington domestic partners.** The same rules apply as in the **Community property** above for domestic partners in California, Nevada, and Washington. Your earned income for the EIC computation does not include any amounts earned by the partner.

## **RULES IF THERE IS A QUALIFYING CHILD**

If you have a child or children and you have met the preceding 7 rules you may be eligible for Earned Income Credit but you must meet some additional (3) rules.

Form 1040 or 1040A must be filed to claim the EIC with a qualifying child. You cannot file Form 1040-EZ. Schedule EIC must also be completed and attached to the return.

**Note.** If your qualifying child also meets the tests to be a qualifying child of another person, only one of you can claim the child for EIC. If the other person can claim the child under the tiebreaker rules you can't claim EIC unless you have another qualifying child. It is possible to claim EIC without a qualifying child.

**Rule 8 - Your Child Must Meet The Relationship, Age, Residency, and Joint Return Test.** In order for your child to be a qualifying child for EIC it must meet four tests. The tests are

1. Relationship
2. Age
3. Residency
4. Joint Return

**1. Relationship test.** To be a qualifying child, a child must be your:

- Son
- Daughter
- Stepchild
- Foster Child (A person is your foster child if the child is placed with you by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction. An authorized placement agency includes a state or local government agency, a tax-exempt organization licensed by a state, and an Indian tribal government or an organization authorized by an Indian tribal government to place Indian children).
- Grandchild
- Adopted child
- Brother
- Sister
- Half brother
- Half sister
- Stepbrother
- Stepsister
- Nephew
- Niece

**2. Age test.** In order to meet the age test the child must be:

- ***Under*** age 19 at the end of the year and younger than you (or your spouse if filing jointly).
- ***Under*** age 24 at the end of the year, and a student, and younger than you (or your spouse if filing jointly).
- Permanently and totally disabled at any time during the year, ***regardless of age.***

***Student defined.*** In order for your child to be classified as a student they must be, during some part of each of any 5 months during the calendar year:

1. A full-time student at a school that has a regular teaching staff, course of study, and regular student body at the school: or
2. A student taking a full-time, on-farm training course given by a school described in (1) above, or a state, county, or local government.

The five months do not need to be consecutive.



**School defined.** A school can be a:

- Elementary school
- Junior or Senior high school
- College or University
- Technical, Trade or Mechanical school

For EIC purposes, on-the-job training courses, correspondence schools or on-line courses **do not qualify** as a school.

**Vocational high school students.** Students who work in co-op jobs in private industry as a part of a school's regular course of classroom and training **are** considered full-time students.

**Permanently and totally disabled.** The child is permanently and totally disabled if **both** of the following apply:

1. The child cannot engage in any substantial gainful activity because of a mental or physical condition.
2. A doctor has determined the condition has lasted or can be expected to last continuously for at least a year and can lead to death.

**Substantial gainful activity.** Substantial gainful activity means performing significant duties over a reasonable period of time while working for pay or profit. Full-time work in a competitive work situation for at least the minimum wage shows that the child can engage in a substantial gainful activity.

Substantial gainful activity is not work done to take care of yourself or your home. It is not unpaid work on hobbies, institutional therapy or training, school attendance, clubs, social programs, and similar activities. However, doing this kind of activity may show that the child can engage in substantial gainful activity.

**3. Residency Test.** The child must have lived with you in the United States for more than half of the year.

**Note.** Even if you paid for most of the child's expenses you cannot claim the EIC if the child **did not** live with you for more than six months. It's possible the IRS may ask for documents to show that you lived with each qualifying child. Documents to keep handy for this purpose include school and child care records and other records that shows the child's address.

**United States.** This includes the 50 states and the District of Columbia. It does not include Puerto Rico or US possessions such as Guam.

**Homeless Shelter.** Your home can be any location where you ordinarily live. It does not necessarily have to be a traditional home as long as your child lived with you for more than six months.

**Military personnel stationed outside the United States.** US military personnel stationed outside the United States on extended active duty are considered to live in the United States during that period for purposes of the EIC.

**Extended active duty.** Extended active duty means you are called or ordered on duty for an indefinite period or for more than a period of more than 90 days. Once you begin serving your extended active duty, you are still considered to have been on extended active duty even if you do not serve the 90 days.

**Birth or death of child.** If your child was born or passed away during the tax year, they are treated as living with you for more than half the year.

**Temporary absences.** Count the time that you or your child is away from home on a temporary absence due to special circumstances as time that the child lived with you. Examples of this include illness, school attendance, business, vacation, military service, and detention in a juvenile facility.

**Kidnapped child.** A kidnapped child is treated as living with you for more than half of the year if the child lived with you more than half of the part of the year before the date of the kidnapping or following the date of the child's return. The child must be presumed by law enforcement authorities to have been kidnapped by someone who is not a member of your family or the child's family. This treatment applies to all years until the child is returned. However, the last year this treatment can apply is the earlier of:

1. The year there is a determination that the child is dead, or
2. The year the child would have reached the age of 18.

If the qualifying child has been kidnapped and meets these requirements, enter "KC", instead of a number on line 6 on Schedule EIC.

**4. Joint return test.** To meet this the qualifying child cannot file a joint return for the year.

The only **exception** to the joint return test is if your qualifying child and his or her spouse file a joint return only to claim a refund of income tax withheld or estimated tax paid.

**Example.** Harry's 18 year old son, Carry, and his 17 year old wife, Sherry, had \$1,100 of wages from part-time jobs and no other income plus they had taxes withheld. Carry and Sherry have no children. Neither Carry or

Sherry are required to file an income tax return but do so anyway to receive a refund of the federal income taxes withheld. This meets the exception to the joint return test so Carry can be Harry's qualifying child for EIC in this regard.

**Rule 9 - The Qualifying Child Cannot Be Used by More Than One Person To Claim the EIC.** In many cases a child meets the tests to be a qualifying person of more than one person. Only one person can actually treat the child as a qualifying child. Only that one person can use the child to be eligible for all of the tax benefits listed below providing that they do qualify.

1. The exemption for the child. (No longer available on federal returns starting 2018).
2. The child tax credit
3. Head of household filing status
4. The credit for child and dependent care expenses
5. The exclusion for dependent care credits
6. The Earned Income Credit.

The other person will not be eligible to take any of these credits unless they have another qualifying child.

***Tiebreaker rules.*** When more than one person can claim a qualifying child sometimes tiebreaker rules need to be used to make a determination as to whom can claim the child for Earned Income Credit and the 5 other tax credits listed above. The tiebreaker rules cannot be used if the other person is your spouse and you file a joint return. The following are the tiebreaker rules:

- If only one of the person's is the child's parent, the child is treated as the qualifying child of the parent.
- If the parents file a joint return together and can claim the child as a qualifying child, the child is treated as the qualifying child of the parents.
- If the parents do not file a joint return together but both parents claim the child as a qualifying child, the IRS will treat the child as the qualifying child of the parent with whom the child lived with for the longer period of time during the year. If the child lived with each parent the same amount of time , the IRS will treat the child as the qualifying child of the parent who had the higher adjusted gross income (AGI) for the year.

- If no parent can claim the child as a qualifying child, the child is treated as the qualifying child of the parent who had the highest AGI for the year.
- If a parent can claim the child as a qualifying child but no parent does claim the child, the child is treated as the qualifying child of the person who had the highest AGI for the year, but only if that person's AGI is higher than the highest AGI of any of the child's parents who can claim the child.

**Example 1.** Anna and her 4 year old daughter, Lana, lived with her mother, Hannah all year. Lana's father, Chester, did not live with Anna or Lana at all during the year. Anna is 23 years old, unmarried and her AGI was \$11,000. Hannah's AGI was \$29,000. Lana can be the qualifying child of either Anna or Hannah because Lana meets the relationship, age, residency and joint return tests for both Anna and Hannah. However, only one of them can claim Lana as the qualifying child.

**Example 2.** Same facts as above except Anna's AGI was \$31,000. Only Anna can claim Lana as a qualifying child because Anna's AGI was higher than Hannah's.

**Example 3.** Same facts as in Example 1 except both Anna and Hannah claim Lana as a qualifying child. In this case only the child's parent, Anna, can claim Lana as the qualifying child.

***Special rule for divorced or separated parents(or parents who live apart).*** A child will be treated as the qualifying child of his or her noncustodial parent (for purposes of claiming an exemption and the child tax credit, but not for the EIC) if all of the following statements are true.

1. The parents:
  - A. Are divorced or legally separated under a decree of divorce or separate maintenance,
  - B. Are separated under a written separation agreement, or
  - C. Lived apart at all during the last 6 months of the year, whether or not they were married.
2. The child received over half of his or her support for the year from the parents.

3. The child is in the custody of one or both parents for more than half the year.
4. Either of the following statements are true:
  - A. The custodial parent signs Form 8332 or a substantially similar statement that he or she will not claim the child as a dependent for the year, and the noncustodial parent attaches the form or statement to his or her tax return. If the divorce decree or separation agreement went into effect after 1984 and before 2009, the noncustodial parent may be able to attach certain pages from the decree or statement instead of Form 8332.
  - B. A pre-1985 decree of divorce or separate maintenance or written separate agreement that applies to the particular tax year provides that the noncustodial parent can claim the child as a dependent, and the noncustodial parent provides at least \$600 for support of the child for the particular tax year.

If a child is treated as the qualifying child of the noncustodial parent under this special rule for children of divorced or separated parents (or parents who live apart), only the noncustodial parent can claim an exemption and the child tax credit for the child. However, only the custodial parent, if eligible, or another eligible taxpayer can claim the child as a qualifying child for EIC.

**Rule 10 - You Cannot Be a Qualifying Child of Another Taxpayer.** You are a qualifying child of another taxpayer if all of the following statements are true:

1. You are that person's son, daughter, stepchild, foster child, or a descendant of any of them. Or, you are that person's brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them.
2. You were:
  - A. Under age 19 at the end of the year and younger than the person claiming you (or that person's spouse if they are filing jointly);

- B. Under age 24 at the end of the year, a student, and younger than the person claiming you (or that person's spouse if they are filing jointly); or
  - C. Permanently and totally disabled, regardless of age.
- 3. You lived with that person in the United States for more than half of the year.
  - 4. You aren't filing a joint return for the year (or are filing a joint return only to claim a refund of withheld income tax or estimated tax paid).

If you are a qualifying child of another taxpayer, you cannot claim the EIC. This is true even if the person for whom you are a qualifying child does not claim the EIC or meet all the conditions to claim the EIC.

***Child of person not required to file a return.*** You are not the qualifying child of another taxpayer (and so may qualify for EIC) if the person for whom you met the relationship, age, residency, and joint return tests is not required to file an income tax return and either:

- Does not file an income tax return
- Files a return only to receive a refund of income tax withheld or estimated tax paid.

## **RULES IF YOU DO NOT HAVE A QUALIFYING CHILD**

**Rule 11 - You Must Be at Least Age 25 but Under Age 65.** You must be at least age 25 but under age 65 at the end of the tax year. If you are married filing a joint return ***either*** you or your spouse must be at least age 25 and under age 65 at the end of the tax year.

***Death of spouse.*** If filing a tax return with your spouse who passed away during the tax year, the age test is met if the spouse was at least age 25 but under age 65 at time of passing. Your spouse is considered to reach age 25 ***on the day before*** their 25th birthday. The spouse is considered to reach age 65 ***on the day of*** their 65th birthday.

**Example.** Ray and his spouse Fay filed a joint return for the tax year. Fay passed away on March 15 of the tax year. Her 25th birthday was on March 14th of the tax year. Fay is considered 25 in regards to the age test. If Fay's 25th birthday was on March 13th she ***would not*** be considered age 25.

**Death of taxpayer.** The same rules apply as **death of spouse** above.

**Rule 12 - You Cannot Be the Dependent of Another Person.** If someone else can claim you as a dependent on their return but does not, ***you are not entitled*** to the EIC.

**Rule 13 - You Cannot Be a Qualifying Child of Another Taxpayer.** Review Rule 8 to check the qualifying child qualifications.

If you are a qualifying child of another taxpayer, you cannot claim the EIC. This is true even if the taxpayer ***does not*** claim the EIC.

- ***Child of person not required to file a return.*** If the taxpayer for whom you meet the qualifying child tests does not file a return, or files a return only to get a refund of income tax withheld or estimated tax paid, may entitle you to claim EIC if you meet the other requirements to do so.

**Rule 14 - You Must Have Lived in the United States More Than Half of the Year.** In order to claim EIC without a qualifying child your home (and your spouse's if filing a joint return) must have been in the United States for half the year.

***United States.*** This includes the 50 states and the District of Columbia. This does not ***include*** Puerto Rico or US possessions such as Guam, US Virgin Islands or American Samoa.

***Homeless Shelter.*** The home can be any location where you regularly live and not necessarily a traditional home. If you lived in a homeless shelter for more than half the year you ***meet*** this rule.

***Military personnel stationed outside the United States.*** US military personnel outside the United States on extended active duty are considered to live in the United States during that duty period for purposes of the EIC.

## **DISALLOWANCE OF THE EIC**

**Form 8862.** If your EIC for any year after 1996 was denied or reduced for any reason other than a math or clerical error, you must attached Form 8862 to the next tax return to claim the EIC with two exceptions.

***Exception 1.*** Do not file Form 8862 if either (1) or (2) below are true.

1. After your EIC was reduced or disallowed in the earlier year:
  - A. You filed Form 8862 in a later year and your EIC for that later year was allowed, and

- B. Your EIC has not been reduced or disallowed again for any other reason other than a math or clerical error.
2. You are taking the EIC without a qualifying child for the tax year and the only reason your EIC was reduced or disallowed in the earlier year was because the IRS determined that a child listed on Schedule EIC was not your qualifying child.

In either one of these cases, the EIC can be taken without filing Form 8862 if all the EIC eligibility requirements are met.

**Exception 2.** Do not file Form 8862 or take the EIC for:

- 2 years after there was a final determination that your EIC claim was due to reckless or intentional disregard of the EIC rules, or
- 10 years after there was a final determination that your EIC claim was due to fraud.

**Exception for math or clerical errors.** If the EIC was denied or reduced as a result of a math or clerical error, do not attach Form 8862 to the next tax return. For example, if your arithmetic is incorrect, the IRS can correct it. If the social security number is not correct, the IRS can deny the EIC. These kind of errors are called math or clerical errors.

**Omission of Form 8862.** If you were required to attach Form 8862 to the tax return, and you claim EIC without attaching Form 8862, your claim will be automatically denied.



# PRACTICE REVIEW QUESTIONS

## CHAPTER 4 EARNED INCOME CREDIT

1. For tax year 2019, what is the maximum AGI for married filing joint filers with zero children to receive Earned Income Credit?
  - A. \$21,370
  - B. \$41,094
  - C. \$52,493
  - D. \$55,952
  
2. Which of the following is not considered investment income?
  - A. Income from rental properties.
  - B. Dividends.
  - C. Interest income.
  - D. All of the above are investment income.
  
3. Which one of the following is considered earned income?
  - A. Pensions
  - B. Social security benefits
  - C. Strike benefits paid by a union.
  - D. Interest income
  
4. Which one of the following forms **cannot** be used to claim Earned Income Credit with a qualifying child?
  - A. Form 1040
  - B. Form 1040A
  - C. Form 1040-EZ
  - D. Schedule EIC
  
5. In order to claim the Earned Income Credit, the qualifying child must meet the age test. Which one of the following does not meet the test.
  - A. Your 18 year old son who is not a student.
  - B. Your 19 year old daughter who is not a student,
  - C. Your 20 year old daughter who is a student.
  - D. Your 23 year old son who is a student.

6. For EIC purposes, which one of the following is **not** considered a school?
- A. A trade school
  - B. A junior high school
  - C. An elementary school
  - D. A correspondence school
7. Extended active duty in the military means you are ordered on duty for a certain period of time. What is that time period?
- A. At least 30 days
  - B. At least 60 days
  - C. At least 90 days
  - D. At least one year

# RESPONSES TO REVIEW QUESTIONS

## CHAPTER 4 – EARNED INCOME CREDIT

1.
  - A. **Correct.** For married filing joint filers with no children the maximum AGI must be less than \$21,370. All other filers with no children their AGI would have to be less than \$15,570.
  - B. **Incorrect.** This amount would be correct for married filing joint filers with one qualifying child.
  - C. **Incorrect.** This amount would be correct for married filing joint filers with two qualifying children.
  - D. **Incorrect.** This amount would be correct for married filing joint filers with three qualifying children.
  
2.
  - A. **Incorrect.** Income from rental properties is considered investment income. If investment income is more than \$3,500 you are no longer eligible for Earned Income Credit.
  - B. **Incorrect.** Dividends are considered investment income.
  - C. **Incorrect.** Interest income is not considered investment income.
  - D. **Correct.** Income from rental properties, dividends, and interest income are each investment income items. You must have less than \$3,500 to be eligible for EIC.
  
3.
  - A. **Incorrect.** Pensions and annuities are considered unearned income.
  - B. **Incorrect.** Social security benefits and railroad retirement benefits are considered unearned income.
  - C. **Correct.** Strike benefits paid by a union to its members are earned income.
  - D. **Incorrect.** Interest earned is considered unearned income.

- 4.
- A. **Incorrect.** Either Form 1040 or 1040A must be filed to claim EIC.
  - B. **Incorrect.** See A above.
  - C. **Correct.** You cannot claim Earned Income Credit using Form 1040-EZ .
  - D. **Incorrect.** Schedule EIC must be attached to Form 1040 or Form 1040A to claim EIC.
- 5.
- A. **Incorrect.** The child meet the age test if they are under age 19.
  - B. **Correct.** This does not meet the age test. The qualifying child must be under age 19 or permanently and totally disabled..
  - C. **Incorrect.** The qualifying child must be under age 24 if they are a student.
  - D. **Incorrect.** See C above.
- 6.
- A. **Incorrect.** A trade school, technical school and a mechanical school are considered schools for EIC purposes.
  - B. **Incorrect.** A junior or senior high school are considered schools for EIC purposes.
  - C. **Incorrect.** An elementary school is considered a school for EIC purposes.
  - D. **Correct.** A correspondence school is not considered a school for EIC purposes. On-line course and on-the-job training do not qualify as a school as well.
- 7.
- A. **Incorrect.** Extended active duty is considered 90 days.
  - B. **Incorrect.** Extended active duty means you are called or ordered on duty for an indefinite period or for a period of more than 90 days.
  - C. **Correct.** Extended active duty is considered more than 90 days.
  - D. **Incorrect.** See C above.





# CHAPTER 5

## TAXABLE AND NONTAXABLE INCOME

The Internal Revenue Code (Code Section 61(a)) defines gross income as follows:

***"Except as otherwise provided in this subtitle, gross income means all income from whatever source derived (but not limited to) the following items:"***

1. Compensation for services, including fees, commissions, fringe benefits, and similar items,
2. Gross income derived from business,
3. Gains derived from dealings in property,
4. Interest,
5. Rents,
6. Royalties,
7. Dividends,
8. Alimony and separate maintenance payments,
9. Annuities,
10. Income from life insurance and endowment contracts,
11. Pensions,
12. Income from discharge of indebtedness,
13. Distributive share of partnership gross income,
14. Income in respect of a decedent, and
15. Income from an interest in an estate or trust.

This then, at the start, is a fairly short and clear definition of gross income. But it has gotten progressively more complex ever since!

This material will cover most of the variations of the original list in the code and also include an alphabetized, quick reference list at the end of this chapter.

The main point is the phrase, “***all income from whatever source,***” means that all income is includible in gross income unless specifically exempt by law.

Although income is most commonly money, the tax definition includes goods and services as well. Income other than cash must be reported at the fair market value of the goods or service received. Fair market value is the amount that would induce a willing seller to sell and a willing buyer to buy.

Gross income includes all income received in the form of money, property, and services and which is not, by law, expressly exempt from tax. Certain benefits are excluded by statute, while other benefits are not included simply because they do not constitute income. Income has been defined as the gain derived from capital, (to the extent that it exceeds your basis in the asset) from labor or from both if it is understood to include profit gained through the sale or conversion of capital assets.

Since income means there is a gain, you can see why a return of capital is not included in gross income.

**Example.** You pay \$5,000 for 100 shares of XYZ stock. Two years later, you sell the stock for \$7,000. You have a gain of \$2,000 and a return of your \$5,000 investment. Only the \$2,000 is included in gross income.

The U.S. Supreme Court has repeatedly held that Congress' broad definition of what constitutes gross income was intended to tax all gain unless ***specifically exempted***.

Income that is taxable must be reported on your return and is subject to tax. Income that is nontaxable ***may*** have to be shown on your tax return, but is ***not*** subject to tax.

The IRS requires taxpayers to keep accurate records of earnings that are not subject to income tax withholding.

Taxpayers constructively receive income when it is credited to their account, or otherwise made available to them, even if they do not have physical possession of it.

**Example.** A taxpayer receives a check in late December in the amount of \$500 for painting a house. The taxpayer waits until January to deposit the check in his personal or business account. The



taxpayer must report the \$500 income on his return for the year ending in December.

If an employer uses an employee's wages to pay the employee's debts, the full amount paid is income to the employee. This also applies if the employee's wages are attached or garnished. In most instances the amount paid or attached will be included on the employee's W-2.

## GROSS INCOME

Following is a discussion of a wide range of income items, some taxable and some nontaxable.

### MISCELLANEOUS COMPENSATION

**Advance Commissions and Other Earnings.** If you receive advance commissions or other amounts for services to be performed in the future, and you are a cash method taxpayer, you must include these amounts in your income in the year you receive them.

**Babysitting.** If you periodically baby-sit for relatives or neighborhood children, the rules for child-care providers also apply to you.

If you are an **employee**, you should receive a Form W-2 if your pay is subject to social security and Medicare taxes. You must include your pay even if you do not receive a W-2.

**Back Pay Awards.** Include in gross income amounts you are awarded in a settlement or judgment for **back pay**. This includes payments made to you for unpaid life insurance premiums and unpaid health insurance premiums. They should be reported to you by your employer on Form W-2.

**Bonuses and Awards.** Amounts you receive for outstanding work, such as bonuses or awards, are included in your gross income and should be shown on your Form W-2. These include prizes such as vacation trips for meeting sales goals. If the prize or award you receive is goods or services, you must include the fair market value of the goods or services in your income.

**Child-Care Providers.** If you provide child-care, either in the child's home or in your home or other place of business, the pay you receive must be included in your income. If you provide the care **in the child's** home, you **may** be an employee. If you provide the care **in your** home or other place of business, you **may or may not** be an employee.

**Holiday Gifts.** If your employer gives you a turkey, ham, or other item of ***nominal value*** at Christmas or other holidays, you ***do not*** have to include the value of the gift in your income. However, if your employer gives you ***cash***, a gift certificate, or a similar item that you can easily exchange for cash, ***you must include*** the value of that gift as extra salary or wages ***regardless*** of the amount involved.

**Interview Expenses.** If an employer asks you to appear for an interview and either pays you an allowance or reimburses you for your transportation and other travel expenses, the amount you receive is generally not taxable. You include as other income on 1040, ***only*** the actual amount you receive that is ***more than*** your ***actual*** expenses.

**Employer's Contributions to Qualified Plan.** Generally, your employer's contributions to a qualified pension plan for you are not included in income at the time contributed. However, employer contributions that are made out of funds that would ***otherwise*** have been paid to you ***as salary***, except that you entered into a salary reduction agreement with your employer (elective deferrals), are excluded from income ***only*** up to an annual limit.

**Employer's Contributions to Nonqualified Plan.** If your employer pays into a ***nonqualified*** plan for you, you generally must include the contributions in your income as wages for the tax year in which the contributions are made. Combine this income with any W-2 income and enter on the wage and salary line of Form W-2.

**Railroad Retirement Annuities.** If you received:

1. Tier 1 railroad retirement benefits that are more than the "social security equivalent benefit,"
2. Tier 2 benefits, or
3. Vested dual benefits,

These payments are treated as pension or annuity income and are taxable under the rules specifically relating to Railroad Retirement Benefits.

**Property Purchased from Employer.** If your employer allows you to buy property at a price ***below*** its fair market value as compensation for your services, you must include in your income, as extra wages, the ***difference*** between the property's fair market value and the amount you paid for it.

**Severance Pay.** Amounts you receive as severance pay are taxable. A lump-sum payment for cancellation of your employment contract is income ***in the tax year you receive it*** and must be reported with your other salaries and wages.

**Sick Pay.** Amounts you receive from your employer while you are sick or injured are part of your salary or wages. You must include in your income, payments made by any of the following:

1. Your employer,
2. A welfare fund,
3. An association of employers or employees, or
4. An insurance company, if your employer paid for the plan.

However, if ***you paid*** the premiums on an accident or health insurance policy, the benefits you receive under the policy are ***not*** taxable.

**Social Security and Medicare Taxes Paid by Employer.** If you and your employer have an agreement that your employer pays your social security and Medicare taxes without deducting them from your gross wages, you must report the amount of tax paid for you ***as taxable wages*** on your tax return. You must also treat the payment as wages for figuring your social security and Medicare taxes and your social security and Medicare benefits. ***However***, these payments ***are not treated*** as social security and Medicare wages if you are a household worker or a farm worker.

**Stock Appreciation Rights.** If your employer grants you a stock appreciation right, do not include it in income ***until*** you exercise (use) the right. When you use the right, you are entitled to a cash payment equal to the fair market value of the corporation's stock on the date of use ***minus*** the fair market value on the ***date the right was granted***. You include the cash payment in income in the year you use the right.

## **FRINGE BENEFITS**

The value of fringe benefits you receive from your employer is taxable and must be included in your income as compensation unless the benefits are specifically excluded by law or you pay fair market value for them.

Generally, your employer determines the amount of your taxable fringe benefits and includes this amount on your Form W-2.

## **GROUP-TERM LIFE INSURANCE**

Generally, the cost of ***up to*** \$50,000 of group-term life insurance coverage provided to you by your employer ***is not included*** in your income. However, you must

include in income the cost of insurance that is **more than** the cost of \$50,000 of insurance reduced by any amount you pay towards the purchase of the insurance.

The amount included in your income is reported as part of your wages in box 1 of your Form W-2.

**Group-Term Life Insurance.** This insurance is term life insurance protection (insurance for a fixed period of time) that:

1. Provides a general death benefit,
2. Is provided to a group of employees,
3. Is provided under a policy carried by the employer, and
4. Provides an amount of insurance to each employee based on a formula that prevents individual selection.

## **MEALS AND LODGING**

You do not include in your income the value of meals and lodging provided to you and your family by your employer at no charge if the following conditions are met:

1. The meals are:
  - a. Furnished **on the business premises** of your employer, and
  - b. Furnished **for the convenience**, of your employer.
2. The lodging is:
  - a. Furnished **on the business premises** of your employer,
  - b. Furnished **for the convenience** of your employer, **and**
  - c. A **condition** of your employment (you must accept it in order to be able to properly perform your duties).

## TRANSPORTATION

If your employer provides you with a qualified transportation fringe benefit, it can **still** be **excluded** from your gross income, up to certain limits. A qualified transportation fringe benefit is:

1. Transportation in a commuter highway vehicle (such as a van) between your home and work place,
2. A transit pass,
3. Qualified parking,
4. Qualified bicycle commuting. **See note in next section.**

The exclusion for commuter highway vehicle transportation and transit pass fringe benefits **cannot be more than** a total of \$260 a month for 2018, regardless of the total value of both fringe benefits.

The **exclusion** for the qualified parking fringe benefit **cannot be more than** \$260 a month for 2018 regardless of its value.

## TAXATION OF CERTAIN FRINGE BENEFITS

Fringe benefits you receive in connection with the performance of your services are included in your gross income as compensation unless you pay fair market value for them or they are specifically excluded by law from your income.

The amount that you will have to include in your income is determined under the **general valuation rule** or under the **special valuation rules**.

The exclusion for qualified bicycle commuting in a calendar year is \$20 multiplied by the number of bicycle commuting months that year. **Note:** This has been suspended for tax years 2018 through 2025.

**General Valuation Rule.** You must include in your gross income the amount by which the fair market value of the fringe benefit is more than the sum of:

1. The amount, if any, you paid for the benefit, and
2. The amount, if any, specifically excluded by law from your gross income.

If you **pay fair market value** for a fringe benefit, **no amount** is included in your gross income.

**Special Valuation Rules.** You may be able to use special valuation rules instead of the general valuation rule for certain commonly provided benefits. Your employer has the option to use any of the special valuation rules. You generally can use a special valuation rule **only** if your employer uses the rule, and you cannot use another special rule to value that benefit. You can, however, use the general valuation rule discussed earlier, based on facts and circumstances. The special valuation rules are:

1. The automobile lease rule.
2. The vehicle cents-per-mile rule.
3. The commuting rule.
4. The employer-operated-eating-facility rule.
5. The unsafe conditions commuting rule.

The specifics of these special valuation rules are quite lengthy. To cover them would require a full chapter of material. A good overview of them can be found in Internal Revenue Service Publication 535, "Business Expenses."

## **DISABILITY INCOME**

Generally, if you retire on disability you must report your pension or annuity as income. In some cases, there is a tax **credit** for people who are permanently and totally disabled.

Generally, you must report as income any amount you receive for your disability through an accident or health insurance plan that is paid for **by your employer**. If both you and your employer pay for the plan, only the amount you receive for your disability that is due to your employer's payments is reported as income.

**Cost Paid by You.** If you pay the entire cost of a health or accident insurance plan, **do not** include any amounts you receive for your disability as income on your tax return. If your plan reimbursed you for medical expenses you deducted in an earlier year, you may have to include some, or all, of the reimbursement in your income.

**Cafeteria Plans.** Generally, if you pay the premiums of a health or accident insurance plan through a cafeteria plan, and the amount of the premiums **was not included** in your income, you must include any benefits you receive in your income. If the amount of the premiums **was included** in your income, you are considered to have paid the premiums and any benefits you receive are **not taxable**.

**Disability Payments.** If you retired ***on disability***, payments you receive are taxed ***as wages*** until you reach minimum retirement age. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled. You must report your taxable disability payments as wages on Form 1040 or Form 1040A, until you reach minimum retirement age.

## **MILITARY AND GOVERNMENT DISABILITY PENSIONS**

Certain military and government disability pensions are not taxable.

**Service-Connected Disability.** You may be able to exclude from income amounts you receive as a pension, annuity, or similar allowance for personal injury or sickness resulting from active service in one of the following government services.

1. The armed forces of any country
2. The National Oceanic and Atmospheric Administration.
3. The Public Health Service.
4. The Foreign Service.

***Conditions for exclusion.*** Do not include the disability payments in your income if any of the following conditions apply.

1. You were entitled to receive a disability payment before September 25, 1975.
2. You receive the disability payments for a combat-related injury. This is a personal injury or sickness that:
  - a. Results directly from armed conflict,
  - b. Takes place while you are engaged in extra-hazardous service,
  - c. Takes place under conditions simulating war, including training exercises such as maneuvers, or
  - d. Is caused by an instrumentality of war.

**Terrorist Attack.** You do not include in your income disability payments you receive for injuries resulting directly from a violent attack that occurs while you are a U.S. government employee performing official duties outside the United States.

## OTHER SICKNESS AND INJURY BENEFITS

In addition to disability pensions and annuities, you may receive other payments for sickness or injury.

**Railroad Sick Pay.** If you receive sick pay under the Railroad Unemployment Insurance Act, these payments are taxable and you must include them in your income. However, you do not include them in your income if they are for an on-the-job injury.

**Workers' Compensation.** Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act.

The exemption also applies to your survivor(s). The exemption from tax, however, does not apply to retirement plan benefits you receive based on your age, length of service, or prior contributions to the plan, even if you retired because of an occupational sickness or injury.

**Note:** If part of your workers' compensation reduces your social security or equivalent railroad retirement benefits received, that part is considered social security (or equivalent railroad retirement) benefits and may be taxable.

**Black-Lung Benefit Payments.** These payments are similar to workers' compensation and generally are not taxable.

**VA Disability Benefits.** Disability benefits you receive from the Department of Veterans Affairs (VA) are not included in your gross income. If you are a military retiree and you receive disability benefits from other than the VA, do not include in your income the amount of disability benefits equal to the VA benefits to which you are entitled.

If you retire from the armed services (based on years of service) and at a later date are given a retroactive service-connected disability rating by the VA, and file a waiver for reduction of your retirement pay in an amount equal to the VA disability compensation, you do not include in your income for the retroactive period (subject to the statute of limitations) the part of your retirement pay you would have been entitled to receive from the VA during that period.

If you receive a lump-sum disability severance payment and are later awarded VA disability benefits, you do not include the disability severance payment in your income (subject to the statute of limitations). However, you must include in your income any lump-sum readjustment or other non-disability severance payment you received on release from active duty, even though the VA later gives you a retroactive disability rating.



**Retroactive VA determination.** If you retire from the armed services based on years of service and are later given a retroactive service-connected disability rating by the VA, your retirement pay for the retroactive period is excluded from income up to the amount of VA disability benefits you would have been entitled to receive.

## STOCK OPTIONS

If you are granted a **nonstatutory** stock option, the amount of income to include and the time to include it depends on whether the fair market value of the option can be readily determined. The fair market value of an option can be readily determined if it is actively traded on an established market.

The fair market value of an option that is not traded on an established market can be readily determined **only** if all of the following conditions exist:

1. You can transfer the option,
2. The option is exercisable immediately in full,
3. The option or the property subject to the option is not subject to any condition or restriction, (other than a condition to secure payment of the purchase price), and
4. The fair market value of the option privilege can be readily determined.

If you receive a **nonstatutory** stock option that has a readily determined fair market value **at the time** it is granted to you, the option is treated like other property received as compensation.

If the fair market value of the option is not readily determined, **you do not have** income until you transfer or exercise the option. When you exercise this kind of option, the amount to include in your income is the **difference** between the **amount you pay** for the property and its **fair market value** at the time you have an unconditional right to receive it.

**Statutory Stock Options.** There are two kinds of statutory stock options:

1. Incentive stock options, and
2. Options granted under employee stock purchase plans.

In each case, you must be an employee of the company granting the option, or a related company, at all times beginning with the date of the grant of the option, until

3 months before you exercise the option (for an incentive stock option, 1 year before if you are disabled). Also, the option must be nontransferable except at death.

**Incentive Stock Options. (ISO's)** If you sell stock acquired by exercising an ISO and satisfy the holding period requirement, your gain or loss from sale is capital gain or loss. Report the sale on Schedule D (Form 1040). The basis of your stock is the amount you paid for the stock.

**Employee Stock Purchase Plans.** If your stock option is granted under an employee stock purchase plan, you do not include any amount in your gross income as a result of the grant or exercise of your option. You report income or loss **when you sell** the stock that you purchased by exercising the option.

## **SPECIAL RULES FOR CERTAIN EMPLOYEES**

This part of the material deals with special rules for people in certain types of employment: members of the clergy, people working for foreign employers, military personnel, veterans, ACTION and Peace Corps volunteers.

### **CLERGY**

If you are a member of the clergy, you must include in your income offerings and fees you receive for marriages, baptisms, funerals, masses, etc., in addition to your salary. If the offering is made to the religious institution, it is not taxable to you.

If you are a member of a religious organization and you give your **outside earnings** to the organization, you **still must include** the earnings in your income. However, you may be entitled to a charitable contribution deduction for the amount paid to the organization.

**Rental Value of a Home.** You **do not include** in your income the **rental value** of a home (or utility expenses) provided to you as a part of your pay for your duties as an ordained, licensed, or commissioned minister. The exclusion cannot be more than the reasonable pay for your services. However, you must include the rental value of the home, and related allowances, as earnings from self-employment on Schedule SE (Form 1040) if you are subject to the self-employment tax.

**Housing Allowance.** A housing allowance paid to you as part of your salary is **not** income to the extent you use it, in the **year received**, to provide a home or to pay utilities for a home you are provided. The amount of the housing allowance you can exclude from your income cannot be more than the reasonable compensation for your services as a minister. Expenses of providing a home include rent, house payments, furniture payments, costs for a garage, and utilities. They do not include the cost of food or servants.

**Homeowner.** If you own your home or are buying it, you can exclude your housing allowance from your income if you spend it for the ***down payment*** on the home, for mortgage payments, or for interest, taxes, utilities, repairs, etc. However, you cannot exclude more than the fair rental value of the home plus the cost of utilities, even if a larger amount is designated as a housing allowance. The fair rental value of a home includes the fair rental value of the furnishings in it.

**Interest and Taxes on Your Home.** You can deduct on Schedule A (Form 1040) the qualified mortgage interest and real estate taxes you pay on your home ***even if*** you use ***nontaxable*** housing allowance funds to make the payments.

## **FOREIGN EMPLOYER**

Special rules apply if you work for a foreign employer.

**U.S. Employer.** If you are a U.S. citizen who works in the United States for a foreign government, an international organization, a foreign embassy, or any foreign employer, you must include your salary in your income.

**Social Security and Medicare Taxes.** You are exempt from social security and Medicare employee taxes if you are employed in the United States by an international organization or a foreign government. However, you must pay ***self-employment tax*** on your earnings from services performed in the United States, ***even though*** you are ***not*** self-employed.

## **MILITARY**

Payments you receive as a member of a military service generally are taxed as wages except for retirement pay, which is taxed as a pension. Allowances generally are not taxed.

**Military Retirement Pay.** If your retirement pay is based on age or length of service, it is taxable and must be included in your gross income as a pension.

**Veterans Nontaxable Income.** Veterans' benefits under any law, regulation, or administrative practice that was in effect on September 9, 1986, and administered by the Department of Veterans Affairs (VA), ***are not included*** in gross income. The following amounts paid to veterans or their families are ***not taxable***:

1. Education, training, or subsistence allowances.
2. Disability compensation and pension payments for disabilities.
3. Grants for homes designed for wheelchair living.

4. Grants for motor vehicles for veterans who lost their sight or the use of their limbs.
5. Veterans' pensions paid either to veterans or to their families.
6. Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including the proceeds of a veteran's endowment policy paid before death.
7. Interest on insurance dividends you leave on deposit with the VA.

## **MISCELLANEOUS TAXABLE INCOME**

**Activity not for Profit.** You must include on your return, income from an activity from which you do not expect to make a profit. An example of this type of activity would be a hobby or a farm you operate mostly for recreation and pleasure.

Deductions for expenses related to the activity are limited. They cannot total more than the income you report, and can be taken only if you itemize deductions on Schedule A (Form 1040).

**Court Award and Changes.** To determine if settlement amounts you receive by compromise or judgment must be included in your income, you must consider the item that the settlement replaces: ***Include*** the following as ordinary income:

1. Interest on any award.
2. Compensation for lost wages or lost profits in most cases.
3. Punitive damages.
4. Amounts received in settlement of pension rights (if you did not contribute to the plan).
5. Damages for:
  - a. Patent or copyright infringement,
  - b. Breach of contract, or
  - c. Interference with business operations.
6. Any recovery under the Age Discrimination in Employment Act.

**Damages Received After August 20, 1996.** Generally, amounts received after August 20, 1996, as damages for nonphysical injuries or sickness or as punitive damages are taxable.

**Damages Received for Nonphysical Injuries or Sickness.** Damages for nonphysical injuries or sickness, such as employment discrimination, defamation, or emotional distress, are generally taxable. However, damages for emotional distress due to nonphysical injuries or sickness are excludable up to the amount paid for medical care for the emotional distress.

Only damages received for physical injuries or physical sickness can be excludable from income. If emotional distress is due to physical injuries or physical sickness, the damages you receive for that emotional distress are not taxable.

**Emotional Distress Defined.** Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

**Punitive Damages.** Punitive damages generally are taxable. It does not matter if they relate to a physical injury or physical sickness. This rule does not create any inference about punitive damages under prior law.

**Pre-existing Agreement.** If you receive damages under a written binding agreement, court decree, or mediation award that was in effect (or issued **on or before** September 13, 1995, you do not have to include these damages in income.

**Notary Public.** Report payments for these services on Schedule C (Form 1040) or Schedule C-EZ (Form 1040). These payments **are not** subject to **self-employment** tax.

**Free Tour.** If you received a free tour from a travel agency for organizing a group of tourists, you must include its value in your income. Report the fair market value of the tour on Form 1040 or on Schedule C or Schedule C-EZ (Form 1040). You **cannot** deduct your expenses in serving as the voluntary leader of the group at the group's request.

**Gambling Winnings.** You must include your gambling winnings in your income on Form 1040. If you itemize your deductions on Schedule A (Form 1040), you can deduct gambling losses you had during the year, but only up to the amount of your winnings.

**Lotteries and Raffles.** Winnings from lotteries and raffles are gambling winnings. In addition to cash winnings, you must include in your income the **fair market value** of bonds, cars, houses, and other noncash prizes.

**Jury Duty.** Jury duty pay you receive must be included in your income on Form 1040. If you must give the pay to your employer because your employer continues to pay your salary while you serve on the jury, you can deduct the amount turned over to your employer as an ***adjustment*** to income.

**Kickbacks.** You must include in your income on Form 1040, or on Schedule C or Schedule C-EZ (Form 1040), kickbacks, side commissions, or similar payments you receive.

**Illegal Income.** Illegal income, such as stolen or embezzled funds, must be included in your gross income on Form 1040, or on Schedule C or Schedule C-EZ (Form 1040) if from your self-employment activity.

**Prepaid Income.** Prepaid income is generally included in your gross income in the year you receive it. Prepaid income includes amount such as rents or interest received in advance and compensation for future services.

**Prizes and Awards.** If you win a prize in a lucky number drawing, television or radio quiz program, beauty contest, or other event, you must include it in your income. For example, if you win a \$50 prize in a photography contest, you must report this income on Form 1040. If you refuse to accept a prize, do not include its value in your income.

## **UNEMPLOYMENT BENEFITS**

The tax treatment of unemployment benefits you receive depends on the type of program paying the benefits.

**Types of Unemployment Compensation.** Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or of a state. It includes the following benefits.

- Benefits paid by a state from the Federal Unemployment Trust Fund.
- State unemployment insurance benefits.
- Railroad unemployment compensation benefits.
- Disability payments from a government program paid as a substitute for unemployment compensation.
- Trade readjustment allowances under the Trade Act Of 1974.
- Unemployment assistance under the Disaster Relief and Emergency Assistance Act of 1974.

**Governmental program.** If you contribute to a governmental unemployment compensation program and your contributions are not deductible, amounts you receive under the program are not included as unemployment compensation until you recover your contributions. If you deducted all of your contributions to the program, the entire amount you receive under the program is included in your income.

**Repayment of Unemployment Compensation Benefits.** If you repaid some of the unemployment compensation benefits in the same year you received them, subtract the amount you repaid from the total amount you received and enter the difference on the “unemployment line of your tax return. Also, enter “repaid” and the amount you repaid on the same dotted line.

If, in the current year, you repaid unemployment compensation that you included in your gross income in an earlier year, you may deduct the amount repaid on Schedule A (Form 1040) as a miscellaneous itemized deduction, not subject to the 2% AGI limitation.

**Strike and Lockout Benefits.** Benefits paid to you by a union from union dues as strike or lockout benefits, including both cash and the fair market value of other property, are ***usually*** included in your income as wages. You can exclude these benefits from your income ***only*** when the ***facts clearly show*** that the union intended them as ***gifts*** to you.

## **BARTERING**

Bartering is an exchange of property or services. You must include in your income, at the time received, the fair market value of property or services you receive in bartering. If you exchange services with another person and you both have agreed ahead of time as to the value of the services that value will be accepted as fair market value unless the value can be shown to be otherwise. Report this income on Schedule C or Schedule C-EZ (Form 1040).

## **CANCELED DEBTS**

Generally, if a debt you owe is canceled or forgiven, other than as a gift or bequest, you must include the canceled amount in your gross income. You have no income from the canceled debt if it is intended as a ***gift*** to you. A debt includes any indebtedness for which you are liable or which attaches to property you hold. Self-employed individuals report the income on Schedule C.

**Mortgage Loan.** If your financial institution offers a discount for the early payment of your mortgage loan, the amount of the discount is ***canceled debt***. You ***must include*** the canceled amount in your gross income.

**Bankruptcy Exclusion.** If your debt is canceled in a bankruptcy case under title 11 of the United States Code, **do not include** the canceled debt in your gross income. However, you must reduce your tax attributes (but not below zero) by the canceled amount that is not included in your income.

## RECOVERIES

A recovery is a return of an amount you deducted or took a credit for in an earlier year. Generally, you must include all or part of the recovered amount in your income in the year the recovery is received.

If you recover an amount that you deducted or took a credit for in an earlier year, include recovery in your income **only to the extent** the deduction or credit reduced your tax in the earlier year.

## ROYALTIES

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as **ordinary income**.

You generally report royalties on Part 1 of Schedule E (Form 1040). However, if you hold an operating oil, gas, or mineral interest or are in business **as a self-employed** writer, inventor, artist, etc., report your gross income and expenses on **Schedule C** or Schedule C-EZ (Form 1040).

## OTHER INCOME

**Car Pools.** You cannot deduct the costs of repairs, gas, and similar items in driving a car in a car pool to and from work. Do not include amounts you receive from the passengers in your income. These amounts are considered reimbursement for your expenses. However, this rule does not apply if you have developed car pool arrangements into a profit-making business of transporting workers for hire.

**Cash Rebate on Purchase of Car or Other Item.** A cash rebate you receive from a dealer or manufacturer of an item you buy is **not** income.

**Example.** You buy a new car for \$9,000 cash and receive a \$400 rebate check from the manufacturer. The \$400 is not income to you. Your **cost is \$8,600**. This is **your basis** on which you figure gain or loss if you sell the car and depreciation if you use it for business.

**Food Program Payments to Day Care Service.** If you operate a day care service and receive payments under the Child Care Food Program administered by the



Department of Agriculture, **do not** include the payments in your gross income to the extent you use them to provide food to children eligible for help under the program.

**Gifts and Inheritances.** Generally, property you receive as a gift, bequest, or inheritance is not included in your income. However, if property you receive this way later produces income such as interest, dividends, or rents, that income is taxable to you. If property is given to a trust and the income from it is paid, credited, or distributed to you, that also is income to you. If the gift, bequest, or inheritance is the income from the property, that income is taxable to you.

**Interest on Frozen Deposits.** In general, you exclude from your income the amount of interest earned on a frozen deposit. A deposit is frozen if, at the end of a calendar year, you cannot withdraw any part of the deposit because:

1. The financial institution is bankrupt or insolvent, or
2. The state where the institution is located has placed limits on withdrawals because other financial institutions in the state are bankrupt or insolvent.

The amount of interest you exclude from gross income for the year is the interest that was credited on the frozen deposit for that tax year ***minus the sum of:***

1. The net amount withdrawn from the deposit during that year, ***and***
2. The amount that could have been withdrawn at the end of that tax year (not reduced by any penalty for premature withdrawals of a time deposit).

The excluded part of the interest is included in your gross income in the tax year it becomes ***withdrawable***.

**Interest on Qualified Savings Bonds.** You may be able to exclude from income the interest from qualified U.S. savings bonds you redeem if you pay qualified higher educational expenses in the same year. "Qualified higher educational expenses" are those you pay for tuition and required fees at an eligible educational institution for you, your spouse, or your dependent. A "qualified U.S. savings bond" is a ***series EE savings bond*** issued after December 31, 1989, to an individual 24 years of age or older.

**Interest on State and Local Government Obligations.** This interest is usually exempt from federal tax.

**Living Expenses Paid by Insurance.** Do not include in your income amounts you receive under an insurance policy for ***additional*** living expenses you and your

family had because you lost the use of your home due to a fire, storm, or other casualty. The amount you **exclude from income** is limited to your **extra living expenses** that are **more than** the normal expenses you would have had. Extra living expenses, for this purpose, include only those to keep you and your family at the **same standard** of living you had before the loss.

## **LIFE INSURANCE PROCEEDS**

Life insurance proceeds paid to you because of the death of the insured person are not taxable unless the policy was turned over to you for a price. This is true even if the proceeds were paid under an accident or health insurance policy or an endowment contract.

**Proceeds not Received in Installments.** If death benefits are paid to you in a lump sum or other than at regular intervals, include in your gross income only the benefits that are more than the amount payable to you at the time of the insured person's death. If the benefit payable at death is not specified, you include in your income the benefit payments that are more than the present value of the payments at the time of death.

**Surrender of Policy for Cash.** If you surrender a life insurance policy for cash, you must include in income any proceeds that are **more than** the amount of premiums that you paid.

## **WELFARE AND OTHER PUBLIC ASSISTANCE BENEFITS**

Do not include in your income benefit payments from a public welfare fund, such as payments due to blindness. Payments from a state fund for the victims of crime **should not be included** in the victims' incomes if they are in the nature of welfare payments. Do not deduct medical expenses that are reimbursed by such a fund. You must include any welfare payments obtained fraudulently.

**Work-Training Program.** Payments you receive from a state welfare agency for taking part in a work-training program are not included in your gross income (except for extra allowances for transportation, etc.), as long as the payments do not total more than the public welfare benefits you would have received otherwise. If the amount you receive (minus the extra allowances) is more than the welfare benefits you would have received, the entire amount must be included in your income as wages.

**Mortgage Assistance Payments.** Payments made under section 235 of the National Housing Act for mortgage assistance are not included in the homeowner's gross income. Interest paid for the homeowner under the mortgage assistance program cannot be deducted.

**Payments to Reduce Cost of Winter Energy.** Payments made by a state to qualified people to reduce their cost of winter energy use are not taxable.

Following is an alphabetical list of most types of income. In the columns on the right side of the page are check marks to indicate whether the item is taxable or nontaxable.

However, it is common for a given item of income to be generally taxable or generally nontaxable, and also have some unusual variation factor that is an exception to its basic status.

So a third column includes a check mark to indicate if an exception to the general rule exists.

The fourth column includes a check mark, when applicable, to indicate when the income item is discussed in more detail in this material.

INCOME RECEIVED	TAXABLE	NON-TAXABLE	WITH EXCEPTIONS	DISCUSSED IN TEXT
Accident Insurance Proceeds		X		
Activity Not For Profit	X			X
Age Discrimination Awards	X			
Agent Orange Payments		X		
Agreement Not To Compete		X	X	
Alaska Permanent Fund Dividends	X			
Alienation Of Affection Awards	X			
Alimony Received	X			
Awards, Generally	X		X	X
Babysitting Income	X			X
Back Pay Awards	X			X
Bad Debt Recoveries	X			
Bargain Purchases From Employer	X			
Barter Income	X			X
Bequests		X		
Black-Lung Benefit Payments		X		X
Bonuses	X			X
Breach Of Contract Damages	X			
Buried Treasure Recovered	X			
Business Interruption Insurance Proceeds	X		X	
Business Income, Net	X			
Cancelled Debts, Generally	X		X	
Cancelled Debt, Bankruptcy		X		X
Cancelled Debt, Farm Debt		X		

<b>INCOME RECEIVED</b>	<b>TAXABLE</b>	<b>NON-TAXABLE</b>	<b>WITH EXCEPTIONS</b>	<b>DISCUSSED IN TEXT</b>
Capital Gain	X			
Car Pool Receipts	X		X	X
Cash Rebates on Purchases		X		X
Casualty Income Proceeds		X	X	
Character Damage Awards	X			
Child Support Payments		X		
Child-Care Income	X			
Clergy, Housing Allowance		X		X
Clergy, Rental Value of Home		X	X	X
Combat Zone Pay, Military		X		
Commissions, Regular or Advanced	X			X
Contest Winnings	X			
Contract Cancellation Payments	X			
Copyright Infringement	X			
Corporate Director Fees	X			
Cost of Living Payments, Military		X		
Crime Victim Benefits		X	X	
Defamation of Character Awards	X			
Directors' Fees, Corporate	X			
Disability Benefits, VA		X		X
Disability Income	X		X	X
Disaster Relief Grants		X		
Distributive Share of Partnerships	X			
Dividends	X			
Election Precinct Official Fees Received	X			
Embezzled Funds	X			
Emotional Distress Via Physical Reasons				X
Emotional Distress Via Nonphysical Reasons				X
Employee Awards	X			
Employee Bonuses	X			
Employment Discrimination Awards	X			
Endowment Policy Proceeds		X		
Estate Income	X		X	
Executor Fees	X			
Exemplary Damages	X			
Fellowship Grants		X	X	

<b>INCOME RECEIVED</b>	<b>TAXABLE</b>	<b>NON-TAXABLE</b>	<b>WITH EXCEPTIONS</b>	<b>DISCUSSED IN TEXT</b>
Food Programs Payments to Day Care		X	X	X
Foster Parent's Reimbursement		X		
Fringe Benefits	X		X	
Frozen Deposit Interest		X	X	
Gains, Capital	X			
Gambling Winnings	X		X	X
Gifts and Inheritances		X		X
Goodwill, Income from Sale of	X		X	
Government Service Pensions	X		X	
Gratuities	X			
Group Life Premiums	X		X	X
Historic Preservation Grants		X		
Hobby Income, Net	X			
Holiday Gifts	X		X	X
Illegal Income	X			X
Incentive Awards, Employment	X			
Indian Fishing Rights, Income from		X		
Inheritances and Gifts		X		X
Interest	X		X	
Interest on VA Insurance Dividends	X			
Interview Expenses		X	X	X
Jurors Mileage Allowance		X		
Jury Duty Pay	X		X	X
Kickbacks	X			X
Libel Awards	X			
Life Insurance Dividends, VA		X		
Life Insurance Proceeds		X	X	X
Life Insurance, Cashed In		X	X	X
Loans, Interest Free		X	X	
Lottery Winnings	X			X
Meals and Lodging, Provided by Employer		X	X	X
Military Combat Pay		X		X
Military Pensions	X		X	X
Mortgage Loan Pay-Off Discounts	X			
Mortgage Assistance Payments		X	X	
Moving Expense Reimbursements	X			
Nobel Prize		X		

<b>INCOME RECEIVED</b>	<b>TAXABLE</b>	<b>NON-TAXABLE</b>	<b>WITH EXCEPTIONS</b>	<b>DISCUSSED IN TEXT</b>
Notary Fees Received	X			
Parking Fringe Benefits		X	X	X
Partnership Income	X			
Patent Infringement	X			
Patents, Income from	X			
Peace Corps Allowances	X		X	
Peace Corps Volunteers, Basic Allowances	X			
Pensions	X		X	
Personal Injury Awards	X			
Physical Sickness Awards	X			
Political Campaign Contributions Received		X	X	
Prepaid Income	X			X
Prizes	X		X	X
Pulitzer Prizes		X	X	
Punitive Damages	X			X
Raffle Winnings	X			X
Railroad Retirement Benefits	X		X	
Railroad Sick Pay	X		X	X
Recoveries of Prior Deductions	X			
Rents Received	X			
Rewards	X			
Royalties Received	X			
Salaries	X			
Sale of Home, Gain on	X	X	X	
Sale of Personal Item at Gain	X			
Saving Bond Interest, EE Qualified		X	X	
Saving Bond Interest, Generally	X			
Scholarships	X		X	
Separate Maintenance Payments	X			
Severance Pay	X			X
Sick Pay, Railroad	X		X	X
Sick Pay, Generally	X		X	
Slander Awards	X			
Social Security Benefits	X		X	
State Tax Refunds Received	X		X	

INCOME RECEIVED	TAXABLE	NON-TAXABLE	WITH EXCEPTIONS	DISCUSSED IN TEXT
Stock Purchase Plan, Employee	X		X	X
Stock Appreciation Rights	X		X	
Stock Options, Incentive	X		X	X
Stock Options, Statutory	X		X	X
Stock Options, Nonstatutory	X		X	X
Strike Benefits		X	X	
Surrender of Custody of a Minor Child Award	X			
Tax Refunds, Federal		X		
Tax Refunds, State	X		X	
Tips	X			
Transit Pass Fringe Benefits		X	X	X
Transportation Furnished by Employer		X	X	X
Treasury Bill Interest	X		X	
Trust, Income from	X			
US Treasury Bill Interest	X		X	
VA Insurance Dividend Interest		X		
VA Disability Benefits		X		X
Veterans' Benefits		X		X
VISTA, Meal and Lodging Allowance	X			
Wages	X			
Welfare Benefits		X	X	X
Welfare Payments Received		X		
Winter Energy Reduction Cost Program		X	X	X
Work-Training Program Payments		X	X	X
Workers' Compensation		X		X





# PRACTICE REVIEW QUESTIONS

## CHAPTER 5 - TAXABLE AND NONTAXABLE INCOME

1. Which one of the following statements is ***incorrect*** in regard to income?
  - A. The receipt of goods and services is considered income.
  - B. The receipt of property is considered income.
  - C. Nontaxable income does not have to be reported on your tax return.
  - D. The return of capital on the sale of assets is not income.
2. Which one of the following statements is ***incorrect*** regarding term life insurance?
  - A. It is insurance that provides general life insurance benefits.
  - B. It is a policy provided to a group of employees.
  - C. It is a policy paid for by the employees.
  - D. It provides an amount of insurance to each employee based on a formula that allows individual selection.
3. If your employer provides you with a qualified fringe benefit, it can be excluded from your gross income. **T/F**
4. Which one of the following statements is ***incorrect*** in regard to disability pay you may receive for sickness or injury?
  - A. Disability pay resulting directly from armed conflict is excludable.
  - B. Disability pay that results in injuries while you are engaged in extra-hazardous services is excludable.
  - C. Disability pay that causes injuries while you are in training exercises is not excludable.
  - D. Disability pay that causes injury resulting by an instrumentally of war is excludible.

5. Which one of the following statements is **incorrect** in regard to disability pay you may receive for sickness or injury?
- A. Railroad sick pay is not taxable unless received for an on-the-job injury.
  - B. Workers compensation received from an occupational injury is fully exempt from tax.
  - C. Black-lung benefit payments are not taxable.
  - D. VA disability benefits are not taxable.
6. The fair market value of a stock option that is not traded on an established market can be readily determined if certain conditions exist. Which one of the following statements is **incorrect** in this regard?
- A. You must be able to transfer the option.
  - B. The option is exercisable in full.
  - C. The option is not subject to any condition or restriction.
  - D. The basis of the option privilege can be readily determined.
7. To qualify for a stock option granted under an employee stock purchase plan, you must be an employee of the company granting the option for a certain number of months before you exercise the option. What is the number of months?
- A. 3
  - B. 6
  - C. 12
  - D. 18
8. A monetary recovery under the Age Discrimination in Employment Act is not taxable. **T/F**
9. Royalties from mineral properties are taxable as capital gains. **T/F**
10. Which one of the following is taxable income?
- A. Crime victim benefits.
  - B. A fellowship grant.
  - C. Prizes and awards with exceptions.
  - D. Federal income tax refund.

11. Which one of the following statements is ***incorrect*** in regard to whether these items are taxable?

- A. Fringe benefits are taxable with exceptions.
- B. Interview expenses are not taxable with exceptions.
- C. Mortgage assistance payments are taxable.
- D. Workers compensation is not taxable.



# RESPONSES TO REVIEW QUESTIONS

## CHAPTER 5 - TAXABLE AND NONTAXABLE INCOME

1.
  - A. **Correct.** The tax definition of income includes goods and services. The receipt of ***good and services*** must be reported at their fair market value.
  - B. **Correct.** The receipt of ***property*** must be included in gross income if it is not ***expressly*** exempt from tax.
  - C. **Incorrect.** Nontaxable income must be included on your tax return but is not subject to tax. It is reported on line 8B of Form 1040.
  - D. **Correct.** The return of any amount over your investment is taxable gain. The return of your investment is not gain and is not taxable.
2.
  - A. **Correct.** Group-term life insurance provides a general death benefit for a fixed period of time.
  - B. **Correct.** It is available to a group of employees carried by the employer.
  - C. **Incorrect.** The policy is paid by the ***employer***. Any amount up to \$50,000 coverage is not subject to income tax.
  - D. **Correct.** The insurance provides an amount of coverage to each employee based on a formula that allows individual selection.
3.
  - A. **True.** A qualified fringe benefit can be for transportation in a van between your home and workplace, a transit pass, or a payment for qualified parking expense. True is the correct answer.
  - B. **False.** A qualified fringe benefit would be included in income if the fair market value of the benefit is more than the amount you paid for the benefit. False is incorrect.

4.

- A. **Correct.** Disability payments you receive from a combat-related injury are excludible from income. This is a personal injury that results directly from armed conflict.
- B. **Correct.** Disability payments you receive from an injury that takes place while you are engaged in extra hazardous service is excludible from income.
- C. **Incorrect.** Disability payments that are caused by injury that took place under conditions such as training exercises such as maneuvers are includible from income.
- D. **Correct.** Disability income that you receive that was caused by an instrumentally of war is excludible from income.

5.

- A. **Incorrect.** Sick pay is taxable. However, payments you receive from the railroad unemployment insurance act that are from on-the-job injuries are not taxable.
- B. **Correct.** Any payments you receive as workers compensation for an occupational sickness or injury are fully exempt, If they are paid under workers compensation act or a similar statute.
- C. **Correct.** These payments are mostly for miners who have been exposed to underground dust, mostly coal miners. The payments are similar to workers' compensation payments and are taxable.
- D. **Correct.** VA disability benefits are not taxable. Disability benefits, other than VA disability benefits received by a military retiree are tax exempt up to the amount of VA benefits the retiree is entitled.

6.

- A. **Correct.** One of the conditions of determining the fair market value of a nonstatutory stock option is that it can be traded.
- B. **Correct.** A nonstatutory stock option must be exercisable immediately in full in order to determine its fair market value.
- C. **Correct.** The option must not be subject to any restriction other than to secure payment of the purchase price. If the fair market value of an option is not readily determined, you do not have income until you exercise the option.
- D. **Incorrect.** The ***fair market value*** of a nonstatutory stock option that can be readily determined is a condition of the amount to include in income.

- 7.
- A. **Correct.** You must be an employee or the company granting the option, at all times until three months before you exercise the option. (The option must be nontransferable except at death).
  - B. **Incorrect.** It need only be three months before you exercise the option.
  - C. **Incorrect.** It need only be three months at the company granting the option (or of a related company).
  - D. **Incorrect.** The 12-month time frame is for an incentive stock option if you are disabled.
- 8.
- A. **True.** True is the incorrect answer because any recovery under the Age Discrimination in Employment Act ***must*** be included in income.
  - B. **False.** False is the correct answer because any recovery from the Age Discrimination in Employment Act is considered ordinary income.
- 9.
- A. **True.** True is incorrect because royalties from mineral properties are taxable as ordinary income ***not*** capital gains.
  - B. **False.** Royalties from copyrights, patents, oil and gas are taxable as ordinary income. False is the correct answer.
- 10.
- A. **Incorrect.** Crime victim benefits are not taxable.
  - B. **Incorrect.** Fellowship grants are not taxable.
  - C. **Correct.** Prizes and awards are taxable at their fair market value. However, if you refuse to accept an award, you are not required to include it in your income.
  - D. **Incorrect.** Federal income tax refunds are not taxable.

11.

- A. **Correct.** Fringe benefits are taxable unless they are specifically excluded by law. The amount required to be included in income is determined under the general valuation rule or under the special valuation rules.
- B. **Correct.** Interview expenses are not taxable if they are paid by an employer for transportation and other travel expenses. However, to the extent the payments that are in excess of your actual cost are taxable.
- C. **Incorrect.** Payments made under Section 235 of the National Housing Act for mortgages assistance are not required to be included in the homeowner's gross income. Also the interest paid for the homeowner under the act cannot be deducted.
- D. **Correct.** Workers compensation payments for occupational sickness or injury are not taxable. The exemption from tax also applies to your survivors.



# CHAPTER SIX

## FOREIGN TAX CREDIT FOR INDIVIDUALS

If foreign taxes are paid or accrued to a foreign country on foreign sourced income and are subject to US tax on the same income there is a choice to take either a credit or an itemized deduction for those taxes. Taken as a deduction, foreign income taxes reduce US taxable income. Taken as a credit, foreign income taxes reduces US tax liability.

### CHOOSING TO TAKE A CREDIT OR DEDUCTION

There is a choice of taking the foreign taxes paid or accrued during the year as either a credit or a deduction. You cannot choose to take a tax credit and tax deduction for foreign taxes paid in the same year. However, you can take a tax credit one year and a tax deduction the next, the same choice does not have to be made every year.

If the foreign tax credit is chosen, in most cases a Form 1116 is filled out and is attached to the return. However, it's possible to qualify for the exception that allows you to take the foreign tax credit without filling out Form 1116. If you choose to take as an itemized deduction, use Schedule A.

**Exceptions for foreign taxes not allowed as a credit.** Even if a credit is claimed for other foreign taxes, a foreign tax can be deducted that is not allowed as a credit if you did any of the following:

- You paid the tax to a country for which a credit is not allowed because it provides support for acts of terrorism, or because the United States does not have or does not conduct diplomatic relations with it or recognize its government and that government is not otherwise eligible to purchase defense articles or services under the Arms Export Control Act.
- You paid withholding tax on dividends from foreign corporations whose stock you did not hold for the required period of time.
- You paid withholding tax on income or gain (other than dividends) from property you did not hold for the required amount of time.
- You paid withholding tax on income or gain to the extent you had to make related payments in substantially or related property.
- You participated in or cooperated with an international boycott.
- You paid taxes in connection with the purchase or sale of oil or gas.
- You paid or accrued taxes on income or gain in connection with a covered asset acquisition. Covered asset acquisitions include certain acquisitions that result in a stepped-up basis for US tax purposes.

**Foreign taxes that are not income taxes.** In most cases, only foreign income taxes qualify for the foreign tax credit. Other taxes, such as foreign real and personal property taxes, do not qualify. But these may be able to be deducted even if the foreign tax credit is claimed. In most cases, these other taxes are deducted only if they are expenses incurred in a trade or business or in the production of income. Also, foreign real estate property taxes can be deducted if they are not trade or business expenses on Schedule A on Form 1040.

**Carrybacks and carryovers.** There is a limit on the credit that can be claimed in a tax year. If qualified foreign taxes exceed the credit limit, the excess may be able to carry over or carry back to another tax year. If qualified foreign taxes are deducted in a tax year, there cannot be a carryback or carryover in that year. A deduction and a credit cannot be taken in the same year.

**Making or changing the choice.** A choice can be made or changed to claim a deduction or credit at any time within 10 years from the regular due date for filing the return (without regard to any extension of time to file) for the tax year in which the taxes were actually paid or accrued. The choice is made or changed on the tax return (or on the amended return) for the year the choice is to be effective.

### **WHY CHOOSE THE CREDIT**

The foreign tax credit is intended to alleviate the double tax burden when the foreign source income is taxed by both the United States and the foreign country. In most cases, if the foreign tax rate is higher than the US rate, there will be no US tax on the foreign income. If the foreign tax rate is lower than the US rate, US tax on the foreign income will be limited to the difference between the rates. The foreign tax credit can only reduce US taxes on foreign source income, it cannot reduce US taxes on US source income.

In most cases it is better to take a credit for qualified foreign taxes than to deduct them as an itemized deduction. Here are a couple of reasons why:

- A credit reduces the actual US income tax on a dollar per dollar basis, while a deduction reduces the income subject to tax.
- The foreign tax credit can be chosen even if you cannot itemize deductions, The standard deduction is allowed along with the credit.
- If the foreign tax credit is chosen, and the taxes paid or accrued exceed the credit limit for the tax year, you may be able to carry over or carry back the excess to another tax year.

## WHO CAN TAKE THE CREDIT

**US Citizens.** If you are a US citizen, you are taxed by the United States on your worldwide income no matter where you live. You are normally entitled to take a credit for foreign taxes that you pay or accrue.

**Resident Aliens.** If you are a resident alien of the United States, you can take a credit for foreign taxes subject to the same general rules as US citizens. If you are a resident of Puerto Rico for the entire tax year, the same rules apply. In most cases, you can take a credit only for those foreign taxes imposed on income you actually or constructively received while you had resident alien status.

**Nonresident Aliens.** Nonresident aliens cannot take the credit in most cases. You may be eligible to take the credit if you meet either of these two conditions:

- You were a bona fide resident of Puerto Rico during the entire tax year.
- You pay or accrue tax to a foreign country or US possession on income from foreign sources that is connected with a trade or business in the United States. However, if you must pay tax to a foreign country or US possession on income from US sources only because you are a citizen or resident of that country or US possession, do not use that tax in figuring the amount of the credit.

## WHAT FOREIGN TAXES QUALIFY FOR THE CREDIT

Usually, the following four tests must be met for any foreign tax to qualify for the credit.

1. The tax must be imposed on you.
2. You must have paid or accrued the tax.
3. The tax must be the legal and actual foreign tax liability.
4. The tax must be an income tax (or a tax in lieu of an income tax).

**Tax Must Be Imposed on You.** You can claim a credit only for foreign taxes that are imposed on you by a foreign country or US possession. For example, a tax that is deducted from your paycheck is considered to be imposed on you. You cannot shift the right to claim the credit by contract or other means.

***Foreign country.*** A foreign country includes any foreign state and its political subdivisions. Income, war profits, and excess profits taxes paid or accrued to a foreign city or province qualify for the foreign tax credit.

**US possessions.** For foreign tax purposes, all qualified taxes paid to US possessions are considered foreign taxes. US possessions include Puerto Rico and American Samoa among others.

**You Must Have Paid or Accrued the Tax.** In most cases, you can claim the credit only if you paid or accrued the foreign tax to a foreign country or US possession. However, there are some instances which follows in which the credit can be claimed even if you did not directly pay or accrue the tax yourself.

**Joint return.** If a joint return is filed, the credit claimed is based on total foreign income taxes paid or accrued by both spouses.

**Partner or S corporation shareholder.** If you are a member of a partnership or a shareholder in a S corporation, you can claim the credit based on your proportionate share of the foreign income taxes paid or accrued by the partnership or S corp. These amounts will shown on the Schedule K-1 you receive from the partnership or S corp. **However**, if you are a shareholder in an S corporation that in turns owns stock in a foreign corporation, you **cannot** claim a credit for your share of foreign taxes paid by the foreign corporation.

**Beneficiary.** A beneficiary of an estate or trust may be able to claim the credit based on their proportionate share of foreign income taxes paid or accrued by the estate or trust. The amount will be shown from the estate's or trust K-1. **However**, the beneficiary must show that the tax was imposed on income from the estate or trust and **not on income** received by the decedent.

**Mutual fund shareholder.** A shareholder of a mutual fund or other regulated investment company (RIC) may be able to claim the credit based on your share of foreign income taxes paid by the fund if it chooses to pass the credit on to its shareholders. This amount will show up on the shareholders Form 1099-Div from the fund which will show your share of foreign income and taxes paid.

**Controlled foreign corporation shareholder.** A shareholder in a controlled foreign corporation and chooses to be taxed at corporate rates on the amount that must be included in gross income from that corporation, can claim the credit based on the shareholders share of foreign paid or accrued by the controlled foreign corporation. If the shareholder makes this election, they must file Form 1118.

**Tax Must Be the Legal and Actual Foreign Tax Liability.** The amount of foreign tax that qualifies is not necessarily the amount of tax withheld by the foreign country. Only the legal and actual foreign tax liability that you paid or accrued during the year qualifies for the credit.

**Foreign tax refund.** You **cannot** take a foreign tax credit for income taxes paid to a foreign country if it is reasonably certain the amount would be refunded, credited, rebated, abated or forgiven if you made a claim.

For example, the United States has tax treaties with many countries allowing US citizens and residents reductions in tax rates of those foreign countries. However, some treaty countries require US citizens and residents to pay the tax figured without regard to the lower treaty rates and then claim a refund for the amount by which the tax actually paid is more than the amount figured using the lower treaty rate. The qualified foreign tax is the amount figured using the lower treaty rate and not the amount actually paid, because the excess tax is refundable.

**Subsidy received.** Tax payments a foreign country returns in the form of a subsidy do not qualify for the foreign tax credit. This applies even if the subsidy is given to a related person or persons who participated with you in a transaction or a related transaction. A subsidy can be provided by any means but must be determined, directly or indirectly, in relation to the amount of tax, or to the base used to figure the tax.

**Shareholder receiving refund for corporate tax in integrated system.** Under some tax laws and treaties, a shareholder is considered to have paid part of the tax that is imposed on the corporation. You may be able to claim a refund of these taxes from the foreign government. The refund must be included (including any withholding) in your income in the year received. Any tax withheld is a qualified foreign tax.

**Tax Must Be an Income Tax (or Tax in Lieu of Income Tax).** In most cases, only income, war profits, and excess profits taxes (income taxes) qualify for the foreign tax credit. Usually, foreign taxes on wages, dividends, interest, and royalties qualify for the credit in most cases.

**Income tax.** Just because the levy is called an income tax by the foreign taxing authority does not make it an income tax for this purpose. A foreign levy is an income tax only if it meets the two following requirements:

1. It is a tax that you have to pay and you receive no specific economic benefit from paying it.
2. The predominant character of the tax is that of an income tax in the United States sense.

A foreign levy may meet these conditions even if the foreign tax law differs from the US tax law.

**Dual-capacity taxpayers.** If you are subject to a foreign country's levy and you also receive a specific economic benefit from that foreign country, you are a "dual-capacity

taxpayer." As a dual-capacity taxpayer you cannot claim a credit for any part of the foreign levy, unless you establish that the amount paid under a distinct element of the foreign levy is a tax, rather than the compulsory payment for a direct or indirect specific economic benefit.

***Pension, unemployment, and disability fund payments.*** A foreign tax imposed on an individual to pay for retirement, old-age, death, survivor, unemployment, illness, disability benefits, or for substantially similar purposes, is not payment for a specific economic benefit if the amount of the tax does not depend on the age, life expectancy, or similar characteristics of that individual.

No deduction or credit is allowed for social security taxes paid or accrued to a foreign country with which the United States has a social security agreement.

***Soak-up taxes.*** A foreign tax is not predominantly an income tax and does not qualify for the foreign income tax credit to the extent it is a soak-up tax. A tax is a soak-up tax to the extent that liability for it depends on the availability of a credit for it against income tax imposed by another country. This rule applies only if and to the extent that the foreign tax would not be imposed if the credit were not available.

***Penalties and interest.*** Amounts paid to a foreign government to satisfy a liability for interest, fines, penalties, or any similar obligation are not taxes and do not qualify for the credit.

***Taxes not based on income.*** Foreign taxes based on gross receipts or the number of units produced, rather than on realized net income, do not qualify unless they are imposed in lieu of an income tax. Taxes based on assets, such as property taxes, do not qualify for the credit.

***Taxes in lieu of income taxes.*** A tax paid or accrued to a foreign country qualifies for the credit if it imposed in lieu of an income tax otherwise generally imposed. A foreign levy is a tax in lieu of an income tax only if it meets the following requirements:

- It is not payment for a specific economic benefit.
- The tax is imposed in place of, and not in addition to, an income tax otherwise generally imposed.

In most cases, a soak-up tax does not qualify as a tax in lieu of an income tax. However, if the foreign country imposes a soak-up tax in lieu of the income tax, the amount that does not qualify for foreign tax credit is the lesser of:

- The soak-up tax
- The foreign tax that was paid is more than the amount that would have paid if subject to the generally imposed income tax.

## FOREIGN TAXES FOR WHICH YOU CANNOT TAKE CREDIT

The following is a list of foreign taxes that are not eligible for the foreign tax credit:

- Taxes on excluded income
- Taxes for which you can only take an itemized deduction
- Taxes on foreign mineral income
- Taxes from international boycott operations
- A portion of taxes on combined foreign oil and gas income
- Taxes of US persons controlling foreign corporations and partnerships who fail to file required informational returns.
- Taxes related to a foreign tax splitting event

**Taxes on Excluded Income.** You cannot take a credit for foreign taxes paid or accrued on certain income that is excluded from US gross income.

***Foreign earned income and housing exclusions.*** Foreign income taxes available for credit must be reduced by the amount of those taxes paid or accrued on income that was excluded from US income under the foreign earned income exclusion or the foreign housing exclusion.

***Wages completely excluded.*** If the wages are completely excluded then there cannot be any credit for any of the foreign taxes paid or accrued on these wages.

***Wages partly excluded.*** If only a portion of the wages are excluded, credit for foreign income taxes can only be taken on the portion that was not excluded.

***Taxes on income from Puerto Rico exempt from US tax.*** If there is income from Puerto Rico sources that are not taxable, there is a reduction of foreign income taxes paid or accrued in proportion to the exempt income.

***Possession exclusion.*** A bona fide resident of American Samoa that has excluded income from sources in American Samoa, will have a reduction of credit on taxes that are paid on the excluded income.

**Taxes for Which You Can Only Take an Itemized Deduction.** Foreign Tax credit cannot be claimed under certain circumstances. In these particular circumstances, however, an itemized deduction can be claimed. A discussion of some of these situations will follow.

***Taxes imposed by sanctioned countries (Section 901(j)Income).*** A foreign income tax credit cannot be claimed for income taxes paid or accrued to any country if the income giving rise to the tax for a sanction period during which:

- The Secretary of State has designated the country as one that repeatedly provides support for acts of international terrorism
- The United States has severed or does not conduct diplomatic relations with the country
- The United States does not recognize the country's government, and that government is not otherwise eligible to purchase defense articles or services under the Arms Export Control Act.

The following countries meet this description for 2018. Income taxes paid or accrued to these countries do not qualify for the credit but an itemized deduction can still be claimed.

- Iran
- North Korea
- Syria
- Burma
- Cuba
- Cote d'Ivoire

***Waiver of denial of the credit.*** A waiver can be granted to a sanctioned country if the President of the United States determines that granting the waiver is in the best interest of the United States and will expand trade and investment opportunities for US companies in the sanctioned country. The president must report to Congress his intentions to grant the waiver and his reasons for granting the waiver not less than 30 days before the date on which the waiver is granted.

***Limit on credit.*** In determining foreign tax credit limit, income from a sanctioned country is a separate category of foreign income unless a Presidential waiver is granted. A separate Form 1116 must be filled out for this income with **box c** checked at the top of the form. Complete the form through line 17 only. This will prevent claiming a credit for foreign taxes paid to the sanctioned country.

***Taxes imposed on certain dividends.*** A foreign tax credit cannot be claimed on dividends paid or accrued if either of the following conditions exist:

- The dividends are on stock held less than 16 days during the 31-day period that begins 15 days before the ex-dividend date.
- The dividends are for a period or periods totaling more than 366 days on preferred stock that was held for less than 46 days during the 91-day period that begins 45 days before the ex-dividend date. If the dividend is for a period of less than 366 days then the above bullet applies.



When figuring how long the stock was held, count the day it was sold, but do not count the day it was acquired or any days in which there was protection from risk of loss.

Regardless of how long the stock was held, credit cannot be claimed to the extent there is an obligation under a short sale or otherwise to make payments related to the dividend for positions in substantially similar or related property.

***Taxes withheld on income or gain (other than dividends).*** For income or gain paid or accrued on property, a foreign tax credit for withholding tax cannot be claimed if either of the following conditions exist:

- If the property was not held for at least 16 days during the 31-day period that begins 15 days before the date on which to receive payment arises, or
- To the extent you have to make related payments on positions in substantially similar or related property.

When figuring how long you held the property, count the day that it was sold, but do not count the day it was purchased or any days which were protected from risk of loss.

***Covered asset acquisition.*** A credit cannot be taken for the disqualified portion of any foreign tax paid in connection with a covered asset acquisition. A covered asset acquisition includes certain acquisitions that result in a stepped-up basis for US tax purposes but not for foreign tax purposes.

***Taxes in connection with the purchase or sale of oil and gas.*** A foreign tax credit cannot be claimed for taxes paid or accrued to a foreign country in connection with the purchase or sale of oil or gas extracted from that country if there is not an economic interest in the oil and gas, and the purchase price or sales price is different from the fair market value of the oil or gas at the time of purchase or sale.

**Taxes on Foreign Mineral Income.** If there was a deduction for percentage depletion allowed for any part of the mineral income, the taxes paid or accrued to the foreign country or possession must be reduced.

**Taxes From International Boycott Operations.** If you participated or cooperated with an international boycott during the tax year, your foreign taxes resulting from the boycott activities will reduce the total taxes available for credit. In most cases this rule does not apply to employees with wages who are living and working in boycotting countries, or to retirees with pensions who are living in these countries. The following is a list of the boycotting countries as of May 2018:

- Iraq
- Kuwait

- Lebanon
- Libya
- Qatar
- Saudi Arabia
- Syria
- United Arab Emirates
- Yemen

Determinations of whether the boycott rule applies are outlined in Revenue Procedure 77-9 in Cumulative Bulletin 1977-1. These are available at most IRS offices.

***Reporting requirements.*** A report with the IRS must be filed if you or any of the following persons have operations in or related to a boycotting country or with the government, a company, or a national of a boycotting country:

- A foreign corporation in which you own 10% or more of the voting power of all voting stock but only if you own the stock of the foreign corporation directly or through foreign entities.
- A partnership in which you are a partner.
- A trust you are treated as owning.

Use Form 5713 to file the report. If you willfully fail to file the report, you may be fined \$25,000 or imprisoned for no more than 1 year, or both in addition to other penalties.

**Taxes on Combined Foreign Oil and Gas Income.** Foreign taxes must be reduced by a portion of any foreign taxes imposed on combined foreign oil and gas income. The amount reduced is the amount by which foreign oil and gas taxes exceed the amount of your combined foreign oil and gas income multiplied by the ratio equal to your pre-credit US tax liability divided by your worldwide income. Any foreign taxes that are reduced may be carried over to other years.

Combined foreign oil and gas income is the sum of foreign oil related income and foreign oil and gas extraction income. Foreign oil and gas taxes are the sum of foreign oil and gas extraction taxes and foreign oil related taxes.

**Taxes of US Persons Controlling Foreign Corporations and Partnerships.** An individual with control of a foreign corporation or partnership for the annual accounting period that ended with or within the tax year, may have to file an annual informational return. If the required informational return is not filed, any foreign taxes used for the foreign tax credit may have to be reduced.

**US persons controlling foreign corporations.** A US citizen or resident who had control of a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period may have to file Form 5471. A US citizen or resident had control of a foreign corporation if at any time during the tax year and owned stock possessing:

- More than 50% of the total combined **voting power** of all classes of stock entitled to vote, or
- More than 50% of the total **value** of shares of all classes of stock of the foreign corporation.

**US persons controlling foreign partnerships.** A US citizen or resident who had control of a foreign partnership at any time during the partnership's tax year, may have to file an annual informational return on Form 8865. A US citizen or resident has control of the partnership if they owned 50% of the capital or profits interest, or an interest to which more than 50% of the deductions or losses were allocated.

A Form 8865 may also have to be filed if a US citizen or resident at any time during the partnership tax year owned a 10% or greater interest in the partnership while the partnership was controlled by US persons owning at least a 10% interest.

**Penalty for not filing Form 5471 or Form 8865.** In most cases, there is a penalty of \$10,000 for each annual accounting period for which there is a failure to provide information. Additional penalties apply if the failure continues for more than 90 days after the day the IRS mails a notice of failure to provide the information.

If there is a failure to file either Form 5471 or 8865 when due, there may be a requirement to reduce foreign taxes by 10% that would be used for the foreign tax credit. Additional reductions occur if the failure to provide continues for 90 days or more after the date the IRS mails the notice of the failure to provide the information. The total reductions shall not exceed the greater of \$10,000 or the income of the foreign corporation or partnership for the accounting period for which the failure occurs. This foreign tax penalty is also reduced by the amount of the dollar penalty imposed.

**Taxes Related to a Foreign Tax Credit Splitting Event.** Reduce taxes paid or accrued by any taxes paid or accrued with respect to a foreign tax splitting event. For foreign taxes paid or accrued after 2010, if there is a foreign tax credit splitting event, do not take the foreign tax into account before the tax year in which the income is taken into account. There is a foreign tax credit splitting event with respect to a foreign income tax if the related income is taken into account by a **covered** person. A covered person is either:

- An entity in which you hold, directly or indirectly, at least a 10% ownership value determined by either vote or value.
- Any person who is related to you.

A covered asset acquisition under Internal Revenue Code section 901(m) is not a foreign tax credit income splitting event under IRC code 909.

The following are some of the more common foreign tax credit splitting events.

***Reverse hybrid splitter agreement.*** A reverse hybrid is a splitter arrangement if foreign income taxes are paid or accrued in respect to the reverse hybrid. A reverse hybrid is an entity that is a corporation for US federal income tax purposes but is a fiscally transparent entity or a branch under the laws of a foreign country imposing tax on the income of the entity.

***Loss-sharing splitter arrangement.*** A foreign group relief or other loss-sharing regime is a loss-sharing splitter arrangement to the extent that a shared loss of a US combined income group could have been used to offset income of that group but is used instead to offset income of another US combined income group.

***US equity hybrid instrument splitter arrangements.*** A US equity hybrid instrument is a splitter arrangement if payments or accruals on or with respect to this instrument meet all of the following conditions:

- They give rise to foreign income taxes paid or accrued by the owner of this instrument.
- They give rise to income tax deductions for the issuer under the laws of a foreign jurisdiction in which the issuer is subject to tax.
- They do not give rise to income for US federal income tax purposes.

A US equity hybrid instrument is one that is treated as equity for US federal income tax purposes but is treated as indebtedness for foreign tax purposes, or with respect to which the issuer is otherwise entitled to a deduction for foreign tax purposes for amounts paid or accrued with respect to the instrument.

***US debt hybrid instrument splitter arrangement.*** A US debt hybrid arrangement is a splitter arrangement if the issuer of the US debt hybrid instrument pays or accrues foreign income taxes with respect to an income in an amount equal to the interest (including OID) paid or accrued on the instrument that is deductible for US federal income tax purposes but not a deduction under the laws of a foreign jurisdiction in which the issuer is subject to tax.

A US debt hybrid instrument is an instrument that is treated as equity for foreign tax purposes but as indebtedness for US federal income tax purposes.

## HOW TO FIGURE THE CREDIT

The foreign tax credit can be claimed from only foreign taxes on income, war profits, or excess profits, or taxes in lieu of those taxes. There is also a limit on the amount of the credit. The credit and limit is filled out on Form 1116. The credit is the amount of foreign tax paid or if smaller, the limit.

If there are unused foreign taxes because the limit was exceeded they can either be carried back 1 year or carry forward for the next 10 years.

There are also tax treaties from other countries that may have to be considered when computing the credit.

***Exemption from the foreign tax credit limit.*** There will be no credit limit and Form 1116 will not have to be filled out if the following conditions are met:

- The only foreign source gross income for the tax year is passive category income.
- The qualified foreign taxes for the tax year are not more than \$300. If filing status is married filing joint the limit is \$600.
- All of the gross foreign income and foreign taxes are reported on a payee statement such as a Form 1099-Div or 1099-Int.
- Election of this procedure for the tax year.

If this election is made, there cannot be any carry back or carry over for any unused foreign tax from the tax year.

**Limit on The Credit.** The foreign tax credit cannot be more than the total US tax liability multiplied by a ratio. The ratio is taxable income from sources outside the US compared to the total taxable income from US sources and foreign sources.

The foreign source income must be separated into categories. The limit treats all foreign income and expenses in each separate category as a single unit and limits the credit to the US income tax on the taxable income from that category from all sources outside the United States.

**Separate Limit Income.** The limit must be calculated for each of the following categories on a separate Form 1116:

- Passive category income
- General category income
- Section 901(j) income
- Certain income re-sourced by treaty

- Any lump-sum distribution from an employer benefit plan for which the special averaging treatment is used to determine the tax.

In figuring the separate limits, the income and losses must be combined for each category from all the foreign sources and then apply the limit.

**Passive category income.** Passive category income consists of passive income and specified passive income. Passive income usually consists of the following:

- Dividends
- Interest
- Rents
- Royalties
- Annuities
- Net gain from the sale of non-income-producing investment property or property that generates passive income
- Net gain from commodities transactions, except for hedging and active business gains or losses of producers, processors, merchants, or handlers of commodities

If foreign source distributions are received from a mutual fund or other regulated investment company that elects to pass through the foreign tax credit, in most cases the income is considered passive. The fund will provide a Form 1099-DIV or substitute statement showing the amount of foreign taxes that it elected to pass on.

**What is not passive income.** The following are examples of income that is not passive:

- Gains or losses from the sale of inventory property or property held mainly for sale to customers in the ordinary course of trade or business.
- Export financing business. This is interest derived from financing the sale of property outside the United States if either the property is manufactured, produced, grown, or extracted in the United States by you or a related person **and** 50% or less of the fair market value of the property is due to imports into the United States.
- High-taxed income. This is passive income subject to foreign taxes that are higher than the highest US tax rate. The high-taxed income and the taxes imposed on it are moved from the passive category income to general category income.
- Active business rents and royalties.
- Any income that is defined in another separate limit category.

***Specified passive category income.*** This consists of:

1. Dividends from a DISC (domestic international sales corporation) or former DISC to the extent the dividends are treated as foreign source income and,
2. Distributions from a former FSC (foreign sales corporation) out of earnings and profits that are attributable to:
  - a) Foreign trade income, or
  - b) Interest and carrying charges derived from a transaction that results in foreign trade income.

**General Category Income.** This is income from sources outside the US that is not passive category income or does not fall into one of the other separate limit categories. The following are some examples:

- Active business income and wages
- Salaries
- Oversea allowances of an employee
- High-taxed income that would ordinarily be passive income.

***Financial services income.*** This is usually treated as a general category income if it derives from a financial institution entity. A financial services entity is predominantly engaged in banking, insurance, financing, or any similar business during the tax year. It also includes passive income and certain incidental income.

**Section 901(j) Income.** This is income earned from activities conducted in sanctioned countries. Income earned from each sanctioned country is subject to a separate foreign tax credit limitation. A separate Form 1116 must be used from income earned from each sanctioned country.

**Certain income Re-Sourced by Treaty.** If a sourcing rule in an applicable income tax treaty treats US sourced income as a foreign source, and there is an election to apply the treaty, the income will be treated as a foreign source.

A separate Form 1116 must be used for each amount of re-sourced income from a treaty country to calculate a separate foreign tax credit limitation for any such income for which benefits are claimed under a treaty.

**Lump-Sum Distribution.** If a foreign source lump-sum distribution (LSD) is received from a retirement plan, and the special averaging treatment for LSDs is used to calculate the tax, a special calculation must be made. Follow the Form 1116 instructions and complete the worksheet to determine the foreign tax credit on the LSD.

**Allocation of Foreign Taxes.** Solely for the purposes of allocating foreign taxes to separate limit income categories, those separate limit categories include any US source income that is taxed by the foreign country or US possession.

If foreign income tax was paid or accrued for a tax year in more than one separate limit category, allocate the tax to the income category to which the tax specifically relates. If the tax is not specifically related to any one category, the tax must be allocated to each category of income.

Net income is figured by deducting from the gross income in each category and from the total gross income taxed by the foreign country or US possession, any expenses, losses, and other deductions definitely related to them under the laws of the foreign country or US possession. If the expenses, losses, and other deductions are not definitely related to a category of income under foreign law, they are apportioned under the principles of the foreign law. If the foreign law does not provide for apportionment, use the principles covered in the US Internal Revenue Code.

**Figuring the Limit.** Before the limit can be determined on the foreign tax credit, the total taxable income from all sources must be calculated. Then for each category of income, then the taxable income from sources outside the United States must be calculated.

Before figuring the taxable income in each category from sources outside the United States, it must be determined whether your gross income from each category is from US sources or foreign sources. Some of the rules for determining the source of income are in the table that follows;



Item of Income	Factor Determining Source
Salaries, wages, other compensation	Where services are performed
Business income:	
Personal services	Where services performed
Sale of inventory--purchased	Where sold
Sale of inventory--produced	Allocation
Interest	Residence of payer
Dividends	Whether US or foreign corporation
Rents	Location of property
Royalties:	
Natural resources	Location of property
Patents, copyrights, etc.	Where property is used
Sale of real property	Location of property
Sale of personal property	Seller's tax home
Pension distributions attributable to contributions	Where services were performed that earned the pension.
Investment earnings on pension contributions	Location of pension trust
Sale of natural resources	Allocation based on fair market value of product at export terminal.

**Allocation of Foreign and US Losses.** Losses must be allocated for both foreign and US for any tax year (to the extent such losses do not exceed the separate limitation incomes for the tax year) among incomes on a proportionate basis.

***Foreign losses.*** If there is a foreign loss when determining the taxable income in a separate limit income category, and there is income in one or more of these categories, the income from the separate categories must be reduced by the loss before reducing income from US sources.

**Example.** Lance has \$12,000 of passive category income and incurred a loss of \$7,000 of general category income. The \$7,000 loss must be used to offset \$7,000 of passive category income.

***How to allocate.*** Foreign losses must be allocated among the separate limit income categories in the same proportion as each categories income bears to the foreign income.

**Example.** Craig has a \$4,000 loss that is general category income, \$6,000 of passive category income, and \$4,000 of income that is re-sourced by treaty. Craig must allocate the \$4,000 loss to the income in the other separate categories.

The passive category income is reduced to  $(\$6,000/\$10,000) \times \$4,000 = \$2,400$

The income re-sourced by treaty is reduced to  $(\$4,000/\$10,000) \times \$4,000 = \$1,600$ .

***Loss more than foreign income.*** If there is a loss remaining after reducing the income in other separate limit categories, use the remaining loss to reduce US source income.

***US Losses.*** The amount of the net loss from sources in the United States is equal to the excess of (1) the foreign sourced income in all of the separate categories in the aggregate, after taking into account any adjustments over (2) the amount of taxable income that was entered on Form 1116, line 18.

**Tax Treaties.** The United States is a party to tax treaties that are basically designed to prevent double taxation of the same income by the United States and the treaty country. Many treaties do this by treating US sourced income as foreign sourced income. Certain treaties have special rules that must be considered when figuring foreign tax credit for a US citizen living in the treaty country. These rules generally limit the amount of US sourced income that is treated as foreign sourced income. The treaties that provide for this type of restriction are Australia, Austria, Bangladesh, Belgium, Bulgaria, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Ireland, Israel, Italy, Japan, Luxembourg, Malta, Mexico, the Netherlands, New Zealand, Portugal, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, and the United Kingdom.

***Report required.*** Certain information may have to be reported with the return if a foreign tax credit is claimed under a treaty provision. If a treaty provision permits a foreign tax credit for a specific tax that is not allowed by the Internal Revenue Code, this information must be reported with your return. Report such information on Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).

## **CARRYBACK AND CARRYOVER**

If the amount of foreign tax paid or accrued exceeds the limit for the tax year, the excess can be carried back one year and then carried forward 10 years if there is any unused foreign tax. A period of less than 12 months for a tax return is considered a tax year.

The unused tax in each category is the amount by which the qualified taxes paid or accrued are more than the limit for that category. The excess limit in each category is the amount by which the limit is more than the qualified taxes paid for that category.

Figure the carrybacks or carryovers separately for each separate limit income category.

**Example 1.** All of Joe's foreign income for tax year 2017 and 2018 was general category income. Joe paid foreign tax in 2017 of \$300 and in 2018 he paid foreign tax of \$500. His limit for foreign tax in 2017 was \$400 and

2018 it was \$300. Joe had unused foreign tax in 2017 of \$100. In 2018, Joe was \$200 over the limit, so Joe can carry back \$100 to 2017 and carry forward the other \$100 to tax year 2019.

**Example 2.** All of Joe's foreign income is general category income for 2013 through 2018. The limit on Joe's foreign tax credit and the qualified foreign tax paid on his general category income for 2013-2018 are as follows:

	<b>Joe's Limit</b>	<b>Foreign Tax Paid</b>	<b>Unused foreign tax (+) or excess limit (-)</b>
2013	\$600	\$800	+200
2014	\$600	\$700	+100
2015	\$500	\$700	+200
2016	\$550	\$400	- 150
2017	\$800	\$700	- 100
2018	\$500	\$550	+ 50

Joe cannot carry forward the unused foreign tax from 2013 (\$200) until 2016. The excess limit of \$150 in 2016 is absorbed and Joe can carry forward \$50 of 2013's unused foreign tax to 2017. The unused tax from 2014 (\$100) is partially absorbed (\$50) in 2017 and the balance (\$50) will carryforward to 2019. The unused foreign tax from 2015 (\$200) will carry forward to 2019 as well.

**Time Limit on Tax Assessment.** When unused foreign tax is carried back, the IRS is given additional time to assess any tax resulting from the carry back. An assessment can be made up to the end of 1 year after the expiration of the statutory period for an assessment relating to the year in which the carry back originated.

**Claim for Refund.** When unused foreign tax is carried back to the first preceding tax year, file Form 1040X for the particular tax year and attach a revised Form 1116.

**Taxes All Credited or All Deducted.** In a given tax year, all foreign taxes are either deducted or all foreign taxes that qualify are claimed as a tax credit. This rule is applied with the carry back and carryover procedure as follows:

- A credit carry back or carryover cannot be claimed in a year in which qualified foreign taxes are deducted.
- Unused foreign taxes cannot be deducted in any year in which they are carried even if qualified foreign taxes are paid and deducted in that particular year.
- A credit cannot be claimed for unused foreign taxes in any year in which they are carried unless a credit is actually being claimed for the particular tax year.

- Unused foreign taxes cannot be carried back or carried over in a year for which the election not to be subject to the foreign tax credit limit is made.

***Unused taxes carried to deduction year.*** If unused foreign taxes are carried in a year in which the foreign tax deduction is chosen, a foreign tax credit limit still must be calculated. If the credit calculation results in an excess limit for the deduction year, any unused foreign taxes carried in the deduction year are treated as being absorbed in that year. Unused foreign taxes are not actually deducted or a tax credit claimed in the deduction year but the treatment reduces the amount of any unused foreign taxes that can be carried to another year.

Because unused foreign taxes cannot be claimed or a credit taken if they are absorbed in a deduction year there is not a tax benefit for them unless an amended return is filed to change the choice of deducting the taxes to claiming the tax credit. The time limit to make this change is 10 years from the regular due date of the return for the deduction year to make this change.

## **HOW TO CLAIM THE CREDIT**

Form 1116 must be filed in order to claim the foreign tax credit unless one of the following exceptions are met.

***Exceptions.*** If the requirements are met that were discussed on page 6-13, **Exemption from the foreign tax credit limit**, and the choice is made to be exempt from the foreign tax credit limit, do not file Form 1116. Instead, enter the foreign taxes directly on Form 1040, line 48, or Form 1040NR, line 46.

A shareholder from a controlled foreign corporation can choose to be taxed at corporate rates on the amount that must be reported in gross income from that corporation, use Form 1118 to claim the credit.

**Form 1116.** A separate Form 1116 must be filed for each of the separate categories of income for which a foreign tax credit can be claimed:

- Passive category income
- General category income
- Section 901(j) income
- Income re-sourced by treaty
- Lump-sum distributions

A Form 1116 consists of four parts:

1. Part I - ***Taxable Income or Loss From Sources Outside the United States***. Enter the gross amounts of your foreign, US possession, source income in the separate limit category that applies.
2. Part II - ***Foreign Taxes Paid or Accrued***. Part II shows the foreign taxes paid or accrued on the income in the separate limit category in foreign currency and US dollars. If there was foreign tax paid to more than one foreign country or US possession, complete a separate line for each. If income passed through from a RIC was received, aggregate all foreign taxes paid or accrued on that income on a single line in Part II.
3. Part III - ***Figuring the Credit***. Part III is used to calculate the foreign tax credit that is allowable.
4. Part IV - ***Summary of Credits From Separate Parts III***. Use this part on one Form 1116 (the one with the largest amount entered on line 22) to summarize the foreign tax credits figured on separate Forms 1116.

**Records to Keep.** The following records should be kept in case of verification required on Form 1116, Form 1040, or Form 1040NR:

- A receipt for each foreign tax payment.
- The foreign tax return if you claim a credit for taxes accrued.
- Any payee statement (such as Form 1099-DIV or Form 1099-INT) showing foreign taxes reported to you.

The receipt or return that is kept as proof should be either the original, a duplicate original, or a duly certified or authenticated copy. If the receipt or return is in a foreign language, also keep a certified translation of it.



# PRACTICE REVIEW QUESTIONS

## CHAPTER SIX - FOREIGN TAX CREDIT

1. Which of the following statements is **correct** in regards to the foreign tax credit?
  - A. A foreign tax credit and a deduction for foreign taxes paid can be taken in the same tax year.
  - B. There is no foreign tax credit.
  - C. A foreign tax credit or a deduction for foreign taxes paid or accrued can be taken for the tax year.
  - D. A deduction for foreign taxes paid or allowed is not allowed.
  
2. Which one of the following individuals are **not** eligible to take the foreign tax credit?
  - A. A citizen of the United States
  - B. A resident alien of the United States
  - C. A non-resident alien
  - D. A bona fide resident of Puerto Rico
  
3. Which of the following foreign taxes are eligible for the foreign tax credit?
  - A. Foreign taxes on excluded income.
  - B. Foreign taxes paid that can only be taken as an itemized deduction.
  - C. Foreign taxes paid on foreign mineral income.
  - D. None of the above are eligible for the foreign tax credit.
  
4. Which one of the following is considered a sanctioned country in 2018?
  - A. Iraq
  - B. Iran
  - C. Israel
  - D. Italy
  
5. Which one of the following statements are **incorrect** in regard to exemptions from the foreign tax credit limit?
  - A. The qualified foreign taxes for the tax year is not more than \$300 for a single filer.
  - B. All of the gross foreign income and taxes are reported on Form 1099-DIV.
  - C. The only foreign source gross income for the tax year is general category income.
  - D. The qualified foreign taxes for the year is not more than \$600 for married filing joint filing status.

6. Which one of the following is **not** considered passive income?
- A. Dividends
  - B. Rents
  - C. Wages
  - D. Annuities
7. The United States has a tax treaty with all of the following countries **except** for which one of the following?
- A. Iran
  - B. Italy
  - C. Israel
  - D. Iceland
8. Form 1116 consists of four parts. Which part is used to calculate the foreign tax credit that is allowable?
- A. Part I
  - B. Part II
  - C. Part III
  - D. Part IV



# RESPONSES TO REVIEW QUESTIONS

## CHAPTER SIX - FOREIGN TAX CREDIT

1.
  - A. **Incorrect.** Either a credit or a deduction for foreign taxes can be taken for the tax year, not both.
  - B. **Incorrect.** Definitely incorrect. See A above.
  - C. **Correct.** See A above.
  - D. **Incorrect.** See A above.
  
2.
  - A. **Incorrect.** A citizen of the United States is eligible to claim the foreign tax credit if foreign taxes are paid or accrued during the tax year.
  - B. **Incorrect.** A resident alien of the United States can claim the foreign tax credit.
  - C. **Correct.** Nonresident aliens cannot take the credit in most cases.
  - D. **Incorrect.** A bona fide resident of Puerto Rico is eligible to take the foreign tax credit.
  
3.
  - A. **Incorrect.** None of the taxes paid on excluded income are eligible for the tax credit. Foreign wage income that is excluded from US income and housing allowance exclusions are a couple of examples of this.
  - B. **Incorrect.** There are some foreign taxes paid that are not eligible for the foreign tax credit but can be used as an itemized deduction on the return. An example of this would be taxes imposed by a sanctioned country.
  - C. **Incorrect.** Taxes paid on foreign mineral income cannot be used for the tax credit. Also, if there was a deduction for percentage depletion allowed for any part of the mineral income, the taxes paid to the foreign country must be reduced.
  - D. **Correct.** A, B, and C were not eligible for the foreign tax credit.

4.

- A. **Incorrect.** Iraq is not on the list of sanctioned countries in 2018. One of the conditions to be on the sanctioned list is that the United States has severed or does not conduct diplomatic relations with the country.
- B. **Correct.** Iran is on the sanctioned list along with North Korea, Syria, Burma, Cuba, and Cote d'Ivoire.
- C. **Incorrect.** Israel is not on the list. Another condition of being a sanctioned country is the Secretary of State has designated the country as one that repeatedly provides support for acts of international terrorism.
- D. **Incorrect.** Italy is not a sanctioned country. One of the conditions of being a sanctioned country is that the United States does not recognize the country's government, and that government is not otherwise eligible to purchase defense articles or services under the Arms Export Control Act.

5.

- A. **Correct.** If foreign taxes paid for a single filer is under \$300 and all other conditions are met, you are exempt from the foreign tax credit limit.
- B. **Correct.** One of the conditions to be exempt is if the 1099-DIV or 1099-INT reports all foreign income and tax on the statement.
- C. **Incorrect.** To be exempt here, the foreign source gross income must be passive category income, ***not*** general category income.
- D. **Correct.** If filing status is married filing joint and foreign tax paid are less than \$600 and all other conditions are met, you are exempt from the foreign tax credit limit.

6.

- A. **Incorrect.** Dividends are considered passive income.
- B. **Incorrect.** Rents are considered passive income.
- C. **Correct.** Wages are considered general category income, ***not*** passive income.
- D. **Incorrect.** Annuities are considered passive income.

7.

- A. **Correct.** Iran **does not** have a tax treaty with the United States.
- B. **Incorrect.** Italy does have a tax treaty with the US. Tax treaties are designed to prevent double taxation of the same income between US and the treaty country.
- C. **Incorrect.** Israel does have a tax treaty with the US.
- D. **Incorrect.** Iceland does have a tax treaty with the US.

8.

- A. **Incorrect.** Part I is used for taxable income or losses from outside the US. Enter the gross amounts of the foreign, US possession, source income in the separate limit category that applies.
- B. **Incorrect.** Part II shows the foreign taxes paid or accrued on the income in the separate limit category in foreign currency and US dollars.
- C. **Correct.** Part III is used to calculate the foreign tax credit that is allowable.
- D. **Incorrect.** Part IV is the summary of credits from separate parts III.



# CHAPTER 7

## **SALE OF PRINCIPAL RESIDENCE**

The material in this chapter discusses rules for the sale of residences sold after May 6, 1997. (Because there is a possibility that previous rules may apply in isolated cases, there is a short summary of the pre-5/7/97 rules at the end of this chapter.)

Throughout this material the terms "principal residence" and "main home" are used interchangeably. The Internal Revenue Service defines each of the terms as "the place you live most of the time."

### **MAIN HOME/PRINCIPAL RESIDENCE**

The definition of "main home" is the home you live in most of the time. Your main home can be a:

1. House,
2. Condominium,
3. Mobile Home,
4. Cooperative Apartment, or
5. Houseboat

Note: To qualify as a main home, a mobile home or a houseboat must meet 3 conditions:

1. It must have sleeping facilities.
2. It must have cooking facilities.
3. It must have bathroom facilities.

**More Than One Home.** If you have more than one home, you can exclude gain only from the sale of your main home. You must include in income gain from the sale of any other home. If you have two homes and live in both of them, your main home is ordinarily the one you live in most of the time.

**Example 1.** You own and live in a house in the city. You also own a beach house, which you use during the summer months. The house in the city is your main home.

**Example 2.** You own a house, but you live in another house that you rent. The rented house is your main home and you cannot exclude gain (discussed later) on the sale of the house you own.

**Property Used Partly as Your Main Home.** If you use **only part** of the property as your main home, the rules discussed in this material apply only to the gain or loss on the sale of **that part** of the property.

## EXCLUDING THE GAIN

You may qualify to exclude from your income all or part of any gain from the sale of your main home. This means that, if you qualify, you will not have to pay tax on the gain up to the limit described under **Maximum Amount of Exclusion**, next. To qualify, you must meet the **ownership** and **use** tests described later.

You can choose **not to take** the exclusion. In that case, you must include in income your **entire** gain. You **cannot** take only **a part** of the eligible exclusion and include the remainder in income.

**Example.** Ted, who is single, sold his main home and realized a \$250,000 gain that he is eligible to exclude from income. Ted lost \$75,000 on the sale of 1000 shares of **Sure-Thing Dot Com** stock he owned. Ted planned to offset his \$75,000 loss with \$75,000 of the gain on the sale of his home and exclude the remaining \$175,000 eligible gain. Ted is not permitted to do so. If he elects to exclude any of the gain, he must exclude the entire maximum allowable.

## MAXIMUM AMOUNT OF EXCLUSION

You can exclude the entire gain on the sale of your main home up to:

1. \$250,000 for single and head of household filers, or
2. \$500,000 if **all** of the following are true.
  - a. You are married and file a joint return for the year.
  - b. **Either** you **or** your spouse meets the ownership test.
  - c. **Both** you **and** your spouse meet the use test.
  - d. During the 2-year period ending on the date of the sale, **neither** you nor your spouse excluded gain from the sale of another home.

## REDUCED MAXIMUM EXCLUSION

You can claim a reduced amount of exclusion if either of the following is true.

1. You did not meet the ownership and use tests, but you sold the home due to:
  - a. A change in place of employment,
  - b. Health, or
  - c. Unforeseen circumstances, to the extent provided in regulations (as discussed below).
2. Your exclusion would have been disallowed because of the rule described in ***More Than One Home Sold During 2-Year Period***, later, except that you sold the home due to:
  - a. A change in place of employment,
  - b. Health, or
  - c. Unforeseen circumstances, to the extent provided in regulations (as discussed later).

**Primary Reason.** If certain sets of facts and circumstances (safe harbors) apply to you, the primary reason you sold the home is considered to be a change in place of employment, health, or unforeseen circumstances. If your home sale does not qualify under one of these safe harbors, factors that may be relevant in determining your primary reason for sale include whether:

1. Your sale and the circumstances causing it were close in time,
2. The circumstances causing your sale occurred during the time you owned and used the property as your main home.
3. The circumstances causing your sale were not reasonably foreseeable when you began using the property as your main home,
4. Your financial ability to maintain your home materially changed,
5. The suitability of your property as a home materially changed, and

6. During the time you owned the property, you used it as your home.

**Change in Place of Employment.** The sale of your main home is because of a change in place of employment if your primary reason for the sale is a change in the location of employment of a qualified individual.

**Qualified Individual.** For purposes of the reduced maximum exclusion, a qualified individual is any of the following.

- You.
- Your spouse.
- A co-owner of the home.
- A person whose main home is the same as yours.

***Employment.*** For this purpose, employment includes the start of work with a new employer or continuation of work with the same employer. It also includes the start or continuation of self-employment.

***Distance safe harbor.*** A change in place of employment is considered to be the primary reason you sold your home if:

1. The change occurred during the period you owned and used the property as your main home, and
2. The new place of employment is at least 50 miles farther from your home than the former place of employment was.

**Health.** The sale of your main home is because of health if your primary reason for the sale is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual. For purposes of this reason, a qualified individual includes, in addition to the individuals listed earlier, any of the following.

- Parent, grandparent, stepmother, stepfather.
- Child, grandchild, stepchild, adopted child.
- Brother, sister, stepbrother, stepsister, half brother, half sister.
- Mother-in-law, father-in-law, brother-in-law, sister-in-law, son-in-law, or daughter-in-law.



- Uncle, aunt, nephew, or niece.
- The sale of your home is not because of health if the sale merely benefits a qualified individual's general health or well-being.

**Example.** Lou and Sue, husband and wife, bought a house that they used as their main home. Sue's father has a chronic disease and is unable to care for himself. Lou and Sue sell their home in order to move into Sue's father's house to provide care for him. Because the primary reason for the sale of their home was the health of a qualified individual. Lou and Sue are entitled to a reduced maximum exclusion.

**Doctor's recommendation safe harbor.** Health is considered to be the primary reason you sold your home if, for one or more of the reasons listed at the beginning of this discussion, a doctor recommends a change of residence.

**Unforeseen Circumstances.** The sale of your main home is because of an unforeseen circumstance if your primary reason for the sale is the occurrence of an event that you did not anticipate before buying and occupying your main home.

**Specific Event Safe Harbors.** Unforeseen circumstances are considered to be the primary reason you sold your home if any of the following events occurred while you owned and used the property as your main home.

1. An involuntary conversion of your home.
2. Natural or man-made disasters or acts of war or terrorism resulting in a casualty to your home, whether or not your loss is deductible.
3. In the case of qualified individuals (listed earlier under **Change in Place of Employment**):
  - a. Death,
  - b. Unemployment (if the individual is eligible for unemployment compensation).
  - c. A change in employment or self-employment status that results in your inability to pay reasonable basic living expenses (listed under Reasonable basic living expenses next),

- d. Divorce or legal separation, or
  - e. Multiple births resulting from the same pregnancy.
4. An event the Commissioner of IRS determined to be an unforeseen circumstance to the extent provided in published guidance and rulings. For example, the Commissioner determined the September 11, 2001, terrorist attacks to be an unforeseen circumstance.

**Reasonable Basic Living Expenses.** Reasonable basic living expenses for your household include the following expenses.

- Amounts spent for food.
- Amounts spent for clothing.
- Housing and related expenses.
- Medical expenses.
- Transportation expenses.
- Tax payments.
- Court-ordered payments.
- Expenses reasonably necessary to produce income.

Amounts spent on these items to maintain an affluent or luxurious standard of living are not reasonable basic living expenses.

### **MORE THAN ONE HOME SOLD DURING 2-YEAR PERIOD**

You cannot exclude gain on the sale of your home if, during the 2-year period ending on the date of the sale, you sold another home at a gain and **excluded** all or part of that gain.

However, you can still claim a **reduced** exclusion if you sold the home due to:

1. A change in place of employment,
2. Health, or
3. Unforeseen circumstances, to the extent provided in regulations (as discussed earlier).

**Example 1.** In September of Year One, Lee and Bee bought a new home. In November of the same year, they sold their old home at a \$40,000 gain. They had owned and lived in the old home for 4 years. They excluded the gain on the sale. On October 1, of Year Three, they sold the home they purchased in September of Year One at a \$15,000 gain. The sale was not due to a change in place of employment or health. Because they had excluded gain on the sale of another home with the 2-year period ending on October 1, of Year Three, they cannot exclude the gain on this sale.

**Example 2.** The facts are the same as in ***Example 1*** except that Lee and Bee did not sell the home purchased in September of Year One until December 3, of Year Three. Because they had not excluded gain on the sale of another home within the 2-year period ending on December 3, of Year Three, they can exclude the gain on this sale.

### OWNERSHIP AND USE TESTS

To claim the exclusion, you must meet the ownership and use tests. This means that during the 5-year period ending on the date of the sale, you must have:

1. ***Owned*** the home for at least **2 years** (the ownership test), ***and***
2. ***Lived in*** the home as your main home for at least **2 years** (the use test).

**Exception.** If you owned and lived in the property as your main home for less than 2 years, you can still claim an exclusion in some cases. The maximum amount you can exclude will be reduced. See ***Reduced Maximum Exclusion***, earlier.

**Example 1 -- Met Use Test but not Ownership Test.** For the last 10 years Ann lived with her parents in a house that her parents owned. On September 1 of Year One, she bought this house from her parents. She continued to live there until December 14, of Year Two when she sold it at a gain. Although Ann ***lived in*** the property as her main home for more than 2 years, she did not ***own*** it for the required 2 years. She cannot exclude any part of her gain on the sale, unless she sold the property due to a change in place of employment or health.

**Example 2 -- Change in Place of Employment.** Dee, who is single, bought her home in August of Year One. In December of Year Two the company she worked for notified her that she would be transferred to another town. She continued to live in the home until June of Year Two when she sold it at a gain and moved to the new town. Because

she owned and lived in the home less than 2 years, she does not meet the ownership and use tests. However, she qualifies to exclude gain because she sold the home due to a change in place of employment.

**Period of Ownership and Use.** The required 2 years of ownership and use during the 5-year period ending on the date of the sale does not have to be continuous.

You meet the tests if you can show that you owned and lived in the property as your main home for either 24 full months or 730 days (365 x 2) during the 5-year period ending on the date of sale.

**Example.** Kay bought and moved into a house in July of Year One. She lived there for 13 months and then moved in with a friend. She moved back into her own house in July of Year Four and lived there for 12 months until she sold it in July of Year Five. Susan meets the ownership and use tests because, during the 5-year period ending on the date of sale, she owned the house for 4 years and lived in it for a total of 25 months.

***Temporary absence.*** Short temporary absences for vacations or other seasonal absences, even if you rent out the property during the absences, are counted as periods of use.

**Example.** Professor Smith, who is single, bought and moved into a house on August 28, of Year One. He lived in it as his main home continuously until January 5, of Year Three, at which time he went abroad for a 1-year sabbatical leave. During part of the period of leave, the house was unoccupied, and during the rest of the period, he rented it. On January 5, of Year Four, he sold the house at a gain. Because his leave was not a short temporary absence, he cannot include the period of leave to meet the 2-year use test. He cannot exclude any part of his gain, unless he sold the house due to a change in place of employment or health, as explained under ***Reduced Maximum Exclusion***, earlier. Even if he did not sell the house due to a change in place of employment or health, he cannot exclude the part of the gain equal to the depreciation he claimed while renting the house. See ***Depreciation for business use after May 6, 1997***, later.

**Ownership and Use Tests Met at Different Times.** You can meet the ownership and use tests during different 2-year periods. However, you must meet both tests during the 5-year period ending on the date of the sale.

**Example.** In Year One, Sue lived in a rented apartment. The apartment building was later changed to a condominium, and she bought her apartment on December 1 of Year Seven. In Year Eight, Sue became ill and on April 14 of that year she moved to her daughter's home. On July 10, of Year Ten while still living in her daughter's home, she sold her apartment.

Sue can exclude gain on the sale of her apartment because she met the ownership and use tests. Her 5-year period is from July 11 of Year Five, to July 10 of Year Ten, the date she sold the apartment. She owned her apartment from December 1 of Year Five to July 10, of Year Ten (more than 2 years). She lived in the apartment from July 11 of Year Five (the beginning of the 5-years period), to April 14, of Year Eight (more than 2 years).

**Cooperative Apartment.** If you sold stock in a cooperative housing corporation, the ownership and use tests are met if, during the 5-year period ending on the date of the sale you:

1. Owned the stock for at least 2 years, ***and***
2. Lived in the house or apartment that the stock entitles you to occupy as your main home for ***at least*** 2 years.

**Exceptions for Individuals with a Disability.** There is an exception to the ***use test*** if, during the 5-year period before the sale of your home:

1. You become physically or mentally unable to care for yourself, ***and***
2. You owned and lived in your home as your main home for a total of at least 1 year.

Under this exception, you are considered to live in your home during any time that you own the home and live in a facility (including a nursing home) that is licensed by a state or political subdivision to care for persons in your condition.

If you meet this exception to the use test, ***you still have to meet*** the 2-out-of-5-year ***ownership test*** to claim the exclusion.

**Members of the Uniformed Services or Foreign Service.** You can choose to have the 5-year test period for ownership and use suspended during any period you or your spouse serve on “qualified official extended duty “ as a member of the uniformed services or Foreign Service of the United States. This means that you may be able to meet the 2-year use test even if, because of your service, you did

not actually live in your home for at least the required 2 years during the 5-year period ending on the date of sale.

If this helps you qualify to exclude gain, you can choose to have the 5-year test period suspended by filing a return for the year of sale that does not include the gain.

**Gain Postponed on Sale of Previous Home.** For the ownership and use tests, you may be able to add the time you owned and lived in a previous home to the time you lived in the home on which you wish to exclude gain. You can do this if you postponed all or part of the gain on the sale of the previous home on a sale prior to May 7, 1997.

**Previous Home Destroyed or Condemned.** For the ownership and use tests, you add the time you owned and lived in a previous home that was destroyed or condemned to the time you owned and lived in the home on which you wish to exclude gain. This rule applies if any part of the basis of the home you sold depended on the basis of the destroyed or condemned home. Otherwise, you must have owned and lived in the **same** home for 2 of the 5 years before the sale to qualify for the exclusion.

## **MARRIED PERSONS**

If you or your spouse files a joint return for the year of sale, you can exclude gain if **either** spouse meets the ownership **and** use tests.

**Example 1 -- One Spouse Sells a Home.** Ann sells her home in June. She marries Dan later in the year. She meets the ownership **and** use tests, but Dan does not. Ann can exclude up to \$250,000 of gain on a separate **or** joint return.

**Example 2 -- Each Spouse Sells a Home.** The facts are the same as in **Example 1** except that Dan also sells a home. He meets the ownership and use tests on his home. Ann and Dan can each exclude up to \$250,000 of gain.

**Death of Spouse Before Sale.** If your spouse died before the date of sale, you are considered to have owned and lived in the property as your main home during any period of time when your spouse owned and lived in it as a main home.

**Home Transferred from Spouse.** If your home was transferred to you by your spouse (or former spouse if the transfer was incident to divorce), you are considered to have owned it during any period of time when your spouse owned it.

**Use of Home After Divorce.** You are considered to have used property as your main home during any period when:

1. You owned it, **and**
2. Your spouse or former spouse is allowed to live in it under a divorce or separation instrument.

## **BUSINESS USE OR RENTAL OF HOME**

You may be able to exclude your gain from the sale of a home that you have used for business or to produce rental income. But you must meet both the ownership and use tests.

**Example 1.** On May 30, of Year One, Eve bought a house. She moved in on that date and lived in it until May 31, of Year Three when she moved out of the house and put it up for rent. The house was rented from June 1, of Year Three to March 31, of Year Five. Eve moved back into the house on April 1, of Year Five and lived there until she sold it on January 31, of Year Seven, Eve owned and lived in the house for more than 2 years as shown in the table following.

<b><u>Five Year Period</u></b>	<b><u>Used as Home</u></b>	<b><u>Used as Rental</u></b>
2/1 of Year Two - 5/31 of Year Three	16 months	
6/1 of Year Three - 3/31 of Year Five		22 months
4/1 of Year Five - 1/31 of Year Seven	<u>22 months</u> 38 months	<u>22 months</u>

Eve can exclude gain up to \$250,000. However, she cannot exclude the part of the gain equal to depreciation she claimed for renting the house, as explained after **Example 2**.

**Example 2.** Bill owned and used a house as his main home from Year One to Year Four. On January 1, of Year Five, he moved to another state. He rented his house from that date until April 30, of Year Seven when he sold it. During the 5-year period ending on the date of sale (May 1, of Year Two - April 30 of Year Seven), Bill owned and lived in the house for 32 months (more than 2 years). He can exclude gain up to \$250,000. However, he cannot exclude the part of the gain equal to the depreciation he claimed for renting the house, as explained next.

**Depreciation for Business Use After May 6, 1997.** If you were entitled to take depreciation deductions because you used your home for business purposes or as rental property, you cannot exclude the part of your gain equal to any depreciation

allowed or allowable as a deduction for periods after May 6, 1997. If you can show adequate records or evidence that the depreciation deduction allowed was less than the amount allowable, the amount you cannot exclude is the smaller figure.

**Example.** Roy sold his main home at a \$30,000 gain. He meets the use and ownership tests to exclude the gain from his income. However, he used part of the home for business in the previous year and claimed \$500 depreciation. He can exclude \$29,500 (\$30,000 - \$500) of his gain. He has a taxable gain of \$500.

**Property Used Partly as Your Home and Partly for Business or Rental During the Year of Sale.** In the year of sale you may have used part of your property as your home and part of it for business or to produce income. Examples are:

- A working farm on which your house was located,
- An apartment building in which you lived in one unit and rented out the others,
- A store building with an upstairs apartment in which you lived, or
- A home with a room used for business (home office) or to produce income.

If you sell the entire property, you should consider the transaction as the sale of two properties. The sale of the part of your property used for business or rental is reported on Form 4797.

To determine the amounts to report on Form 4797, you must divide your selling price, selling expenses, and basis between the part of the property used for business or rental and the part used as your home. In the same way, if you qualify to exclude any of the gain on the business or rental part of your home, also divide the maximum exclusion between that part of the property and the part used as your home.

***Excluding gain on the business or rental part of your home.*** You generally can exclude gain on the part of your home used for business or rental ***if*** you owned and lived in that part of the home for at least 2 years during the 5-year period ending on the date of the sale.

**Example.** You sold your home on November 1, of the current year. You had bought the home ten years ago and had owned and lived in it the entire 5-year period ending on the date of sale. For the first 2½ years of that period, you used the entire house as your main home. For the last 2½ years, you used ¾ (75%) of the house as your main home and ¼ (25%) of the house for business. Your records show:



Purchase price .....	\$80,000
Depreciation (on business part; all after 5/7/1997) .....	\$1,363
Selling price .....	\$160,000
Selling expenses .....	\$10,000

Because you meet the ownership and use tests for the entire house, you can claim the exclusion for both the home and business parts. You start by finding the adjusted basis of each part. You determine that three-fourths (75%) of your purchase price was for the part used as your home; one-fourth (25%) was for the part used for business.

	Personal <u>(3/4)</u>	Business <u>(1/4)</u>
Purchase Price.....	\$60,000	\$20,000
Minus: Depreciation.....	<u>0</u>	<u>1,363</u>
Adjusted Basis.....	<u>\$60,000</u>	<u>\$18,637</u>

Next, you figure the gain on each part, dividing your selling price and selling expenses between the two parts.

	Personal <u>(3/4)</u>	Business <u>(1/4)</u>
Selling Price.....	\$120,000	\$40,000
Minus: Selling expenses.....	<u>7,500</u>	<u>2,500</u>
	112,500	37,500
Minus: Adjusted basis .....	<u>60,000</u>	<u>18,637</u>
Gain .....	<u>\$52,500</u>	<u>\$18,637</u>

Then, to figure your taxable gain and exclusion on each part, you decide to fill out a separate **Worksheet 2 (Part 2)** for each part, dividing your maximum exclusion between the two parts. You are single, so your maximum exclusion is \$250,000.

<u>Part 2 – Exclusion and Taxable Gain</u>	Personal <u>(3/4)</u>	Business <u>(1/4)</u>
6) Depreciation after May 6, 1997 .....	<u>0</u>	<u>\$1,363</u>
7) Subtract line 6 from gain .....	<u>52,500</u>	<u>17,500</u>
8) Maximum exclusion .....	187,500	\$62,500
9) Exclusion (Smaller of line 7 or line 8) .....	52,000	17,500
10) Taxable gain (gain minus line 9) .....	0	*
11) Smaller of line 6 or line 10 .....	0	*

\* Lines 10 and 11 do not need to be filled out for the business part.

The gain from the part used as your home does not have to be reported on your return, because you can exclude all of it. You report the gain from the business part (\$18,863) in Part III of Form 4797. Your taxable gain from the business part is \$1,363 (\$18,863 - \$17,500).

## **BASIS**

You will need to know your basis in your home to determine any gain or loss when you sell it. Your basis is its cost if you bought it or built it. If you got it in some other way (inheritance, gift, etc.) its basis is either its fair market value when you got it or the adjusted basis of the person you got it from.

While you owned your home, you may have made adjustments (increases or decreases) to your home's basis. The result of these adjustments is your home's adjusted **basis**, which is used to figure gain or loss on the sale of your home.

### **COST AS BASIS**

The cost of property is the amount you pay for it in cash, debt obligations, or other property.

**Purchase.** If you buy your home, your basis is its cost to you. This includes the purchase price and certain settlement or closing costs. Your purchase price includes your down payment and any debt, such as a first or second mortgage or notes you gave the seller in payment for the home.

***Seller-paid points.*** If the person who sold you your home ***paid points on your loan***, you may have to reduce your home's basis by the amount of the points, as follows:

1. If you bought your home after 1990 but before April 4, 1994 you must reduce your basis by the seller-paid points ***if you deducted*** the points as home mortgage interest in the year paid.
2. If you bought your home after April 3, 1994, then you must reduce your basis by the seller-paid points, ***even if you did not*** deduct them.

***Settlement fees or closing costs.*** When you bought your home, you may have paid settlement fees or closing costs in addition to the contract price of the property. You can include in your basis the settlement fees and closing costs you pay for buying the home. You ***cannot*** include in your basis the fees and costs for getting a mortgage loan. A fee for buying the home is any fee you would have to pay even if you paid cash for the home.

Settlement fees **do not include** amounts placed in escrow for the future payment of items such as taxes and insurance.

Some of the settlement fees or closing costs that you **can include** in the basis of your property are:

1. Abstract fees (abstract of title fees),
2. Charges for installing utility services,
3. Legal fees (including fees for the title search and preparing the sales contract and deed),
4. Recording fees,
5. Survey fees,
6. Transfer fees,
7. Owner's title insurance, and
8. Any amounts the seller owes that you agree to pay, such as:
  - a. Certain real estate taxes (discussed in detail later),
  - b. Back interest,
  - c. Recording or mortgage fees,
  - d. Charges for improvements or repairs, and
  - e. Sales commissions.

Some settlement fees and closing costs **not included** in your basis are:

1. Fire insurance premiums,
2. Rent for occupancy of the house before closing,
3. Charges for utilities or other services related to occupancy of the house before closing,
4. Any fee or cost that you deducted as a moving expense,
5. Charges connected with getting a mortgage loan, such as:

- a. Mortgage insurance premiums (including VA funding fees),
  - b. Loan assumption fees,
  - c. Cost of a credit report, and
6. Fees for refinancing a mortgage.

**Real estate taxes.** Real estate taxes for the year you bought your home may affect your basis, as shown in the following chart.

IF...	AND.....	THEN the taxes....
You pay taxes that the seller owed on the home (the taxes up to the date of the sale)	The seller does <b>not</b> reimburse you	Are added to the basis of your home.
	The seller reimburses you	Does <b>not</b> affect the basis of your home.
The seller paid taxes for you (the taxes beginning on the date of the sale)	You do <b>not</b> reimburse the seller	Are subtracted from the basis of your home.
	You reimburse the seller	Does <b>not</b> affect the basis of your home.

**Construction.** If you contracted to have your house built on land you own, your basis is:

- 1. The cost of the land, plus
- 2. The amount it cost you to complete the house, including:

- a. The cost of labor and materials,
- b. Any amounts paid to a contractor,
- c. Any architect's fees,
- d. Building permit charges,
- e. Utility meter and connection charges.

Your cost includes your down payment and any debt, such as a first or second mortgage or notes you gave the seller or builder. It also includes certain settlement or closing costs. You may have to reduce your basis by points the seller paid for you. For more information, see ***Seller-paid points*** and ***Settlement fees or closing costs***, earlier.

***Built by you.*** If you built all or part of your house yourself, its basis is the total amount it cost you to complete it. ***Do not include*** in the cost of the house:

- The value of your own labor, or
- The value of any other labor you did not pay for.

**Temporary housing.** If a builder gave you temporary housing while your home was being finished, you must ***reduce your basis*** by the part of the contract price that was for the temporary housing. To figure the amount of the reduction, multiply the contract price by a fraction. The numerator is the value of the temporary housing, and the denominator is the sum of the value of the temporary housing plus the value of the home.

**Cooperative apartment.** Your basis in the apartment is usually the cost of your stock in the co-op housing corporation, which may include your share of a mortgage on the apartment building.

**Condominium.** To determine your basis in a condominium, use the same rules as for any other home.

## **BASIS OTHER THAN COST**

You must use a basis other than cost, such as fair market value, if you got your home as a gift, from your spouse, as an inheritance, or in a trade. If you got your home in any of these ways, see the following discussion that applies to you.

**Fair Market Value.** Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of the relevant facts. Sales of similar property,

on or about the same date, may be helpful in figuring the fair market value of the property.

**Home Received as Gift.** Use the following chart to find the basis of a home you received as a gift.

If the donor's adjusted basis at the time of the gift was....	THEN your basis is ...
More than the fair market value of the home at that time.	<p>The same as the donor's adjusted basis at the time of the gift.</p> <p><b>Exception:</b> If using the donor's adjusted basis results in a loss when you sell the home, you must use the fair market value of the home at the time of the gift as your basis.</p> <p>If using the fair market value results in a gain, you have neither gain nor loss.</p>
Equal to or less than the fair market value at that time, and you received the gift before 1977.	The smaller of: <b>1.</b> Donor's adjusted basis, plus any federal gift tax paid on the gift or <b>2.</b> The home's fair market value at the time of the gift.
Equal to or less than the fair market value at that time, and you received the gift after 1976.	The same as the donor's adjusted basis, plus the part of any federal gift tax paid that is due to the net increase in value of the home (explained next).

***Part of federal gift tax due to net increase in value.*** Figure the part of the federal gift tax paid that is due to the net increase in value of the home by multiplying the total gift tax paid by a fraction. The numerator (top part) of the fraction is the net increase in the value of the home, and the denominator (bottom part) is the fair market value of the home.

The net increase in the value of the home is its fair market value minus the donor's adjusted basis.

**Home Received from Spouse.** You may have received your home from your spouse or from your former spouse incident to your divorce.

***Transfers after July 18, 1984.*** If you received the home ***after*** July 18, 1984, there was no gain or loss on the transfer. Your basis in this home is generally the same as your spouse's (or former spouse's) adjusted basis just before you received it. This rule applies ***even if*** you received the home in exchange for cash, the release of marital rights, the assumption of liabilities, or other consideration.

If you owned a home jointly with your spouse or your spouse transferred his or her interest in the home to you, your basis in the half interest received from your spouse is ***generally the same*** as your spouse's adjusted basis just before the transfer. This also applies if your former spouse transferred his or her interest in the home to you incident to your divorce. Your basis in the half interest you already owned does not change. Your new basis in the home is the total of these two amounts.

***Transfers before July 19, 1984.*** If you received your home before July 19, 1984, in exchange for your release of marital rights, your basis in the home is generally its ***fair market value*** at the time you received it.

**Home Received as Inheritance.** If you inherited your home, your basis is its ***fair market value*** on the date of the decedent's death or the later alternate valuation date if that date was used for federal estate tax purposes. If an estate tax return was filed, the value listed for the property generally is your basis. If a federal estate tax return did not have to be filed, your basis in the home is the same as its appraised value at the date of death for purposes of state inheritance or transmission taxes.

***Surviving spouse.*** If you are a surviving spouse and you owned your home jointly, your basis in the home will change in a non-community property state. The new basis for the half interest that your spouse owned will be one-half of the fair market value on the date of death (or alternate valuation date). The basis in your half will remain one-half of the adjusted basis determined previously. Your new basis is the total of these two amounts.

**Example.** Your jointly owned home had an adjusted basis of \$50,000 on the date of your spouse's death, and the fair market value on that date was \$100,000. Your new basis in the home is \$75,000 (\$25,000 for one-half of the adjusted basis plus \$50,000 for one-half of the fair market value).

***Community property.*** In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), each spouse is usually considered to own half of the community property. When either spouse dies, the fair market value of the community property generally becomes the basis

of the entire property, including the part belonging to the surviving spouse. For this to apply, at least half the value of the community property interest must be includible in the decedent's gross estate, whether or not the estate must file a return.

**Example.** Assume the facts are the same as in the previous example but in a community property state. Your new basis in the home will be \$100,000, the fair market value of the entire property.

**Home Received in Trade.** If you acquired your home in a trade for other property, the basis of your home is generally the fair market value of the other property at the time of the trade. If you traded one home for another, you have made a sale and purchase. In that case, you may have realized a gain.

## **ADJUSTED BASIS**

Adjusted basis is your basis ***increased*** or ***decreased*** by certain amounts.

**Increases to Basis.** These include any:

1. Additions and other improvements that have a useful life of more than 1 year,
2. Special assessments for local improvements, and,
3. Amounts you spent after a casualty to restore damaged property.

**Decrease to Basis.** These include any:

1. Gain you postponed from the sale of a previous home before May 7, 1997,
2. Deductible casualty losses,
3. Insurance payments you received or expect to receive for casualty losses,
4. Payments you received for granting an easement or right-of-way,
5. Depreciation allowed or allowable if you used your home for business or rental purposes.
6. Residential energy credit (generally allowed from 1977 through 1987) claimed for the cost of energy improvements that you added to the basis of your home,



7. Adoption credit you claimed for improvements added to the basis of your home,
8. Nontaxable payments from an adoption assistance program of your employer that you used for improvements you added to the basis of your home,
9. First-time homebuyers credit (allowed to first-time buyers of a home in the District of Columbia), and
10. Energy conservation subsidy excluded from your gross income because you received it (directly or indirectly) from a public utility after 1992 to buy or install any energy conservation measure. An energy conservation measure is an installation or modification that is primarily designed either to reduce consumption that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home.

**Improvements.** These add to the value of your home, prolong its useful life, or adapt it to new uses. You add the cost of additions and other improvements to the basis of your property.

**Example.** Putting a recreation room or another bathroom in your unfinished basement, putting up a new fence, putting in new plumbing or wiring, putting on a new roof, or paving your unpaved driveway are improvements. An addition to your house, such as a new deck, a sunroom, or a new garage is also an improvement.

<p>The following chart lists some other examples of improvements.</p> <p><b>Additions</b>  Bedroom  Bathroom  Deck  Garage  Porch  Patio</p> <p><b>Lawn &amp; Grounds</b>  Landscaping  Driveway  Walkway  Fence</p>	<p><b>Heating &amp; Air Conditioning</b>  Heating system  Central air conditioning  Furnace  Duct work  Central humidifier  Filtration system</p> <p><b>Plumbing</b>  Septic system  Water heater  Soft water system  Filtration system</p> <p><b>Interior Improvements</b>  Built-in appliances  Kitchen modernization</p>
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Retaining wall Sprinkler system Swimming pool	Flooring Wall-to-wall carpeting
<b>Miscellaneous</b> Storm windows Doors New roof Central vacuum Wiring upgrades Satellite dish Security system	<b>Insulation</b> Attic Walls and floors Pipes and ductwork

**Improvements no longer part of home.** Your home's adjusted basis does not include the cost of any improvements that are no longer part of the home.

**Example.** You put wall-to-wall carpeting in your home 15 years ago. Later, you replaced that carpeting with new wall-to-wall carpeting. The cost of the **old carpeting** you replaced is **no longer** part of your home's adjusted basis.

**Repairs.** These maintain your home in good condition but do not add to its value or prolong its life. You do not add their cost to the basis of your property.

**Example.** Repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken windowpanes are examples or repairs.

**Exception.** The entire job is considered an improvement if items that would otherwise be considered repairs are done as part of an extensive remodeling or restoration of your home.

**Recordkeeping.** You should keep records to prove your home's adjusted basis. Ordinarily, you must keep records for 3 years after the due date for filing your return for the tax year in which you sold your home. But if you sold your home before May 7, 1997, and postponed tax on any gain, the basis of that home affects the basis of your new home you bought. Keep records proving the basis of both homes as long as they are needed for tax purposes.

The records you should keep include:

- Proof of the home's purchase price and purchase expenses,
- Receipts and other records for all improvements, additions, and other items that affect the home's adjusted basis,

- Any worksheets you used to figure the adjusted basis of the home you sold, the gain or loss on the sale, the exclusion, and the taxable gain,
- Any Form 2119, **Sale of your Home**, that you filed to postpone gain from the sale of a previous home before May 7, 1997, and
- Any worksheets you used to prepare Form 2119, such as the **Adjusted Basis of Home Sold Worksheet** or the **Capital Improvements Worksheet** from the Form 2119 instructions.

## SPECIAL SITUATIONS

The situations that follow may affect your exclusion.

**Expatriates.** You cannot claim the exclusion if the expatriation tax applies to you. The expatriation tax applies to U.S. citizens who have renounced their citizenship (and long-term residents who have ended their residency) if one of their principal purposes was to avoid U.S. taxes.

**Home Destroyed or Condemned.** If your home was destroyed or condemned, any gain (for example, because of insurance proceeds you received) qualifies for the exclusion.

Any part of the gain that cannot be excluded (because it is more than the limit) may be ***postponed*** under other rules.

**Sale of Remainder Interest.** Subject to the other rules in this chapter, you can choose to exclude gain from the sale of a remainder interest in your home. If you make this choice, you ***cannot*** choose to exclude gain from your sale of any other interest in the home that you sell separately.

***Exception for sales to related persons.*** You cannot exclude gain from the sale of a remainder interest in your home to a related person. Related persons include your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.). Related persons also include certain corporations, partnerships, trusts, and exempt organizations.

## REPORTING THE GAIN

Do not report the sale of your main home on your tax return unless:

- You have a gain and you do not qualify to exclude all of it, or

- You have a gain and choose not to exclude it.

If you have any taxable gain on the sale of your main home that cannot be excluded, report the entire gain realized on Schedule D (Form 1040). Report it on line 1 or line 8 of Schedule D, depending on how long you owned the home. If you qualify for an exclusion, show it on the line directly below the line on which you report the gain. Write "Section 121 exclusion" in column (a) of that line and show the amount of the exclusion in column (f) as a loss.

**Installment Sale.** Some sales are made under arrangements that provide for part of the entire selling price to be paid in a later year. These sales are called "installment sales." If you finance the buyer's purchase of your home yourself, instead of having the buyer get a loan or mortgage from a bank, you probably have an installment sale. You may be able to report the part of any gain that ***you cannot exclude*** on the installment basis.

## REAL ESTATE AND TRANSFER TAXES

When you sell your main home, treat real estate and transfer taxes on that home as discussed in this section.

**Real Estate Taxes.** You and the buyer must deduct the real estate taxes on your home for the year of sale according to the number of days in the real property tax year that each owned the home.

- You are treated as paying the taxes up to, ***but not including***, the date of sale. You can deduct these taxes as an itemized deduction on Schedule A (Form 1040) in the year of sale. It does not matter what part of the taxes you actually paid.
- The buyer is treated as paying the taxes ***beginning with*** the date of sale.

If the buyer paid your share of the taxes (or any delinquent taxes you owed), the payment ***increases*** the selling price of your home. The buyer adds the amount paid to his or her ***basis*** in the property.

**Example.** The tax on Dennis and Beth White's home was \$620 for the year. Their rental property tax year was the calendar year, with payment due August 1. They sold the home on May 7. Dennis and Beth are considered to have paid proportionate share of the real estate taxes on the home even though they did not actually pay them to the taxing authority.

Dennis and Beth owned their home during the real property tax year for 126 days (January 1 to May 6, the day before the sale). They figure their deduction for taxes as follows.

1. Enter the total real estates taxes for the real property tax year..... \$620
2. Enter the number of days in the real property tax year that you owned the property..... 126
3. Divide line 2 by 365..... .345
4. Multiply line 1 by line 3. This is your deduction. Enter it on Schedule A (Form 1040)..... \$214

Since the buyers paid all of the taxes, Dennis and Beth also include the \$214 in the home's selling price. The buyers add the \$214 to their basis in the home. The buyers can deduct \$406 (\$620 - \$214), the taxes for the part of the year they owned the home.

**Transfer Taxes.** You ***cannot deduct*** transfer taxes, stamp taxes, and other incidental taxes and charges on the sale of a home as itemized deductions. However, if you pay these amounts as the seller of the property, they are expenses of the sale and reduce the amount you realize on the sale. If you pay these amounts as the buyer, include them in your cost basis of the property.



# PRACTICE REVIEW QUESTIONS

## CHAPTER 7 SALE OF RESIDENCE

1. Which one of the following statements is **incorrect** in regard to a home qualifying as your main home?
  - A. A condominium qualifies.
  - B. A cooperative apartment qualifies.
  - C. A mobile home does not qualify.
  - D. A houseboat qualifies.
  
2. Which one of the following statements is **correct** in regard to a houseboat qualifying as your main home?
  - A. It only is required to have cooking and bathroom facilities.
  - B. It only is required to have sleeping and bathroom facilities.
  - C. It only is required to have cooking and sleeping facilities.
  - D. It is required to have sleeping, cooking, and bathroom facilities.
  
3. Lee sold his home in March and had a \$600,000 gain. Lee married Dee later in the year. Dee did not live in the home until they married. Lee qualifies for the ownership and use test but Dee does not. What is the maximum amount of gain Lee can exclude from the sale?
  - A. \$0
  - B. \$200,000
  - C. \$250,000
  - D. \$500,000
  
4. Dan and his wife Ann sold their principal residence and recognized a \$600,000 gain. They had owned and lived in the home for 2 out of the last 5 years. What is the maximum gain they can exclude from income?
  - A. \$0
  - B. \$250,000
  - C. \$500,000
  - D. \$600,000

5. Which one of the following statements is **correct** in regard to the exclusion of the maximum amount of gain on the sale of a principal residence by a married couple?
- A. They must file a joint return.
  - B. They qualify only if both meet the ownership test.
  - C. They qualify if either one meets the use test.
  - D. To qualify, either one could have excluded gain on the sale of a principal residence in the past two years.
6. You may qualify for a reduced exclusion of the gain on the sale of your residence if the reason is for “unforeseen circumstances”. Which one of the following statements is **incorrect** in this regard?
- A. An involuntary conversion of your home does not qualify as an unforeseen circumstance.
  - B. A natural disaster qualifies as an unforeseen circumstance.
  - C. An act of terrorism qualifies as an unforeseen circumstance.
  - D. Divorce qualifies as an unforeseen circumstance.
7. Individuals who sell their principal residence before they have owned and lived in it for 2 out of the last 5 years may qualify for a reduced exclusion of gain if the cause of the sale was linked to unemployment and being unable to make the mortgage payments. **T/F**
8. Ray and Mae had owned and lived in their principal residence for one year when Mae gave birth to triplets. Because of the sudden increase of the size of their family, they needed a larger home. Even though they had not owned and lived in their home for 2 out of the last 5 years, they will be allowed to sell and exclude a reduced amount of gain on the sale. **T/F**
9. “X” and “Y” had owned and lived in their home for only one year. At that time, “X” and “Y” divorced and sold their home at a gain. “X” and “Y” are not permitted to exclude any part of their gain. **T/F**



10. One of the circumstances that allow you to take a reduced exclusion on the sale of your principal residence is because you became unemployed and were no longer able to pay reasonable basic living expenses. Which one of the following statements is **incorrect** in regard to reasonable basic living expenses?
- A. Amounts spent for food are considered reasonable expenses.
  - B. Amounts spent for paying taxes are not considered reasonable expenses.
  - C. Court-ordered payments are considered reasonable expenses.
  - D. Expenses reasonably necessary to produce income are considered reasonable expenses.
11. In order to exclude gain from the sale of your principal residence, you must meet both the use test and the ownership in the same 2-year period. **T/F**
12. Dan had owned and lived in his principal residence for two out of the last five years. However, during that time Dan rented it out for the three weeks vacation he took during the two years. Because Dan rented his home during his vacation, the three weeks cannot be included as part of his two years living in the home. **T/F**
13. Which one of the following statements is **incorrect** in regard to settlement of escrow fees paid when you buy a home?
- A. Recording fees may be included in the basis.
  - B. Back interest the seller owes and you pay can be included in your basis.
  - C. Loan assumption fees may be included in the basis.
  - D. Owners' title insurance may be included in the basis.
14. Which one of the following statements is **incorrect** in regard to settlement fees and closing costs incurred in the purchase of a home?
- A. Fire insurance premiums are not included in your basis.
  - B. Loan assumption fees are not included in your basis.
  - C. Charges for installing utility service are included in your basis.
  - D. Rents for occupancy of the house before closing are not included in the basis.

15. Ed bought a principal residence. He paid property taxes in escrow that the seller owed and did not reimburse Ed for them. Which one of the following statements is **correct** in this regard?
- A. Ed can deduct the taxes as an ordinary expense.
  - B. Ed must add the amount to the basis of his home.
  - C. The seller can deduct the taxes as an ordinary expense.
  - D. The seller is allowed to deduct the amount of taxes Ed paid as a current deduction.
16. Which one of the following statements is **incorrect** in regard to the basis of your home you build on land you own?
- A. The cost of labor is included in your basis.
  - B. Any architects fees are included in your basis.
  - C. The value of your own labor is included in your basis.
  - D. The cost of the land is included in your basis.
17. Which one of the following statements is **incorrect** in regard to the basis of your home?
- A. Deductible casualty losses decrease the basis.
  - B. Payments received for granting an easement increases the basis.
  - C. Depreciation allowed decreases the basis.
  - D. Insurance you received for casualty losses decreases the basis.
18. Ann paid \$2,000 to have carpets installed in her home three years ago and added the \$2,000 to the basis of her home. Ann paid \$3,000 to have the old carpets removed and new carpets installed in the current year. What is the total amount that Ann can currently include in her current basis?
- A. \$1,000
  - B. \$2,000
  - C. \$3,000
  - D. \$5,000

# RESPONSES TO REVIEW QUESTIONS

## CHAPTER 7 – SALE OF RESIDENCE

1.
  - A. **Correct.** A condominium qualifies if it is your main home and you live in it most of the time.
  - B. **Correct.** A cooperative apartment qualifies if you sold the ownership stock that you had held in it for at least 2-out-of-the-last-5 years and that you had lived in it for 2-out-of-the-last-5 years.
  - C. **Incorrect.** A mobile home qualifies if it has cooking, sleeping and bathroom facilities and you have owned and lived in for the required minimum required time.
  - D. **Correct.** A houseboat qualifies if it has sleeping, bathroom and cooking facilities and you have owned and lived in it for the minimum amount of time.
2.
  - A. **Incorrect.** A houseboat is also required to have sleeping facilities.
  - B. **Incorrect.** A houseboat is also required to have cooking facilities.
  - C. **Incorrect.** A houseboat is also required to have bathroom facilities.
  - D. **Correct.** A houseboat is required to have sleeping, cooking and bathroom facilities in order to qualify as a main home.
3.
  - A. **Incorrect.** Although Lee and Dee were married in the year Lee sold his home, Dee does not qualify for any exclusion because she did not live in the home the required amount of time. However, Lee does qualify and is eligible for the maximum allowable exclusion of gain allowed when only one individual qualifies.
  - B. **Incorrect.** Under some circumstances a home seller may qualify for a **reduced** exclusion of gain. An example would be if he or she sold the home because of health reasons or being laid off from his or her job and needed to sell because of those circumstances. However, Lee had no such problems and is eligible to exclude the maximum amount allowable for one person.
  - C. **Correct.** Only Lee (and not Dee) qualifies for the owned and lived in requirements, so his maximum allowable exclusion is the statutory \$250,000.
  - D. **Incorrect.** The maximum allowable excludable amount for a married couple is \$500,000 when both qualify under the “owned and lived in rule”.

- 4.
- A. **Incorrect.** Because Dan and his wife have met the required 2-out-of-5 year ownership and residency requirements, they qualify for exclusion of some gain on their home.
  - B. **Incorrect.** \$250,000 exclusion is the amount that is allowed **one** qualified individual. In this case, **both** spouses qualify.
  - C. **Correct.** Because both Dan and Ann qualify for the ownership and residency requirements, they qualify for the \$500,000 maximum exclusion.
  - D. **Incorrect.** The maximum amount of exclusion of gain for a married couple filing a joint return is \$500,000. The \$100,000 gain in excess of \$500,000 must be included in Dan and Ann's income.
- 5.
- A. **Correct.** They must file a joint return. If so, then the maximum exclusion of gain is \$500,000.
  - B. **Incorrect.** Only one spouse is required to meet the ownership test in order to take in order the maximum allowable exclusion of gain.
  - C. **Incorrect.** They both must meet the 2-out-of-the-last-5 year use test when only one meets the ownership test.
  - D. **Incorrect.** To qualify for an exclusion of gain on the sale of their principal residence, each spouse must not have excluded gain from the sale of another home.
- 6.
- A. **Incorrect.** An involuntary conversion of your home may qualify as an unforeseen circumstance and allow you to sell before 2-out-of-5 year rule. You would be eligible to take a reduced amount of gain.
  - B. **Correct.** A natural disaster might qualify you for a reduced exclusion of gain. A natural disaster might have caused your home to be partially or completely destroyed.
  - C. **Correct.** An act of terrorism may qualify as an unforeseen circumstance and allow you to take a reduced exclusion on the gain of the sale of your home. This will apply whether or not your loss is deductible.
  - D. **Correct.** A divorce that necessitates the sale of your home before you have owned and lived in it for the required 2-out-of-5 years may qualify you for a reduced exclusion of gain. Also, a legal separation will also allow the exclusion of gain.
- 7.
- A. **True.** The logic of this is that the individual may not be able to continue making the mortgage payments and should not be penalized because a loss of his or her job. A is the correct answer.
  - B. **False.** B is **incorrect** because in order to qualify for a reduced exclusion in this situation, the individual must eligible be eligible for unemployment compensation.

- 8.
- A. **True.** An increase in family size and the need for a larger home may qualify taxpayers to qualify for a reduced exclusion on the early sale of their present home. **A is the correct answer.**
  - B. **False.** The present rule applies **only** to multiple births resulting from the same pregnancy. False is incorrect.
- 9.
- A. **True.** If divorce is the cause for a married couple to sell their home at a time before they have owned and lived in it the required 2-out-of-5 years, they qualify for a reduced exclusion of gain. In this case, by filing separate returns, **each** spouse would be eligible for a reduced amount of gain. A is the incorrect answer.
  - B. **False.** **False is the correct answer** because divorce is one of the safe harbor events if the use and ownership time periods are not met.
- 10.
- A. **Correct.** The amounts spent for food are considered reasonable basic living expenses. However, the expenses spent on food (and other qualified items) to maintain an affluent lifestyle will not be considered reasonable expenses.
  - B. **Incorrect.** The payment of taxes is considered a reasonable expense. This applies to Federal, state and local taxes.
  - C. **Correct.** Court ordered payments are considered reasonable expenses. It has not yet been clarified if this includes parking and traffic tickets.
  - D. **Correct.** These expenses are for the production of income and are considered reasonable.
- 11.
- A. **True.** True is incorrect because the 2-year ownership and use test are not required to be simultaneous. They can be at different times during the 5-year period. Also, the use test does not have to be continuous. As long as you live in the home for 730 days (2 X 365) in the last 5 years, you qualify for the use test. And as an additional benefit, you are not penalized for temporary absences for vacations and certain limited seasonal trips.
  - B. **False.** **False is the correct answer** because the 2-year ownership and use test are not required to be simultaneous. They can be at different times during the 5-year period.

12.

- A. **True.** True is incorrect. The rules specifically permit a home owner to rent his or her home out during vacations or other temporary seasonal absences. Furthermore the homeowner is not required to include the rent received in income nor is she or he permitted to deduct any expenses including depreciation.
- B. **False.** **B is the correct answer** because short temporary absences for vacations or other seasonal absences, even if you rent out the property during the absences, are counted as periods of use.

13.

- A. **Correct.** Recording fees paid by the buyer are not deductible as ordinary expenses but may be included in the basis of your home. Also, the seller's recording fees that you (the buyer) pays may be included in your basis.
- B. **Correct.** Mortgage interest is normally taken as an ordinary deduction on Schedule A. However, any interest that the **seller** owes and you pay cannot be deducted as an ordinary deduction but must be included in your basis.
- C. **Incorrect.** Loan assumption fees may **neither** be deducted as an ordinary expense **nor** included in your basis. In fact, no fees or charges incurred to obtaining a mortgage on your principal residence are currently deductible or allowed to be included in your basis. However, these fees and charges are usually currently deductible on the purchase of a rental property.
- D. **Correct.** Owner's title insurance must be added into your basis. It cannot be currently deducted.

14.

- A. **Correct.** Fire insurance premiums may not be included in the basis of your principal residence. Nor can the premiums be deducted as an ordinary expense. (Fire insurance premiums on a rental property may be currently deducted.)
- B. **Correct.** Also no other charges for obtaining a mortgage loan are allowed to be included in your basis or to be currently deducted. Some of the mortgage loan charges are not allowed to be included in your basis are mortgage insurance premiums, loan assumption fees, the cost of a credit report or fees for refinancing a mortgage.
- C. **Incorrect.** Fees for installing service may not be included in the basis of your home. (The fees would be included in the basis of a rental home.)
- D. **Correct.** Rent is not a tax deductible item for individuals who rent their homes. So the same rule applies to a homebuyers temporary rental.

15.

- A. **Incorrect.** Ed must add the seller-owed taxes to the basis of the home.
- B. **Correct.** If the seller had reimbursed Ed, the basis of Ed's home would not be affected. In this case, the seller would be able to currently deduct the taxes.
- C. **Incorrect.** The seller can currently deduct any taxes and **only** if he reimburses Ed.
- D. **Incorrect.** In this example, the seller can neither currently deduct the taxes nor reduce his selling price by the amount Ed paid.

16.

- A. **Correct.** The cost of the labor (including any contract labor) is included in your basis.
- B. **Correct.** Both architect's fees and building permit charges must be included in your basis. These costs cannot be currently deducted.
- C. **Incorrect.** The value of your own labor cannot be included in your basis or currently deducted. This applies even if you take off time from your regular job.
- D. **Correct.** The cost of land is included in your basis. It specifically is your basis in the land, not the fair market value of the land.

17.

- A. **Correct.** The deduction of a casualty loss is the equivalent of having an unreimbursed loss. This, then, would reduce the value (and basis) of your home.
- B. **Incorrect.** The payment received is the equivalent of having sold a portion of your property and have kept the property. So it **decreases** your basis.
- C. **Correct.** Depreciation allowed is the equivalent of having been partially compensated for your home and still owning all of it. (for your home to qualify for depreciation, you must have used a portion of it for your trade or business.)
- D. **Correct.** Example: You have a casualty loss on your home. You do not repair it, and instead received an insurance check for it.

18.

- A. **Incorrect.** Ann cannot simply add the difference of the replacement cost (\$3,000) less the original cost (\$2,000) and include the \$1,000 in her basis.
- B. **Incorrect.** Ann must discontinue using the original \$2,000 as her basis.
- C. **Correct.** Ann is permitted to include the \$3,000 cost of the replacement carpets.
- D. **Incorrect.** Ann cannot continue to include the original \$2,000 cost in her basis. She must delete the \$2,000 and use the \$3,000 cost of the replacement carpets.



# **GLOSSARY**

## **(SYSTEM 3)**

Accounting Plans. An accounting by an employee to his or her employer for the expenses paid by the employer.

Activity Not-for-Profit. An activity where there is some income but where the individual's primary reason for the activity is for his or her hobby.

Appraisal Fees. Fees paid to another individual (usually with professional credentials) for a determination of the value of some property.

Back Pay Awards. An amount of money paid for some work performed in the past.

Bartering. The exchange of property or services from one individual to another for services performed.

Basis, Home Received as an Inheritance. The basis of a home inherited by an individual is the fair market value of the home at the date of inheritance or the alternative valuation date.

Business Bad Debt. An amount of money owed to a business by an entity that is uncollectible.

Business Liability Insurance. An insurance that covers a variety of potential liabilities that a business may incur in its operation.

Cancelled Debt. An amount of money owed that is written off as uncollectible by a debt holder.

Check-Writing Fees. The amount charged by a financial institution for negotiating a depositor's check.

Construction Costs as Basis. The costs incurred in the constructing of an asset. In real property. They include the cost of land, building materials, labor and other expenses relating to the construction.

Disability Income. Income paid to a disabled individual.

Distance Test. The required distance a taxpayer must move to qualify for deducting moving expenses.

Entertainment Expenses. The cost of an entity entertaining a potential customer with the intent of gaining business from that customer.

Excess Reimbursement. An amount reimbursed for expenses (usually by an employer) that is in excess of the actual amount spent.

Fair Market Value. A value determined by an arms-length transaction between a willing seller and willing buyer both of whom are aware of the relevant facts.

Group-Term Life Insurance. A fixed amount of insurance paid to decedent's estate at death.

Holiday Gifts. A gift (usually by an employer) to an employee that is of modest value and is not cash or convertible to cash.

Home Office Expenses. The expenses of the cost of a portion of one's home that is used as an office away from his or her regular office. Expenses may or may not be deductible.

Household Employers. Individuals who employ other individual(s) for work in the householder's home.

Indefinite Work Assignment. A job assignment of an individual that is away from the individual's home to a single different location that is expected to last more than one year.

Kickbacks. Income received, usually secretly, for a transaction between two individuals that is intended to circumvent the normal acceptable above-board transactions.

Lobbying Activities. Activities by an individual to influence (usually politicians) to gain a favorable rule or law.

Local Transportation Expenses. Expenses of getting from one workplace to another when you are not traveling away from home.

Moving Expenses. The amount of expenses paid to move from one geographical location to another, usually relating to a new employment location.

Occupational Taxes. Taxes assessed to individuals for the privilege of being employed in a particular geographical location.

Prepaid Income. Income that is paid in advance from one entity to another for goods or services not yet delivered.

Punitive Damages. A monetary award paid for a physical injury or sickness from one entity to another for some damage caused. The award is usually taxable.

Qualifying Person. An individual who qualifies to be taken as a dependent of another individual.

Reimbursements. An amount paid to an employee by his or her employer for moving expenses.

Royalties. An amount of money paid by one entity to another for the privilege of using or selling the individual's product.

Severance Pay. An amount of money paid by an employer to an employee who is being terminated.

Sick Pay. An amount of money paid to an employer who is absent from work because of illness.

Time Test. The minimum time an individual must be employed at a new place of employment in order to qualify to deduct moving expenses.

Travel Expenses. Expenses incurred by an employee while traveling away from home for his or her employer.

Worker's Compensation. An amount of money received by a worker for injuries he or she received in the workplace.

Work-Related Expense. An expense paid by a household employer that qualifies as a tax deductible expense.



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